# Book Review Essay

# Executive Compensation: Who Decides?

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION. By Lucian Bebchuk[†] and Jesse Fried.[††] Cambridge, MA: Harvard University Press, 2004. Pp. xii, 278. $24.95.

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## I. Introduction

U.S. corporate law vests control of the corporation in the board of directors and those executives to whom the board properly delegates

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decisionmaking authority.[1] The discretionary powers thus conferred on directors and officers, however, are to be directed towards a single end; namely, the maximization of shareholder wealth.

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end . . . .[2]

In practice, corporate governance all too often departs from this ideal model with respect to both means and ends. As to means, the statutory model of director primacy often gives way to a reality of management domination. The directors become mere figureheads who rubberstamp decisions made by senior management. The widespread phenomenon of the "Imperial CEO" is but the latest manifestation of this perversion of the statutory scheme.[3]

As for the ends, the managers who control the corporation are inevitably tempted to put personal interest ahead of shareholder wealth maximization. In particular, as executive compensation has spiraled up in the last couple of decades, many observers believe that top corporate managers are benefiting themselves at the expense of shareholders.[4] This view finds two able advocates in law professors Lucian Bebchuk and Jesse Fried, who develop this argument in their new book, *Pay Without Performance*.[5] They forcefully contend that "managers have used their influence [over corporate boards of directors] to obtain higher compensation through arrangements that have substantially decoupled pay from performance."[6] In other words, the executive compensation scandal is not the rapid growth of management pay in recent years, as too many glibly opine,[7] but rather the failure of compensation schemes to award high pay only for top performance.[8]

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1. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001) (the corporation's business and affairs "shall be managed by or under the direction of a board of directors"). All state corporate codes likewise provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents. *See* MODEL BUS. CORP. ACT ANN. § 8.01 cmt. (1995) (reviewing statutes).

2. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

3. *See, e.g.*, D. Quinn Mills, *Paradigm Lost: The Imperial CEO*, DIRECTORS & BOARDS, Summer 2003, at 41 (asserting that "it's the responsibility of the board of directors to restrain the greed of the CEO, and it can't be done in large companies with today's too-powerful CEO").

4. *See, e.g.*, Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 67 (1992) (arguing that performance-based executive "compensation generates some significant problems which harm corporations and in turn impact shareholder wealth").

5. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

6. *Id.* at 6.

7. *See, e.g.*, Michael B. Dorff, *Softening Pharoah's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFFALO L. REV. 811, 813–14 (2003); Susan J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay*

Bebchuk and Fried begin *Pay Without Performance* by setting up a foil against which the remainder of the book will argue—namely, those financial economists who contend that "despite some lapses, imperfections, and cases of abuse, executive [compensation] arrangements have largely been shaped by market forces and boards loyal to shareholders."[9] The first four chapters of the book are thus devoted to knocking down the proposition that management pay is an efficient product of arm's-length bargaining between the board of directors and senior managers.

The second major chunk of the book (Chapters 5 and 6) develops Bebchuk and Fried's opposing thesis, which they label the "managerial power" perspective. They claim that "directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation."[10] As a result, executive pay has greatly exceeded the levels that would prevail if directors loyal to shareholder interests actually bargained with managers at arm's length.

The third major section of the book constitutes the bulk of the text, marching relentlessly through one form of executive compensation after another. Moving from severance payments (Chapter 7) to the ease with which managers may cash out equity-based compensation (Chapter 14), Bebchuk and Fried tell a consistent story of how management influence taints and distorts the compensation process. Although they frequently refer to theoretical models and empirical studies that support their argument, this section was clearly written with a lay reader in mind. Bebchuk and Fried's efforts in this regard are quite successful; they have produced a highly accessible indictment of executive compensation practices. Unfortunately, as we shall see, they do so at the cost of nuance.

Finally, the last two chapters of the text are devoted to proposed reforms designed to restore the link between pay and performance. Chapter 15 suggests relatively minor tweaks to existing compensation practices, with a

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*Between Executives and Rank and File Employees*, 36 MICH. J.L. REFORM 115, 115–18 (2002); *see also* Charles M. Elson, *Corporate Law Symposium: The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 649 n.2 (1995) (describing the "public outcry" about excessive executive compensation, including the legislative and political attention to the issue in the mid-1990s).

8. Bebchuk and Fried "strongly support equity-based compensation, which in principle can provide managers with desirable incentives." *Id.* at 7. They go on to argue that their "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." *Id.* at 8. Hence, they emphasize "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." *Id.* at 9.

9. *Id.* at 1.

10. *Id.* at 4.

strong emphasis on making them more transparent to investors. In contrast, Chapter 16 offers up a number of radical proposals that collectively would work a dramatic shift in the structure of corporate governance. Their intent is nothing less than making "*directors* not only more independent of executives but also *less independent of shareholders*."[11]

In Part II of this Review Essay, I critique Bebchuk and Fried's managerial power model. In brief, their text makes a significant and valuable contribution to the literature by synthesizing and systematizing the managerialist account of executive compensation. On the downside, however, the central argument is neither new nor wholly explanatory. As we shall see, there are other explanations for current executive compensation practices that Bebchuk and Fried treat as competing, but which in fact are complimentary.[12]

In Part III, I turn to Bebchuk and Fried's proposed reforms, focusing especially on their ambitious agenda for reshaping basic tenets of corporate governance. It is perhaps somewhat unfair to focus the bulk of my attention on Bebchuk and Fried's proposals, given that they disclaim any intent "to provide a detailed blueprint for reform."[13] Some of their proposed reforms, however, track ideas already being given serious consideration at the SEC or in the academic literature.[14] In fact, Bebchuk has been a prominent proponent of these possible regulatory actions.[15] In addition, an analysis of their reform proposals will shed additional light on their critique of the existing executive compensation scheme. In particular, it will demonstrate that Bebchuk and Fried err in their claim that judicial review of executive compensation is unthinkingly deferential. As we shall see, deference to the board of directors by both shareholders and courts is what makes the modern

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11. *Id.* at 207 (emphasis added).

12. Others have reached the same conclusion, albeit by somewhat different paths. *See, e.g.*, Iman Anabtawi, Overlooked Alternatives in the Pay Without Performance Debate (Dec. 21, 2004) (unpublished manuscript, on file with the Texas Law Review) (arguing that the managerial power model has serious limitations, whereas tournament theory, team production theory, and path dependence theory better capture executive pay practices); John E. Core et al., Is U.S. CEO Compensation Inefficient Pay Without Performance? (Jan. 13, 2004) (unpublished manuscript) (reviewing BEBCHUK & FRIED, *supra* note 5), *available at* http://papers.ssrn.com/abstract=648648.

13. BEBCHUK & FRIED, *supra* note 5, at 189. Bebchuk and Fried justify their abbreviated treatment of possible reforms by citing to other work that Bebchuk has published on the subject, including an article now available in the *Harvard Law Review*: Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005). BEBCHUK & FRIED, *supra* note 5, at 202.

14. For example, Bebchuk and Fried discuss the SEC's pending proposal to allow shareholders to nominate candidates for the board of directors and to place the names of such candidates on the corporation's proxy statement. *See id.* at 208–12; *see also infra* notes 170–78 and accompanying text (discussing both the SEC proposal and Bebchuk and Fried's proposal to broaden it).

15. Several statements made by Professor Bebchuk in support of such reforms are available on the SEC website. *See* SEC, Spotlight on Security Holder Director Nominations, *at* http://www.sec.gov/spotlight/dir-nominations.htm (last modified Apr. 30, 2004).

corporation feasible. Put another way, when the question—"Who decides?"—is asked, the answer is "the board of directors," whether one is discussing executive compensation or any other aspect of corporate governance. So it should remain. Courts and regulators therefore should not follow Bebchuk and Fried's outline of corporate governance reform.

## II. Bebchuk and Fried's Critique of Executive Compensation

Executive compensation undeniably has grown by leaps and bounds over the last two decades. Compensation of top managers has grown significantly faster than that of ordinary workers. By 2003 the average large firm CEO made 500 times what the average worker made.[16] As a result, the sums involved have become quite substantial: "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)."[17]

Yet, we live in an era in which many occupations carry such vast rewards. Lead actors routinely earn $20 million per film. The NBA's average salary is about $4 million per year.[18] Top investment bankers can earn annual bonuses of up to $3 million.[19] Unless one's objection is solely based on the size of executive compensation, perhaps for redistributionist reasons, which Bebchuk and Fried disclaim,[20] one must be able to distinguish corporate managers from these other highly paid occupations.

Bebchuk and Fried do so by observing that actors and sports stars bargain at arm's length with their employers.[21] In contrast, Bebchuk and Fried argue, managers essentially set their own compensation.[22] As a result, they claim, even though managers are under a fiduciary duty to maximize shareholder wealth,[23] executive compensation arrangements often fail to provide executives with proper incentives so to do and may even cause executive and shareholder interests to diverge.

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16. *CEOs and Their Indian Rope Trick*, ECONOMIST, Dec. 11, 2004, at 61 ("In 1991 the pay of the average American large-company boss was about 140 times that of the average worker; by last year, it was over 500 times, and growing.").

17. BEBCHUK & FRIED, *supra* note 5, at 9.

18. Robert Strauss, *A 'Concierge' to N.B.A. Stars*, N.Y. TIMES, Aug. 18, 2002, at 4NJ.

19. *See, e.g.*, Jenny Anderson, *That Line at the Ferrari Dealer? It's Bonus Season on Wall Street*, N.Y. TIMES, Dec. 28, 2004, at A1 (describing a bonus of $2.8 million for a senior investment banker).

20. *See supra* note 8.

21. *See* BEBCHUK & FRIED, *supra* note 5, at 20–21 (comparing CEOs and star athletes).

22. *See id.* at 2 (arguing "that the pay-setting process in publicly traded companies has strayed far from the arm's-length model" because "managerial power has played a key role in shaping managers' pay arrangements").

23. *See supra* text accompanying note 2 (declaring that the power of directors must be exercised to maximize shareholder profit).

### A. *The Arm's-Length-Bargaining Model of Executive Compensation*

The so-called principal–agent problem arises because agents who shirk do not internalize all of the costs thereby created;[24] the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking.[25] Although agents thus have strong ex post incentives to shirk, they have equally strong ex ante incentives to agree to contractual arrangements designed to prevent shirking.

Wherever a principal–agent problem is found, we thus expect to see a mixture of carrots and sticks designed to constrain shirking. The sticks include ex post sanctions, up to and including dismissal. The carrots include incentives that align the agent's interests with those of the principal.

Corporate management is viewed conventionally as a classic principal–agent problem. The literature widely credits Adolf Berle and Gardiner Means with tracing the problem to the separation of ownership and control in public corporations.[26] They observed that shareholders, who conventionally are assumed to own the firm, exercise virtually no control over either day-to-day operations or long-term policy.[27] Instead, control is exercised by a cadre of professional managers.[28] This "separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge . . . ."[29]

The literature identifies three particular ways in which the interests of shareholders and managers may diverge. First, and most obviously,

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24. Shirking by an agent includes any action of the agent that fails to advance the interests of the principal. As such, shirking is not limited to malfeasance or self-dealing but also includes various forms of misfeasance and even honest mistakes. Put more generally, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships. *See generally* Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1405–07 (1992) (discussing why rational agents will shirk).

25. In a classic article, Professors Alchian and Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 780 (1972). The marginal productivity of each worker is difficult to measure, and their joint output cannot be separated easily into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.

26. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

27. *Id.* at 4–5.

28. *See id.* (giving examples of companies whose shareholders have ceded authority to management control).

29. *Id.* at 6. As we shall see below, describing shareholders as owners of the corporation is a misnomer. *See infra* notes 189–90 and accompanying text. Even so, however, there is a conflict of interest between the personal incentives of managers and their contractual obligations to shareholders. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 419–24 (2002) (discussing the contractual basis of the shareholder-wealth-maximization norm).

managers may shirk—in the colloquial sense of the word—by substituting leisure for effort.[30] Second, managers who make significant nondiversifiable investments in firm-specific human capital and hold undiversified investment portfolios in which equity of their employer is substantially over-represented will seek to minimize firm-specific risks that shareholders eliminate through diversification.[31] As a result, managers generally are more risk averse than shareholders would prefer. Third, managers' claims on the corporation are limited to their tenure with the firm, while the shareholders' claim have an indefinite life. As a result, managers and shareholders will value cash flows using different time horizons; in particular, managers will place a low value on cash flows likely to be received after their tenure ends.[32]

In theory, these divergences in interest can be ameliorated by executive compensation schemes that realign the interests of corporate managers with those of the shareholders.[33] In fact, however, two of the three most common forms of executive compensation merely exacerbate the problem.

Executive compensation commonly is grouped into three basic categories: (1) salary and benefits that do not depend on the firm's performance; (2) options and other incentive compensation that are based on the performance of the firm's stock price; and (3) bonuses and other incentive compensation that are based on the firm's performance according to specified accounting metrics.[34] Salary and other non-performance-based compensation schemes lack incentives that align manager and shareholder interests; in theory, moreover, they can cause those interests to further diverge.[35] Managers compensated with fixed claims on the corporation's assets will want to reduce risk, because they will value preservation of assets more than creating new wealth.[36] Likewise, they will favor retention of earnings within the firm, rather than disbursement to shareholders.[37]

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30. MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 144 (2000).

31. *Id.* at 144–45. In general, equity holdings are commonly thought to make managers less risk averse up to a point at which they hold "too much" equity. *See infra* note 110.

32. JENSEN, *supra* note 30, at 145.

33. *See* James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 749 (1995) (noting the rising use of compensation plans intended to align the interests of managers and shareholders). Indeed, according to Bebchuk and Fried, the "official theory" claims that executive compensation arrangements actually "tend to increase value." BEBCHUK & FRIED, *supra* note 5, at 3.

34. JENSEN, *supra* note 30, at 145.

35. On the other hand, there is some reason to doubt whether compensation in fact significantly affects managerial behavior. *See infra* notes 99–110 (reviewing findings suggesting that pay and performance are inherently decoupled).

36. JENSEN, *supra* note 30, at 146.

37. *Id.* Bebchuk and Fried critique salary and related non-performance-based benefits in Chapter 10. They note that these arrangements "weaken the link between compensation and performance" and "sometimes even create counterproductive incentives." BEBCHUK & FRIED, *supra* note 5, at 121. Somewhat surprisingly, Bebchuk and Fried contend that in the 1990s, "it was

Consistent with this theoretical framework, Bebchuk and Fried summarize empirical evidence showing that "managers' cash compensation has been at most weakly tied" to performance.[38]

Because accounting metrics can be disaggregated to reflect the performance of particular divisions within a firm, bonuses and other accounting-based compensation schemes are an important tool for incentivizing mid-level managers, whose contributions are limited to a particular area of the firm.[39] In contrast, bonuses paid to senior managers may actually induce counterproductive behavior. A number of empirical studies show that bonus-based compensation affects the choice of accounting techniques, with managers favoring those that shift income to current periods.[40] In addition, Bebchuk and Fried document a number of other problems with bonuses, including the undemanding performance targets set by many boards, the lowering of performance targets when it appears that management will not achieve the target necessary for bonuses to be paid, and the granting of gratuitous bonuses in connection with corporate acquisitions.[41]

Accordingly, the literature tends to focus on stock options and other forms of incentive compensation premised on the company's stock market performance. The economist most closely identified with the modern principal–agent theory, Michael Jensen, observes that such forms of compensation "are well suited to control the effort and horizon problems, since the market value of the stock reflects the present value of the entire future stream of expected cash flows."[42] Indeed, as recently as 1999, Bebchuk himself observed that: "Bonuses, stock options, and other forms of performance-based pay tie managers' fate to shareholders' return."[43] The proposition is well enough established to have found its way out of the academic literature and into the case law.[44]

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widely believed that" cash compensation to executives "was largely based on performance." *Id.* at 135. If so, and they cite no authority for that proposition, that perception was inconsistent with the well-established analysis of executive compensation summarized by Jensen's critique. The point is significant because it goes to the novelty of Bebchuk and Fried's analysis. In my view, the chapter on non-performance-based compensation does not break new theoretical ground. Instead, its principal contribution to the literature consists of a very fine review of the empirical evidence supporting the theoretical critique.

38. BEBCHUK & FRIED, *supra* note 5, at 123.

39. JENSEN, *supra* note 30, at 146.

40. *Id.* at 147.

41. BEBCHUK & FRIED, *supra* note 5, at 124–30.

42. JENSEN, *supra* note 30, at 146.

43. Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487, 489 (1999).

44. *See, e.g.*, Carlton Inv. v. TLC Beatrice Intern. Holdings, Inc., Civ. A. No. 13950, 1996 WL 189435 at *4 (Del. Ch. 1996) (stating that the "theory of stock option grants is premised on a belief in their beneficial employee incentive effect").

The logic of stock options and their ilk, of course, is that the firm only pays for performance. Ideally, a firm with a current stock market price of $10 per share might grant its CEO one million options vesting in two years with a two-year exercise period and a strike price of $20 per share. In order for the CEO to reap any return from such options, the firm's stock price must double during the next four years, which would light a substantial fire under the CEO.[45] Conversely, however, the firm might grant the CEO one million at-the-money options exercisable immediately, which provide a financial windfall but minimal incentive effect. Whether effective pay-for-performance schemes of the former type or ineffective schemes of the latter type will prevail depends mainly on the process by which the board of directors sets compensation.

According to Bebchuk and Fried, there is an "official theory" of options, in particular, and executive compensation, in general, that informs both the financial economics literature and, perhaps more important, the case law.[46] In this official story, compensation schemes are claimed to be "the product of arm's-length bargaining" between managers "attempting to get the best possible deal for themselves and boards seeking to get the best possible deal for shareholders."[47] As a result, financial economists loyal to the arm's-length-bargaining model assume compensation schemes are generally efficient, while courts generally defer to decisions by the board of directors.[48]

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45. In fact, such an option grant might provide the CEO with too many incentives. Daniel, Martin, and Naveen find "that, all else equal, firms with higher incentives are perceived to be riskier, and pay a higher credit spread on their debt." Naveen D. Daniel et al., The Hidden Cost of Managerial Incentives: Evidence from the Bond and Stock Markets 23 (Sept. 2004) (unpublished manuscript), *available at* http://papers.ssrn.com/abstract=612921.

> We [document] a hidden cost of incentive alignment, in the form of a higher cost of capital. This higher cost of capital, however, need not necessarily be harmful to shareholders as long as the high-risk projects chosen by the managers are also positive-NPV (or if incentives reduce perquisite consumption by the CEO). We find, however, that firms with lower levels of incentives show significantly better abnormal returns than firms with higher levels of incentives. Perversely, shareholders appear to be suffering costs, on balance, from the very managerial incentives that were designed to aid them.

*Id.* at 24.

46. BEBCHUK & FRIED, *supra* note 5, at 15–18.

47. *Id.* at 2.

48. *Id.* at 18. According to proponents of the arm's-length-bargaining model, the substantial size of executive paychecks is not inconsistent with the proposition that executive compensation schemes effectively address the principal–agent problem. To the contrary, the size of such paychecks is deemed to be evidence that the principal–agent problem is being addressed. As the theory goes, corporate managers tend to be risk averse relative to shareholders because the former make substantial investments in firm-specific human capital that expose them to nondiversifiable firm-specific risk and tend to hold poorly diversified investment portfolios weighted excessively towards the corporation's stock. *See* Melvin A. Eisenberg & Brett H. McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 HASTINGS L.J. 1335, 1366 n.36 (2003) (explaining that "the managers who actually control such corporations will have all of their human capital, and much of their financial capital, tied up in the corporation, and hence are likely to behave in a risk-averse way"). When a corporation asks such managers to accept variable, performance-based

### B. *The Managerial Power Model*

Bebchuk and Fried start at the same point as the arm's-length-bargaining model they set up as their principal foil—namely, with the principal–agent problem.[49] As with the arm's-length-bargaining model, their managerial power model assumes that the problem of agency costs arising out of the separation of ownership and control is the central concern of corporate governance.[50] In contrast to the arm's-length-bargaining model, however, their managerial power model denies that executive compensation arrangements remedy the principal–agent problem; to the contrary, Bebchuk and Fried assert that the executive compensation process is tainted by the same set of agency costs it purportedly solves.[51]

To be clear, Bebchuk and Fried disclaim any objection to the high compensation that might be obtained by a manager who brings unique skills to the table or, for that matter, by a manager who is an unusually adept bargainer.[52] Instead, they are complaining about compensation levels attributable to positional advantage rather than skill.[53]

According to Bebchuk and Fried, boards of directors—even those nominally independent of management—have strong incentives to acquiesce in executive compensation that pays managers rents (i.e., amounts in excess of the compensation that management would receive if the board had bargained with them at arm's length).[54] The first of these incentives flows from the fact that directors often are chosen de facto by the CEO.[55] Once a

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compensation in lieu of fixed salary and benefits, the firm increases the manager's exposure to such risks. Because risk and return are positively correlated, managers will demand a higher return on their services to compensate for the additional risk. *See* BEBCHUK & FRIED, *supra* note 5, at 19 ("Linking compensation to performance may require a company to increase an executive's level of compensation because pay that is sensitive to performance is less valuable to managers than fixed pay with the same expected value."). In other words, firms must pay managers a risk premium to induce them to accept variable, performance-based compensation in lieu of a fixed salary. In turn, the "official theory" predicts that overall pay should rise as reliance on performance-based compensation increases, which is consistent with the pattern observed in the 1990s, during which both the absolute value of executive compensation and the percentage comprised of stock options increased. *See* John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 297 (2004) (noting that "executive compensation shifted during the 1990s from being primarily cash-based to primarily equity-based" and providing data on the growing reliance on stock options).

49. *See* BEBCHUK & FRIED, *supra* note 5, at 15–17 (discussing the "agency problem").

50. *See id.* at 16 (arguing that agency costs "can affect a wide variety of managerial choices").

51. *Id.* at 61–62.

52. *See supra* note 8 (noting Bebchuk and Fried's disclaimer of opposition to high executive compensation as such).

53. *See* BEBCHUK & FRIED, *supra* note 5, at 62 (claiming that managers use their influence over the board of directors to set their own compensation at a level higher than that which would obtain in arm's-length bargaining).

54. *Id.* at 62.

55. *See id.* at 26 (describing the significant and often decisive influence of CEOs in the process of selecting directors).

director is on the board, pay and other incentives give the director a strong interest in being reelected;[56] in turn, due to the CEO's considerable influence over selection of the board slate, directors have an incentive to stay on the CEO's good side.[57] Second, Bebchuk and Fried argue that directors who work closely with top management develop feelings of loyalty and affection for those managers, and they become inculcated with norms of collegiality and team spirit that induce directors to go along with bloated pay packages.[58]

According to Bebchuk and Fried, those few directors who resist these incentives and seek to put shareholder interests first face a number of obstacles. The inherent information asymmetry between full-time managers and part-time independent directors puts the latter at a significant disadvantage.[59] By definition, moreover, part-time outside directors can devote relatively little time and attention to adequately supervising the corporation and its managers.[60]

Bebchuk and Fried acknowledge that executive compensation is subject to a number of constraints, but contend that these are largely ineffectual.[61] Stock ownership by directors only weakly aligns director and shareholder interests, leaving board members unwilling to incur the pecuniary and social costs of bucking when bloated pay packages come up for approval.[62] "The markets for capital, corporate control, and managerial labor" purportedly apply constraints that are "hardly stringent" and "permit substantial deviations from arm's-length contracting."[63]

Finally, and importantly for purposes of their proposed reforms, Bebchuk and Fried argue that shareholders have but limited power to intervene when boards approve excessive executive compensation packages.[64] Shareholder litigation has been largely ineffectual, both for substantive and procedural reasons.[65] As to substantive issues, courts generally invoke the business judgment rule as the relevant standard of review and, accordingly, typically end up deferring to the board's decision.[66] As to procedural issues, the rules governing derivative litigation place

56. *See id.* at 27–31 (discussing ways in which the CEO can lavish benefits on members of the board).

57. *Id.* at 25.

58. *Id.* at 31–34.

59. *Id.* at 36–37.

60. *Id.*

61. *See id.* at 34 (describing the potential costs to most directors of favoring executives as rather small).

62. *See id.* at 34–36.

63. *Id.* at 4; *see generally id.* at 53–58 (discussing the limits of such market forces).

64. *Id.* at 45–52.

65. *Id.* at 45–48.

66. *Id.* at 46.

substantial barriers to litigation that many shareholders find difficult to overcome.[67]

Shareholder voting also has proved an ineffectual constraint, or so Bebchuk and Fried claim. Until recently, shareholders did not even have to approve all stock option plans and still do not get to approve all compensation plans.[68] Shareholder proposals placed on the corporation's proxy statement pursuant to SEC Rule 14a-8 generally must be phrased in precatory language when dealing with issues related to executive compensation.[69] Finally, shareholders have minimal ability to displace directors who approve bloated executive compensation packages.[70]

The principal constraint on managerial power in Bebchuk and Fried's account is the risk of incurring "outrage." When a board approves a compensation package under which the CEO or other top managers will receive rents, they will incur a cost for doing so only when the package is perceived negatively "by outsiders whose views matter to the directors and executives."[71] To avoid this constraint, managers and directors devote considerable attention to camouflaging "both the level and performance-insensitivity of executive compensation."[72] Indeed, the bulk of the book comprises a series of plausible stories about how particular compensation packages are designed to camouflage bloated CEO compensation.

The net effect of managerial power is that CEO pay packets are higher than would obtain under arm's-length bargaining and less sensitive to performance. As a result, compensation of CEOs and other top managers has become a not-insignificant chunk of corporate earnings: In 1998–2002, the aggregate compensation paid to the top five executives at the 1,500 companies included in the ExecuComp database totaled about $100 billion (in 2002 dollars).[73] Yet, Bebchuk and Fried claim, much of that pay has been insensitive to the performance of those companies. Hence, they contend, reforms designed to better link pay and performance are necessary.

### *C. A Critique of the Managerial Power Model*

*1. Is It New?*—The intellectual framework on which *Pay Without Performance* was built is not new. The concept of corporate separation of ownership and control, so widely attributed to Berle and Means, in fact can

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67. *Id.* at 46–47.

68. *Id.* at 48–51.

69. *Id.* at 51–52; *see also* 17 C.F.R. § 240.14a-8.

70. BEBCHUK & FRIED, *supra* note 5, at 207–08.

71. *Id.* at 5.

72. *Id.*

73. *Id.* at 9.

be traced back at least to the 1890s.[74] The idea that even nominally independent directors are mere rubberstamps for management likewise is decades old. For example, in 1976, Ralph Nader famously compared directors to "cuckolds" who are "often the last to know when [their] dominant partner—management—has done something illicit."[75] In an influential text published in the same year, Professor Melvin Eisenberg argued that real-world boards of directors are essentially passive, with most of their proper functions being performed by senior executives.[76] Arguing that the board's principal remaining function was the selection and monitoring of the firm's chief executive, Eisenberg further claimed that most boards failed to perform adequately that residual task.[77]

Even the idea that managers control the compensation process is not new. In 1996, for example, Professor Charles Elson wrote:

> The most significant problem facing corporate America today is the management-dominated, passive board of directors. A common occurrence in many of our largest corporations is that passive boards are responsible for excessive executive compensation and, more importantly, poor corporate performance. The board, created to monitor management in order to ensure effective decision-making, has evolved into a body that, in its most extreme form, simply "rubber stamps" executive prerogative. Management, no longer checked, freely engages in conduct that is slothful, ill-directed, or self-dealing—all to the corporation's detriment.[78]

To their credit, Bebchuk and Fried are relatively circumspect in their claims with respect to the novelty of their work. On the one hand, they acknowledge that versions of the managerial power argument have long been a staple of complaints by activists and media critics and of scholarly analysis by academic lawyers.[79] On the other hand, they argue that the bulk of academic work on executive compensation has been performed by financial economists. In turn, they argue, financial economists have articulated a

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74. *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836–1937, at 357 (1991) (discussing contributions of Alfred Marshall around 1890); *id.* at 16 (discussing contributions made by William W. Cook in 1891).

75. RALPH NADER ET AL., TAMING THE GIANT CORPORATION 64 (1976).

76. MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139–41 (1976).

77. *Id.* at 162–72.

78. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127–28 (1996); *see also* Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 132 (2003) (noting that the success of the Bebchuk & Fried article that precipitated *Pay Without Performance* "is not due to the novelty of the thesis" and offering examples). I discuss that article *infra* at note 97 and accompanying text.

79. BEBCHUK & FRIED, *supra* note 5, at 2–4.

seriously flawed "official view" of executive compensation that has exercised substantial influence both in the boardroom and the courtroom.[80]

None of this is to deny, moreover, that Bebchuk and Fried have made an important contribution to the literature. They have synthesized a considerable body of evidence and theory, which they have applied in a systematic way to many critical executive compensation practices. They have also helped draw new attention from both the media and the academy to one of the oldest running sores in corporate governance.

2. *Is It Complete?*—Physicists have long sought a unified field theory, which would provide a single set of simple laws that explain the four interactions or forces that affect matter—i.e., the strong, electromagnetic, weak, and gravitational forces. To date, they have failed, which provides a strong cautionary tale for anyone seeking a unified field theory of social interactions among fallible humans, whose behavior is far harder to predict than is that of, say, an electron.

It is somewhat difficult to determine the extent of the claim Bebchuk and Fried are making about the explanatory power of their model. On the one hand, they appropriately acknowledge that the degree of management power over the board of directors varies from firm to firm.[81] Indeed, at one point they appear to limit the domain of their model to cases in which share ownership is widely dispersed and there is no single shareholder or group of shareholders with large enough holdings to exercise effective control.[82] Elsewhere, however, they acknowledge that some of the compensation practices they criticize occur even in firms with stockholders holding large blocks.[83] They spin these findings by arguing that managers retain significant power even in firms with large shareholders, which implicitly claims a very large domain for their model.[84]

The point is not only that the managerial power model may have a limited domain. To the contrary, the more important lesson to be drawn here is that Bebchuk and Fried cannot exclude competing explanations for much of the evidence on which they rely. Why would a controlling shareholder permit managers to extract rents at its expense? Does it not seem more plausible that large blockholders tolerate the challenged compensation practices because they are consistent with shareholder interests rather than

80. *Id.* Economist Kevin Murphy appears to concede this point. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 857 (2002) (referring to the "optimal contracting approach adopted by most financial economists").

81. BEBCHUK & FRIED, *supra* note 5, at 43.

82. *Id.* at 82–83.

83. *Id.* at 86.

84. *Id.*

representing management's ability to extract rents inconsistent with shareholder wealth maximization? Support for this explanation is provided by a recent study finding that "highly paid CEOs are more skilled when firms are small or when there are fewer environmental constraints on managerial discretion. This *link between pay and skill is especially strong if there is a blockholder* to monitor management . . . ."[85] As such, the observation that the allegedly questionable compensation practices occur both in companies with dispersed ownership and those with concentrated ownership may suggest that those practices are attributable to phenomena other than managerial control.[86]

Whether one is persuaded by *Pay Without Performance*'s broadest claims thus depends in large measure on whether one buys Bebchuk and Fried's interpretation of the evidence, which is often plausible but contestable. Consider the practice of split-dollar life insurance policies. It is generally accepted that firms used such policies because of the favorable tax treatment formerly accorded such policies. In advancing a managerial power explanation for this practice, Bebchuk and Fried speculate that "because split-dollar policies involve a third party—the insurance company—they entail significant transaction costs, and these transaction costs *could* outweigh any tax benefits."[87] Perhaps so, but the argument is far from compelling.

In fact, a review of Bebchuk and Fried's book by John Core, Wayne Guay, and Randall Thomas argues "that in many settings where 'managerial power' exists, observed contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally."[88] Accordingly, they contend, the managerial power and optimal contracting models are "complementary, and not competing, explanations."[89]

Indeed, while Bebchuk and Fried marshal considerable evidence in support of their managerial power model, there is much competing evidence

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85. ROBERT DAINES ET AL., THE GOOD, THE BAD, AND THE LUCKY: CEO PAY AND SKILL 5 (Jan. 2005) (emphasis added) (N.Y.U., Law & Econ. Research Paper Series, Working Paper No. 04-035), *available at* http://papers.ssrn.com/abstract=622223. This result is also supported by a study of IPO firms, which found that the presence of a large blockholder was correlated with lower CEO compensation and higher performance sensitivity. *See infra* text accompanying note 142.

86. Part of the problem is that the managerial power model is nonfalsifiable in important respects. *See* Murphy, *supra* note 80, at 857 (arguing that "the primary problem" with the outrage-constraint analysis "is not the lack of empirical support but rather that, as developed, it is irrefutable"). One might ask, for example: What is the value to directors of complying with the various social norms against rocking the boat? How do we know that the utility a director gains thereby outweighs the possible loss in share value, the damage to the director's reputation, and so on? Bebchuk and Fried have not—and likely cannot—value these concerns sufficiently well to make a meaningful comparison.

87. BEBCHUK & FRIED, *supra* note 5, at 132 (emphasis added).

88. Core et al., *supra* note 12, at 30.

89. *Id.* at 6.

suggesting that executive compensation packages are designed to align managerial and shareholder interests. Consider, for example, the much maligned practice of management perquisites.[90] If managerial power has widespread traction as an explanation of compensation practices, one would assume that the evidence would show no correlation between the provision of perks and shareholder interests. In fact, however, *The Economist* recently reported on an interesting study of executive perks finding just the opposite:

> Raghuram Rajan, the IMF's chief economist, and Julie Wulf, of the Wharton School, looked at how more than 300 big companies dished out perks to their executives in 1986–99. It turns out that neither cash-rich, low-growth firms nor firms with weak governance shower their executives with unusually generous perks. The authors did, however, find evidence to support two competing explanations.
>
> First, firms in the sample with more hierarchical organisations lavished more perks on their executives than firms with flatter structures. Why? Perks are a cheap way to demonstrate status. Just as the armed forces ration medals, firms ration the distribution of conspicuous symbols of corporate status.
>
> Second, perks are a cheap way to boost executive productivity. Firms based in places where it takes a long time to commute are more likely to give the boss a chauffeured limousine. Firms located far from large airports are likelier to lay on a corporate jet.[91]

In other words, executive perks seem to be set with shareholder interests in mind, which is inconsistent with the possibility that managerial power offers a unified field theory of executive compensation.

Additional support for that proposition is provided by Todd Henderson and James Spindler in a recent analysis of a number of practices criticized by Bebchuk and Fried, including perquisites, corporate loans, and encouragement of conspicuous consumption by top management.[92] In brief, they hypothesize that firms seek to discourage top employees from saving so as to avoid the final period problem that arises when such employees accumulate sufficient wealth to fund a luxurious retirement. Reduced savings by such employees encourages them to seek continued employment,

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90. *See, e.g.*, Lucian A. Bebchuk, *The Case For Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 37 (1982) (positing that managers pursue corporate acquisitions so as to expand the size of their firm, "because there is a clear link between a firm's size and its managers' remuneration, perquisites, power, and prestige"). Curiously, Bebchuk and Fried focus mainly on the provision of perks in retirement. BEBCHUK & FRIED, *supra* note 5, at 107–09.

91. *In Defence of the Indefensible, Is Showering the Boss With Perks Good For Shareholders?*, ECONOMIST, Dec. 2, 2004, at 62.

92. M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. (forthcoming 2005), *available at* http://papers.ssrn.com/abstract=597661.

which vitiates the final period problem and provides ongoing incentives against shirking. By encouraging current consumption, the oft-decried practices of providing top employees with munificent perks and loans in fact maximize the joint welfare of managers and shareholders.[93]

These examples are not intended as a comprehensive rebuttal of the managerial power model, but rather to highlight the possibility that many executive compensation practices are at least as consistent with an arm's-length-bargaining model as the managerial power model.[94] This Review Essay is not intended to provide a complete literature review. Instructively, however, a number of scholars who have undertaken a more exhaustive review of the literature have concluded that the evidence is considerably less compelling than Bebchuk and Fried claim. Iman Anabtawi concludes, for example, that "there is limited evidence to support the claim that managers exert influence over boards of directors to decouple their pay from their performance."[95] Kevin Murphy likewise offers "evidence inconsistent with the managerial power hypothesis."[96] Franklin Snyder concludes that "most of the results that [Bebchuk and Fried] see as requiring us to postulate managerial dominance turn out to be consistent with a less sinister explanation."[97] Holmstrom and Kaplan note that many observers complain that executive compensation packages "represent unmerited transfers of shareholder wealth to top executives with limited if any beneficial incentive effects," but offer a review of the evidence providing "several reasons to be skeptical of these conclusions."[98] In sum, it seems plausible that the evidence does not exclusively support the managerial power model but rather

93. Corporate loans to executives were recently banned by the Sarbanes–Oxley Act. 15 U.S.C. § 78m(k) (Supp. II 2002). Interestingly, Bebchuk and Fried nevertheless devote an entire chapter to the topic as an illustration of how boards purportedly camouflage the total amount of compensation paid executives. BEBCHUK & FRIED, *supra* note 5, at 112–17. In addition to the possibility discussed in the text that such loans may in fact be consistent with shareholder interests, the banning of such loans arguably demonstrates that minor regulatory reform can have a significant impact, which calls into question the necessity or desirability of the sweeping reforms Bebchuk and Fried propose.

94. Not all aspects of salary and bonus compensation can be so easily squared with shareholder interests, of course. Bebchuk and Fried, for example, point to the odd practice of awarding bonuses not required by existing contracts, such as the common practice of awarding bonuses to executives whose firms have acquired other firms. They point out that "in about 40 percent of large acquisitions, the CEO of the acquiring firm received a gratuitous multimillion-dollar bonus for completing the deal." BEBCHUK & FRIED, *supra* note 5, at 127. Given that acquisitions often destroy wealth for the acquiring company's shareholders, *id.* at 128, this practice is particularly difficult to square with the optimal contracting model of executive compensation.

95. *See* Anabtawi, *supra* note 12, at 32.

96. Murphy, *supra* note 80, at 868.

97. Snyder, *supra* note 78, at 165.

98. Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 16 J. APPLIED CORP. FIN. 8, Spring 2003, at 12, *available at* http://papers.ssrn.com/abstract=441100.

supports multiple hypotheses that may prove complementary rather than competing.

3. *Does It Matter?*—Perhaps both Bebchuk and Fried and the financial economists who serve as their foils have misstated the problem. There is relatively little evidence that CEOs are motivated by pay, which suggests the possibility that CEOs are motivated principally by other concerns such as ego, reputation, and social-effort norms.[99] Put another way, the latter considerations may be the principal mechanisms by which the principal–agent problem is resolved. If so, evidence advanced by either side to show that incentive compensation either does or does not improve performance tells us nothing except that researchers have mined the data to find a spurious correlation. Worse yet, at least from the perspective of those who wish to use compensation to address the principal–agent problem, the goal of linking pay and performance inevitably will prove an exercise in futility.

It will be helpful at this point to categorize the problem of incentivizing CEOs and other top managers in a slightly different way than we did above. First, it may be necessary to give CEOs an incentive to work hard rather than slacking. Second, it may be necessary to give CEOs an incentive to make shareholder-wealth-maximizing choices when selecting projects and business ventures for the firm. Finally, it may be necessary to give CEOs an incentive not to engage in self-dealing, whether such self-dealing takes the form of excessive perquisites, conflicted-interest transactions with the firm, or outright theft.

It seems unlikely that performance-based compensation schemes deter an executive bent on self-dealing. Because the impact of a self-dealing transaction is spread across all shareholders, the negative effect on the executive's equity-based compensation and existing equity holdings likely will be a small fraction of the positive benefit to be obtained from the self-dealing transaction. Accordingly, rather than counting on compensation or other market-based forces to constrain self-dealing, corporate law seeks to deter it through harsh penalties and strong norm-setting rhetoric.[100]

It also seems unlikely that performance-based compensation schemes do much to affect the degree of managerial slack. In the first place, slackers will rarely climb to the top of the greased pole. By the time a CEO prevails in the repeated promotion tournaments that must be won in order to reach the top of the corporate hierarchy, moreover, the CEO likely will have fully internal-

99. Tyler Cowen, *Nice Work if You Can Get It*, WALL ST. J., Dec. 23, 2004, at D8. As we shall see, however, I conclude that it is implausible that pay and performance are wholly unrelated. *See infra* subsection II(C)(3)(c).

100. *See* BAINBRIDGE, *supra* note 29, at 306–07 (discussing corporate law sanctions against self-dealing).

ized a slate of social-effort norms.[101] Finally, once the CEO reaches the top of the corporate ladder, he remains subject to monitoring and competition by his immediate subordinates.[102] As such, we would expect the CEO's performance to be more sensitive to self-esteem and reputation than to variable incentive compensation. Consistent with this expectation, two leading finance theorists posit that "few managers at the top of major United States corporations are lazy or inattentive to stockholders' interests. On the contrary, the pressure to perform can be intense."[103] Accordingly, monetary compensation probably serves less as a direct incentive than as a status counter for top CEOs.[104]

This hypothesis is supported by a recent survey asking why companies adopt performance-based incentive compensation. The study found that many companies do so even though the relevant decisionmakers believe that money does not motivate executives. Instead, performance-based compensation was seen as a symbol of the executive's success, both internally and vis-à-vis peers in other firms. In addition, some companies explained that they used performance-based compensation because their peers did and, relatedly, because it gave their compensation legitimacy in the eyes of the establishment.[105]

In contrast, performance-based compensation plausibly should affect CEO incentives when making capital budgeting decisions.[106] Suppose the CEO is presented with two mutually exclusive projects requiring roughly the same capital investment, but with significantly different net present values (NPVs). Because risk and return are positively correlated, the higher NPV project typically will be the more risky one.[107] All else being equal, that is the project that stockholders will prefer.[108] Because managers are inherently

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101. *See generally* Anabtawi, *supra* note 12, at 33–36 (discussing tournament theory-based explanations of CEO compensation).

102. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293 (1980).

103. RICHARD A. BREALY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 23 (7th ed. 2003).

104. Cowen, *supra* note 99, at D8 ("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).").

105. Ruth Bender, *Why Do Companies Use Performance-Related Pay for their Executive Directors?*, 12 CORP. GOV. INT'L REV. 521, 527–30 (2004).

106. For an overview of capital budgeting and the role of net present value calculations in that process, see BREALY & MYERS, *supra* note 103, at 14–22, 221–43.

107. In theory, a firm should undertake any project with a positive NPV. *Id.* at 21. In practice, however, some projects may be mutually exclusive. Alternatively, constraints on firm resources may require capital rationing in which the firm must choose between multiple projects all having a positive NPV. *See generally id.* at 105–09 (explaining the effects of capital rationing on the net present value rule).

108. *See id.* at 109 (when capital constraints require hard rationing by the firm, it "should invest its available cash in the package of projects having the largest aggregate net present value").

more risk averse than diversified shareholders,[109] however, managers may prefer the less risky project. Here then is where performance-based compensation theoretically comes into play, by giving managers an incentive to choose the more risky project. On the other hand, however, if CEO behavior is motivated mainly by the nonpecuniary incentives discussed above, performance-based compensation will not be efficacious even in this context.[110]

*a. Explaining the Otherwise Inexplicable.*—If pay and performance are inherently decoupled, many of the practices Bebchuk and Fried condemn as products of management power take on a more benign appearance. Bebchuk and Fried note, for example, that the vast majority of CEO stock options are granted with a strike price equal to the company's stock price at the time the options are issued (so-called "at-the-money" options).[111] Out-of-the-money options have a greater incentive effect, generate higher pay-for-performance sensitivity, and, on average, boost firm value.[112] Accordingly, Bebchuk and Fried attribute the predominance of at-the-money options to managerial power over the compensation process.[113]

According to Bebchuk and Fried, the sub-optimality of at-the-money options is compounded by the widespread practice of repricing options when the stock price falls below the strike price. Firms formerly repriced options by reducing the strike price to the corporation's new, lower stock price.[114] This practice fell into disuse, however, when the FASB required firms to expense such repriced options.[115] Today, firms get around that barrier by simply issuing new options at the new lower strike price.[116] In some cases,

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109. *See supra* note 48.

110. Alternatively, because equity-based incentive compensation further weights the CEO's investment portfolio towards stock of the employer, we would at least expect the CEO to eventually reach a point of diminishing returns beyond which additional equity grants fail to provide much additional incentive. Indeed, a recent study of CEO stock ownership targets by Robert Parrino suggests that, as equity-based incentive compensation increases the proportion of the CEO's personal portfolio consisting of stock of the employer, the CEO will become more conservative in decisionmaking and the firm will begin to show sub-par performance. Robert Parrino, *Rewrapping the Package: Managerial Incentives and Corporate Governance*, TEX. BUS. REV., Dec. 2002, at 1, 5, *available at* http://www.mccombs.utexas.edu/research/bbr/bbrpub/tbr/pdf/Dec_02.pdf; *cf.* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 697–98 (1994) (noting that directors of corporations who have a significant portion of their personal wealth tied up in the corporation's stock may "demand that management adopt a more conservative risk-taking posture" which may have the affect of "deter[ing] the sort of aggressive behavior that brings the potential of significant profit and asset growth").

111. BEBCHUK & FRIED, *supra* note 5, at 160.

112. *Id.* at 160–61.

113. *Id.* at 162–64.

114. *Id.* at 165.

115. *Id.*

116. *Id.*

the executives are even permitted to retain the old, out-of-the-money options, which retain some value.[117] Again, Bebchuk and Fried attribute the repricing phenomenon to managerial power over the compensation process, arguing that "any form of repricing . . . weakens the link between pay and performance."[118]

If pay does not motivate executive performance, however, these practices make considerably greater sense. Suppose, for example, that the market-clearing price for a particular executive's services is $3 million. If pay and performance are not linked, there would be no reason to include any element of incentive compensation in the executive's pay package. Under current tax laws, however, there is a substantial disincentive for firms to pay fixed compensation in excess of the deductible amount of $1 million per year.[119] In order to ensure that the executive receives a total of $3 million per year, while still obtaining the maximum tax benefits for the firm, the company should pay the executive a fixed salary of $1 million and provide the executive with stock options having an expected value of $2 million.[120] In order to minimize the riskiness of the stock options, so as to satisfy the executive's demand for certain compensation, the firm should price those options at the money. In addition, in the event the stock price falls, the firm should reprice the options so as to ensure the executive will receive the full expected $2 million.[121] Hence, the board, acting at arm's length, might well engage in practices that Bebchuk and Fried contend show the influence of managerial power.

*b. Pay, Performance, and the Capital Markets.*—The absence of a motivational link between pay and performance also would help explain the otherwise puzzling observation that capital market forces have failed to constrain executive compensation. As Tyler Cowen observed:

> Assume the worst—that CEOs and boards are in cahoots. Outside capital still approaches this corrupt bundle from its own arm's-length point of view. If the problem were a big one, surely some firms would set up truly rational and fair executive-pay incentives to attract capital at a lower cost. And over time we would expect those firms to

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117. *Id.*

118. *Id.* at 166.

119. *See* I.R.C. § 162(m) (2000) (limiting the deduction for non-performance-based compensation paid to senior executives of public corporations to $1 million per year).

120. Alternatively, the firm might structure the executive's compensation as $1 million in salary and a $2 million bonus. Although the bonus component would purport to be performance-based, so that the firm can achieve favorable tax treatment for it, in our example the bonus in fact is unlikely to have—or be intended to have—significant marginal incentive effects.

121. Although the firm would have no legal obligation so to do, failure to do so would have adverse reputational consequences and provide perverse incentives for the executive in question.

> succeed in the marketplace. But there is no evidence of this happening.[122]

Granted, as Bebchuk and Fried point out, existing corporations relatively rarely resort to selling equities in the capital markets.[123] If shareholders perceive a motivational link between pay and performance, however, that link should be reflected in initial public offerings. If a firm going public lacks performance-sensitive compensation arrangements, and investors care about such incentives, the firm's cost of capital should rise. In turn, this reduces the return on the IPO to entrepreneurial employees and increases the firm's level of unsystematic risk for all employees. Accordingly, as Cowen observes, we should observe constraints on managerial power in IPO firms. Yet, we do not.[124]

Curiously, Bebchuk and Fried do not discuss the IPO market, focusing solely on the impact of the market for additional capital on existing firms.[125] In that regard, however, they make an argument that they presumably would extend to the IPO market:

> Admittedly, a reduction in the price at which new shares would be issued would decrease the wealth of all existing shareholders, including executives. As we have noted, however, executives typically hold only a small fraction of the firm's shares and thus bear only a small part of the reduction in existing shareholders' wealth. The cost that the executives themselves would have to bear would likely be too small to discourage them from seeking the direct benefits of favorable compensation arrangements.[126]

True, the impact on the firm's cost of capital of going public without constraints on managerial power would be spread across all shares. But that is not the real issue. If stock in the company for which the executive works constitutes a substantial part of the executive's portfolio, a relatively small impact on share price would translate into a large percentage decrease in the executive's net worth. In addition, Bebchuk and Fried overlook the risk that increased cost of capital poses to the executive's nondiversifiable investments in firm-specific human capital. In order for executives to be willing to forgo a reduction in the cost of capital that could be obtained from adopting constraints on managerial power, they would have to anticipate

122. Cowen, *supra* note 99, at D8.

123. BEBCHUK & FRIED, *supra* note 5, at 56.

124. *See infra* text accompanying note 140 (discussing a study finding "little support" for the managerial power model in IPO firms).

125. *See* BEBCHUK & FRIED, *supra* note 5, at 56–57 (discussing capital markets as a constraint on managerial power).

126. *Id.* at 57.

receiving very substantial rents from highly favorable executive pay arrangements.[127]

In the IPO setting, moreover, the executives are not the only relevant decisionmakers. Instead, entrepreneurs, venture capitalists, and underwriters are also key participants in the process. It is in the interest of such actors to maximize the price at which the company goes public. If IPO investors discount the price they are willing to pay in the absence of constraints on managerial power, those actors presumably would insist that the corporation's organic documents and employment contracts include such constraints. The apparent failure of IPO firms to go public with such constraints in place suggests that IPO investors do not value performance-sensitive pay or, at least, that they do not value constraints on management power designed to prevent pay packages unlinked to performance.[128] In either case, the absence of such constraints is an important—and unanswered—strike against the managerial power model.

*c. Summation.*—It seems implausible that there is no motivational link between pay and performance. In many settings where incentive-based compensation seems appropriate, we observe a mix of fixed and variable pay. In major motion pictures, for example, we observe leading actors being paid a fixed salary plus a percentage of the gate. Star athletes' contracts also often include performance-based bonuses. This pattern suggests that pay and performance are linked to some extent, which comports with common sense. The analysis in this section suggests, however, that the link may be weaker than is commonly supposed. If so, Bebchuk and Fried's observation that executives receive a considerable amount of pay that is not performance-sensitive has far less policymaking traction than they claim for it.

*4. Does It Still Hold True?*—Portions of *Pay Without Performance* are based on a law review article Bebchuk and Fried published (with then coauthor David Walker) in 2002.[129] Several versions of that paper were posted to the Social Science Research Network Electronic Library, including one as early as December 2001.[130] In the interim, the world has changed.

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127. This scenario thus is to be contrasted to the case of self-dealing transactions, where the executive has a known and, presumably, substantial benefit to offset against the small and dispersed impact on the share price of his misconduct. *See supra* text accompanying note 100 (discussing that scenario).

128. The latter hypothesis is supported by the evidence that investors also are unwilling to pay for charter or bylaw provisions reducing the extent to which directors are insulated from shareholder control. *See infra* note 206 and accompanying text.

129. Lucian Arye 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).

130. LUCIAN AYRE BEBCHUK, JESSE M. FRIED & DAVID I. WALKER, EXECUTIVE COMPENSATION IN AMERICA: OPTIMAL CONTRACTING OR EXTRACTION OF RENTS? (Nat'l Bureau

In June 2002, the New York Stock Exchange's board approved new listing standards that, among other things, significantly enlarged the role and power of independent members of listed companies' boards of directors.[131] NASDAQ and AMEX adopted similar changes.[132] A number of the new listing standards speak directly to the problems identified by Bebchuk and Fried.

In July 2002, President Bush signed into law the "Public Company Accounting Reform and Investor Protection Act" of 2002 (the Sarbanes–Oxley Act),[133] which he praised for making "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[134] Again, a number of those reforms speak directly to the sources of managerial power identified by Bebchuk and Fried.

Unfortunately for Bebchuk and Fried, they were thus caught in a time bind. Many incremental reforms that they might have proposed are now law, but we do not yet know how well those reforms will work. In response, Bebchuk and Fried adopted a consistent tactic of treating those reforms as a first step but not a complete solution.

Under the NYSE's new listing standards, for example, listed companies must create a compensation committee, comprised solely of independent directors, whose minimal duties include setting the CEO's compensation.[135] The committee must adopt written charters specifying their roles, duties, and powers, which must at a minimum conform to the listing standard's detailed requirements.[136] The committee also is now charged with hiring compensation consultants, a task previously left to management.[137] To address the longstanding problem of director interlocks, in which the CEOs of two companies would sit on each other's compensation committee, and presumably scratch each other's back, the new listing standards provide that

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of Econ. Research, Working Paper No. W8661, Dec. 2001), *available at* http://papers.ssrn.com/abstract=294099.

131. NYSE, REPORT OF THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 6 (2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf. The new listing standards were subsequently approved by the SEC and went into force. *See* Self-Regulatory Organizations, Securities Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003).

132. Self-Regulatory Organizations, Securities Exchange Act Release No. 50,263, 69 Fed. Reg. 53,747 (Aug. 25, 2004) (approving amended AMEX corporate governance listing standards); Self-Regulatory Organizations, Securities Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003) (approving NASDAQ corporate governance listing standards).

133. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 1, 15, 18, 28, and 29 U.S.C.).

134. Mike Allen, *Bush Signs Corporate Reforms into Law; President Says Era of 'False Profits' is Over*, WASH. POST, July 31, 2002, at A4.

135. NYSE, LISTED COMPANY MANUAL § 303A.05(a) (2004) [hereinafter NYSE MANUAL].

136. *Id.* at § 303A.05(b).

137. Indeed, Bebchuk and Fried are sharply critical of the prior practice. BEBCHUK & FRIED, *supra* note 5, at 38. They claim that management "may be a source of recommendations for such a consultant," *id.* at 39, but provide no evidence of such developments.

a director may not be deemed independent if he is employed (or has been employed in the last three years) by a company in which an executive officer of the listed company serves as a member of the compensation committee.[138]

Bebchuk and Fried dismiss these developments on grounds that the new standards "merely make mandatory a practice that most public companies already have been following for some time."[139] Surely this view is too glib. In the first place, all public corporations—not just "most"—must now comply with these requirements. In the second, transforming what were once mere matters of good practice into affirmative legal requirements may have a salutary effect. To be sure, I am speculating here, something for which I have criticized Bebchuk and Fried, but the larger point is that we simply don't know yet. As a practical matter, the process of implementing the new listing standards has just begun. Inevitably, it will take time to determine whether they are as toothless as Bebchuk and Fried claim.

Instructively, however, a recent study of compensation committees in IPO firms found "little support for the managerial power model."[140] They found no evidence that including insiders or executives from other firms on the compensation committee was correlated with either higher CEO pay levels or lower incentives.[141] Instead, noting that higher director compensation was coupled with higher CEO compensation and that the presence of large blockholders was correlated with lower CEO compensation, the study concludes that "CEO pay and incentives are set taking into account the supervisor (compensation committee)'s self-interest rather than simply assuming the supervisor will act on the owner's behalf or co-opt with CEO."[142]

The NYSE's new standards also address a cornerstone element of Bebchuk and Fried's managerial power model—namely, the CEO's influence over the selection, reappointment, and compensation of directors.[143] The new standards require that all listed corporations create a nominating and corporate governance committee comprised solely of independent directors.[144] This committee is charged with nominating or, at least, recommending new directors to the board.[145] Bebchuk and Fried applaud this change but argue it will prove inadequate to fully address the power of the CEO.[146] Westphal and Zajac, however, have demonstrated that as board

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138. NYSE MANUAL, *supra* note 135, at § 303A.02(b)(iv).

139. BEBCHUK & FRIED, *supra* note 5, at 25.

140. Martin J. Conyon & Lerong He, *Compensation Committees and CEO Compensation Incentives in US Entrepreneurial Firms*, 16 J. MGMT. ACCT. RES. 35, 50 (2004), *available at* http://papers.ssrn.com/abstract=546110.

141. *Id.*

142. *Id.* at 6.

143. *See supra* notes 55–57 and accompanying text.

144. NYSE MANUAL, *supra* note 135, at § 303A.04(a).

145. *Id.* at § 303A.04(b)(i).

146. BEBCHUK & FRIED, *supra* note 5, at 26.

power increases relative to the CEO—measured by such factors as the percentage of insiders and whether the CEO also served as chairman—newly appointed directors become more demographically similar to the board.[147] Accordingly, enhanced powers of independent directors to control the nomination process may prove a more effective constraint on CEO influence than Bebchuk and Fried predict.

The new listing standards also substantially limit the CEO's ability to financially reward compliant directors. The new rules, for example, limit the amount of additional compensation directors may receive over and above their director fees.[148] They also limit the amount of business that may be conducted between the corporation and a business associated with one of its independent directors.[149] Once again, however, Bebchuk and Fried regard these developments as inadequate, claiming experience teaches that relatively small financial rewards can align director incentives with the interests of the CEO.[150]

Even if Bebchuk and Fried are correct that small financial incentives can affect director decisionmaking, one must take into account the counterincentives created by modern trends in director compensation. In the last decade, it has become increasingly common for directors to be compensated with restricted stock of the corporation they serve rather than in cash.[151] In theory, this change in board compensation practices should align director incentives with the interests of shareholders. Bebchuk and Fried, however, claim that the incentives thereby created are minimal:

> Consider, for example, a director who owns 0.005% of the company's shares. And suppose that the director is contemplating whether to approve a compensation arrangement requested by the CEO that would reduce shareholder value by $10 million. Given the director's fraction of total shares, the reduction in the value of the director's holdings that would result from approval of the CEO's request would be only $500. Such a cost, or even one several times larger, is highly unlikely to overcome the various factors exerting pressure on the director to support the CEO's request.[152]

This argument is unpersuasive for several reasons. First, although Bebchuk and Fried elsewhere invoke the behavioral research on social and psychological factors that affect director decisionmaking to explain why

147. James D. Westphal & Edward J. Zajac, *Who Shall Govern?: CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 60–62 (1995).

148. NYSE MANUAL, *supra* note 135, at § 303A.02(b)(ii).

149. *Id.* at § 303A.02(b)(iii).

150. BEBCHUK & FRIED, *supra* note 5, at 29.

151. Charles M. Elson & Robert B. Thompson, Van Gorkom*'s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 588 (2002).

152. BEBCHUK & FRIED, *supra* note 5, at 34.

directors do not rock the boat,[153] here they fail to take into account the evidence suggesting that most individuals are loss averse.[154] Accordingly, small losses to the stock portfolio will have greater psychological weight than small incentives provided by the CEO, all else being equal. Second, Bebchuk and Fried's chosen minute amount of stock ownership, while perhaps not an uncommon level, fails to take into account the possibility that for many directors the shares they own in the company on whose board they serve will constitute a substantial part of that director's net worth.[155] A director who owns $100,000 worth of stock in a corporation with a market float of $1 billion will have considerable incentives to resist even changes that will make a small reduction in the value of those shares if his total portfolio amounts to only $200,000. Instructively, at least five studies provide empirical support for the proposition that increased director stockownership leads to better decisionmaking by directors.[156] Especially relevant is a study by Charles Elson, which found that relatively small dollar value stock holdings by outside directors were positively correlated with performance-sensitive executive compensation.[157]

Finally, the NYSE's new listing standards significantly tighten the definition of director independence. To be sure, the evidence as to the corporate governance value of director independence is, at best, mixed.[158] Yet, the new rules are only now taking effect. In addition, as Bebchuk and Fried concede, the amount of time independent directors are devoting to board work, including compensation decisions, has been increasing

153. *See id.* at 31–34 (discussing social norms and cognitive biases affecting director decisionmaking).

154. Clark Freshman, *Tweaking the Market for Autonomy: A Problem-Solving Perspective to Informed Consent in Arbitration*, 56 U. MIAMI L. REV. 909, 942 (2002) (noting that "individuals are loss-averse, and they resist making decisions that they experience as sacrificing something").

155. Bebchuk and Fried also claim that a director will not oppose shareholder-value-destroying projects because the loss from those projects will be less than their annual compensation. BEBCHUK & FRIED, *supra* note 5, at 205. But this fails to take into account the effect such projects would have on the director's total portfolio, which in many cases may be a substantial multiple of their annual compensation. The incentives of such directors will be to encourage value-creating projects.

156. R. Franklin Balotti et al., *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?*, 55 BUS. LAW. 661, 672–77 (2000) (summarizing studies). Finally, note that this argument is inconsistent with Bebchuk and Fried's claim elsewhere that executive compensation schemes have systemic effects on shareholder value. If that claim is correct, the hypothetical director necessarily should consider not only the immediate impact on shareholder value of the compensation scheme in question, but also all of the systemic effects that might follow. If those systemic effects are large relative to the size of the corporation and its earnings, directors who owned a considerable amount of stock in the corporation, relative to their net worth, have considerable incentives to oppose the CEO's request. *See infra* notes 252–61 and accompanying text (arguing that Bebchuk and Fried have failed to make a case for a systemic managerial power problem).

157. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 994 (1993).

158. *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 386–88 (2002) (reviewing several contradictory empirical studies relating to firm performance and director independence).

significantly in recent years.[159] Once again, it may be too early to tell whether the new rules will cause significant changes.

Although Sarbanes–Oxley does not directly regulate executive compensation, it does contain a number of provisions that do so indirectly. First, in the event a corporation is obliged to restate its financial statements due to misconduct, the CEO and CFO must return to the corporation any bonus, incentive, or equity-based compensation they received during the 12 months following the original issuance of the restated financials, along with any profits they realized from the sale of corporate stock during that period.[160] Second, subject to some minor exceptions, the Act prohibits a corporation from directly or indirectly making or even arranging for loans to its directors and executive officers.[161] Finally, the Act prohibits executives from trading during so-called "blackout periods" in which the employees participating in 401(k) and other stock-based pension plans are forbidden from trading.[162]

In sum, Bebchuk and Fried acknowledge that the changes just described will move the executive compensation process towards the arm's-length ideal, but contend that those changes do not eliminate the various factors that they claim give directors incentives to favor executives at the expense of shareholders.[163] Accordingly, they claim, more sweeping reforms are required.[164] But how do we know? These changes are only now taking effect. Surely it is too soon to tell, especially since there is evidence that the changes already in place can be expected to have salubrious effects.[165]

*5. Summary.*—One size does not fit all, a point even Bebchuk and Fried concede in their more modest moments.[166] The managerial power model they develop is a useful reminder that management-captured boards are still with us. At the same time, however, their more ambitious claim that managerial power is "pervasive,"[167] and thus broadly explanatory of

159. BEBCHUK & FRIED, *supra* note 5, at 37.

160. 15 U.S.C. § 7243.

161. 15 U.S.C. § 78m(k).

162. 15 U.S.C. § 7244.

163. BEBCHUK & FRIED, *supra* note 5, at 202–03; *see also id.* at 27 ("To be sure, the effect of the new stock exchange regulations boosting the role of independent directors in the nominating process will become clear only with time.").

164. *Id.* at 215–16.

165. Anecdotally, it may be noteworthy that *The New York Times* claims: "For many academics and analysts, the trial over the $140 million severance package of Mr. Ovitz, the former Hollywood agent who was hired as Disney's president in 1995 and fired 14 months later, signals the end of an era in which celebrity executives managed their companies as personal fiefs." Laura M. Holson, *After the Ovitz Trial: Ushering in a New Era of Humility in Hollywood*, N.Y. TIMES, Dec. 20, 2004, at C1.

166. BEBCHUK & FRIED, *supra* note 5, at 80 (noting that the extent of managerial power is not uniform across companies).

167. *Id.* at 2.

executive compensation practices, remains contested. Not all of the evidence is consistent with the managerial power model. Where the key issue is one's interpretation of the evidence, other plausible explanations can be advanced. All of which tends to call into question the justification for the radical reform proposals put forward by Bebchuk and Fried. Accordingly, we now turn to those proposals.

## III. Who Decides?

There is a most curious lacuna at the heart of *Pay Without Performance*: How big is the problem? As noted, Bebchuk and Fried expressly disclaim any intent to object to the size of executive compensation in any absolute sense.[168] Instead, they object solely to that portion of executive compensation constituting rents (as they define the term).[169] Oddly, however, they nowhere provide a metric for assessing the extent of those rents. They assume that those rents are significant in size, but they offer no real estimate.

This is particularly puzzling because Bebchuk and Fried offer not only a positive account of executive compensation, but also an aggressive reform package designed to impose strong new constraints on the compensation setting process. Chapter 15 offers a set of reforms directed specifically at the process by which executive compensation is set. These reforms are mere modest tweaks, however, in comparison to the substantial changes to the basic structure of corporate governance they propose in Chapter 16. In this Part, I argue that Bebchuk and Fried have failed to make the case for those latter changes.

### *A. Shareholder Democracy to the Rescue?*

Bebchuk and Fried blame the sub-optimality of executive compensation arrangements on the deep structure of corporate governance, under which they claim "directors' incentives to enhance shareholder value are not generally sufficient to outweigh the various factors that induce boards to favor executives."[170] Accordingly, Bebchuk and Fried propose a series of legal changes designed to strengthen the role of shareholders in corporate governance.

Bebchuk and Fried favor the SEC's pending proposal on shareholder director nominations, for example, but claim it does not go far enough.[171] At present, the director nomination machinery is under the control of the incumbent board of directors. When it is time to elect directors, the

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168. *Id.* at 9; *see supra* note 8.

169. BEBCHUK & FRIED, *supra* note 5, at 9.

170. *Id.* at 189.

171. *See id.* at 208–10 (discussing Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274)).

incumbent board nominates a slate, which is then put forward on the company's proxy statement. If adopted, proposed new Rule 14a-11 would permit shareholders, upon the occurrence of certain specified events and subject to various restrictions, to have their nominees placed on the company's proxy statement and ballot.[172] A shareholder-nominated director thus could be elected to the board in a fashion quite similar to the way shareholder-sponsored proposals are now put to a shareholder vote under SEC Rule 14a-8.[173]

Bebchuk and Fried propose expanding the proposal to allow "a significant group of shareholders," defined as those meeting the rather minimal requirement of 5% ownership for at least one year, to nominate a complete slate of directors.[174] Companies also should be required to distribute proxy statements for the proposed slate and pay their expenses.[175]

In addition to their expanded version of Rule 14a-11, Bebchuk and Fried offer three other major governance changes: First, eliminating staggered boards of directors.[176] Second, allowing shareholders to initiate changes in the corporation's state of incorporation or to amend the articles of incorporation.[177] Finally, using corporate disclosures in a therapeutic fashion as a constraint on executive compensation.[178]

Presumably, all this is to be done at the federal level, which would work a significant shift in the balance of federal and state authority over corporate governance. I have elsewhere critiqued Lucian Bebchuk's penchant for federalizing corporate governance.[179] While acknowledging that the evidence on the economic impact of competitive federalism is mixed, I have argued that the weight of the empirical evidence supports our current system in which states have primary authority over corporate governance.[180] Setting aside the economics, moreover, I have criticized Bebchuk's approach as "betray[ing] a complete lack of sympathy for the vital relationship between federalism and liberty."[181] In lieu of rehashing those arguments here,

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172. For an overview of proposed Rule 14a-11, see Stephen M. Bainbridge, *A Comment on the SEC's Shareholder Access Proposal*, ENGAGE, Apr. 2004, at 18–20.

173. 17 C.F.R. § 240.14a-8 (2004) (addressing when a company must include a shareholder's proposal in its proxy statement).

174. BEBCHUK & FRIED, *supra* note 5, at 210.

175. *Id.* at 210–11.

176. *Id.* at 211–12.

177. *Id.* at 212–13.

178. *Id.* at 192–93. I have elsewhere argued that the SEC lacks authority to use its disclosure rules for therapeutic purposes and, moreover, that doing so is unwise public policy. BAINBRIDGE, *supra* note 29, at 481–82.

179. Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 26, 30–31.

180. *Id.*

181. *Id.* at 30.

however, I will argue in this Review Essay that Bebchuk and Fried's proposals are unsound whether adopted at the state or federal level.

### B. *The Case Against Shareholder Democracy*

Two decades ago, Roberta Romano observed that:

> A survey of the literature suggests that the last major work of original scholarship was Adolf Berle and Gardiner Means' *The Modern Corporation and Private Property*.
>
> An essential difference between Berle and contemporary corporate law reformers is that he had a normative theory of the corporation and its place in the polity, whereas many advocates of reform are uninterested or unwilling to articulate the vision of the good society that informs their policy package.[182]

Nowhere in *Pay Without Performance* do Bebchuk and Fried lay out in detail their "normative theory of the corporation and its place in the polity." At best, they offer a thinly articulated assumption that the normative end of corporate governance is shareholder wealth maximization. Indeed, they expressly aver their intent to offer a "completely pragmatic and consequentialist" approach "focusing on shareholder value and the performance of corporations (and, in turn, the economy as a whole)."[183]

To be clear, I do not intend to criticize Bebchuk and Fried for failing to take into account the interests of constituencies other than shareholders; to the contrary, I share their belief that shareholder wealth maximization is the proper decisionmaking norm in corporate governance.[184] Instead, my point is only that one needs a model of the firm and of corporate governance in order to assess the merits of particular policy proposals. In recent work, I have developed just such a model, known as director primacy,[185] which reveals the flaws in Bebchuk and Fried's proposals.

*1. The Contractual Basis of Shareholder Rights.*—The dominant model of the corporation in legal scholarship is the so-called nexus-of-contracts theory, or contractarianism. Building on Ronald Coase's article, *The Nature*

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182. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923–24 (1984) (footnotes omitted).

183. BEBCHUK & FRIED, *supra* note 5, at 8.

184. *See, e.g.*, Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) (explaining why shareholder-wealth maximization is preferable to the various forms of stakeholderism under which directors are to consider the interests of other corporate constituencies when making decisions).

185. *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003). My work on this model was greatly influenced by that of Michael Dooley, especially his 1992 article, Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992), which in turn drew on KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974).

*of the Firm*,[186] modern contractarians view the corporation not as an entity but as an assembly of various constituencies acting together to produce goods or services.[187] In other words, the firm is not a thing, but rather a legal fiction representing the nexus of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.

In the nexus-of-contracts model, law is treated as a set of default rules providing a standard form contract that is voluntarily adopted, often with modifications, by the parties. This insight has important implications for a host of corporate law aspects; most notably, for present purposes, it encourages a fundamental rethinking of the relationship of shareholders to the corporation. The conventional phrase "separation of ownership and control" bequeathed to us by Berle and Means[188] implicitly conceives of corporate law as a species of property law. The corporation, it assumes, is a thing capable of being owned. In turn, shareholders are posited as the corporation's owners,[189] with all the ethical and metaphorical baggage associated with the idea of ownership in a free society that values the rights of private property.

Nexus-of-contracts theory rejects this basic proposition. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept in nexus-of-contracts theory. Someone owns each input, but no one owns the totality. Instead, the corporation is an aggregation of people bound together by a complex web of contractual relationships.

Accordingly, shareholders have no natural or inherent rights of ownership or control.[190] Instead, they have only those rights for which they bargained. And those rights are extremely limited.

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186. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

187. As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993). *See generally* BAINBRIDGE, *supra* note 29, at 27–33 (outlining the nexus-of-contracts model).

188. BERLE & MEANS, *supra* note 26, at 4.

189. For example, Melvin Eisenberg has argued that shareholders possess most of the incidents of ownership, which he identified as including "the rights to possess, use, and manage, and the rights to income and to capital." Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1999). Accordingly, he argued, shareholders own the corporation. *Id.*

190. Shareholders have no right to use or possess corporate property. *Cf.* W. Clay Jackson Enters., Inc. v. Greyhound Leasing and Fin. Corp., 463 F. Supp. 666, 670 (D.P.R. 1979) (stating that "'even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property'" (quoting Green v. Victor Talking Mach. Co., 24 F.2d 378, 380 (2d Cir. 1928))). Management rights, of course, are assigned by statute solely to the board of directors and those officers to whom the board properly delegates such authority. *See supra* note 1. Indeed, to the extent that possessory and control rights are the indicia of a property right, the board is a better candidate for identification as the corporation's owner than are the shareholders. As an early New York opinion put it, "the directors in the performance of their duty possess [the

In fact, shareholder control rights are so weak that they scarcely qualify as part of corporate governance. Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors, and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolutions.[191] As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible.[192] In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.[193]

These direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decisionmaking. Three sets of statutes are especially noteworthy: (1) disclosure requirements pertaining to large holders;[194] (2) shareholder voting and communication rules;[195] and (3) insider trading and short-swing profits rules.[196] These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks.[197]

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corporation's property], and act in every way as if they owned it." Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

191. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 174–77 (1995) (summarizing state corporate law on shareholder voting entitlements).

192. DEL. CODE ANN. tit. 8, § 109(a) (2001) (allowing shareholders to change bylaws without board approval); *id.* § 211(b) (allowing shareholders to elect directors without board approval).

193. *See generally* Bayless Manning, *Reviews*, 67 YALE L.J. 1477, 1485–89 (1958) (describing incumbent control of the proxy voting machinery).

194. Securities Exchange Act § 13(d) and the SEC rules require extensive disclosures from any person or group acting together which acquires beneficial ownership of more than 5% of the outstanding shares of any class of equity stock in a given issuer. 15 U.S.C. § 78m(a) (2001). The disclosures required by § 13(d) impinge substantially on investor privacy and thus may discourage some investors from holding blocks greater than or equal to 5% of a company's stock. U.S. institutional investors frequently cite § 13(d)'s application to groups and the consequent risk of liability for failing to provide adequate disclosures as an explanation for the general lack of shareholder activism on their part. Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 461 (Peter Newman ed., 1998).

195. To the extent shareholders exercise any control over the corporation, they do so only through control of the board of directors. As such, it is the shareholders' ability to affect the election of directors that determines the degree of influence they will hold over the corporation. The proxy regulatory regime discourages large shareholders from seeking to replace incumbent directors with their own nominees. *See* Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1075–84 (describing incentives against proxy contests). It also discourages shareholders from communicating with one another. *See infra* note 198.

196. *See* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 712–13 (1995) (noting insider-trading concerns raised by shareholder activism).

197. Large block formation may also be discouraged by state corporate law rules governing minority shareholder protections. Under Delaware law, a controlling shareholder has fiduciary obligations to the minority. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). A controlling shareholder who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). A controlling shareholder who uses its influence to effect a freeze-out merger in which the minority shareholders are bought out at

Second, they discourage communication and coordination among shareholders.[198]

The bargain-based understanding of the limited shareholder rights just described has two implications relevant for our purposes. First, and perhaps most controversially, it suggests the illegitimacy of reforms intended to give shareholders a second bite at the apple by bestowing on them ex post rights for which they did not bargain ex ante. Those who have freely entered into a contractual relationship under which they have highly circumscribed rights should not later be heard to complain that they got only that for which they had bargained.

Second, even if one takes the more lenient view that changes in the default rules of corporate law may be made ex post, there is still a strong presumption in favor of the status quo. If corporate law in fact is properly understood as a sort of standard form contract, the social justification for providing such a contract is to increase social wealth by facilitating private ordering. Parties for whom the default rules provided by statute and case law are a good fit can take the default rules off the rack, without having to bargain over them. Parties for whom the default rules are inappropriate, in contrast, are free to bargain out of the default rules.

If transaction costs are zero, the default rules—whether contained in a statute or a private standard form contract—do not matter very much.[199] In the face of positive transaction costs, however, the default rule begins to matter quite a lot. Indeed, if transaction costs are very high, bargaining around the rule becomes wholly impractical, forcing the parties to live with an inefficient rule. In such settings, we cannot depend on private contracting to achieve efficient outcomes. Instead, statutes must function as a substitute for private bargaining. The public corporation—with its thousands of shareholders, managers, employees, and creditors, each with different interests and asymmetrical information—is a very high transaction cost environment indeed.

In order to facilitate private ordering in such a high transaction cost setting, the law generally provides what is known as a "majoritarian default."[200] In effect, the law performs a thought experiment: "If the parties

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an unfairly low price likewise faces liability. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

198. *See* Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233 (2000) (explaining that liberalization of the proxy rules has not significantly affected shareholder communication practices).

199. This is simply a straightforward application of the famous Coase Theorem, which asserts that, in the absence of transaction costs, the initial assignment of a property right will not determine its ultimate use. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

200. For a discussion of alternatives to the majoritarian default and a defense against its principal challengers, see Stephen M. Bainbridge, *Contractarianism in the Business Associations*

could costlessly bargain over the question, which rule would they adopt?" It then adopts that bargain as the corporate law default rule.

Our corporate law system of competitive federalism gives lawmakers incentives to offer majoritarian defaults that investors will prefer. States compete in granting corporate charters. After all, the more charters the state grants, the more franchise and other taxes it collects. Basic economic common sense tells us that investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not lend to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms thereby become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers therefore have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters thus should deter states from adopting excessively promanagement statutes. The empirical research is not free from doubt, but much of it supports this view of state competition, suggesting that efficient solutions to corporate law problems win out over time.[201] Accordingly, there should be a presumption in favor of those legal regimes that have emerged from the Darwinian selection process as dominant.

Long-term survival of particular rules likewise justifies such a presumption. Because corporate law rules are, in general, mere default rules,[202] parties are free to depart from those rules and adopt contrary provisions in the corporation's organic documents. In competitive capital markets, if managerial power and the resultant capture of rents by management were serious concerns, we would expect to see firms opting out of the default rules that allegedly permit management capture of the board. As we have seen, however, we do not observe such opt-outs in either the market for additional capital or, more tellingly, the IPO market.[203]

In sum, the nexus-of-contracts model provides several reasons for granting a presumption in favor of the existing regime of limited shareholder control rights instead of the radical expansion of shareholder control rights proposed by Bebchuk and Fried. Nothing in their managerial power model offers a comparable theoretical justification for their proposals. Instead, their

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*Classroom:* Kovacik v. Reed *and the Allocation of Capital Losses in Service Partnerships*, 34 GA. L. REV. 631, 651–59 (2000).

201. *See supra* text accompanying note 180.

202. *See generally* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990) (criticizing the view that corporate law has significant mandatory rules).

203. *See supra* notes 122–28 and accompanying text (indicating that the lack of such opt-outs indicates that investors do not regard constraints on managerial power to be particularly important).

proposals apparently rest solely on the pragmatic grounds that shareholders would prefer those proposals. As we shall see, however, shareholders likely prefer the set of contract terms that limits their control rights.

2. *Who Decides? a.k.a. Director Primacy?*—There is no more basic question in corporate governance than "who decides." Is a particular decision or oversight task to be assigned to the board of directors, management, or shareholders? As we have seen, corporate law generally assigns decisionmaking to the board of directors or the managers to whom the board has properly delegated authority.[204] Executive compensation is no exception.

Bebchuk and Fried doubtless would protest that they do not intend to let shareholders set executive compensation. Instead, they propose only to allow shareholders to replace the board of directors when the shareholders are dissatisfied with the board's decisions. Yet, this is a difference in form only. Ultimately, the power to review is the power to decide. "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B . . . ."[205] The question thus remains: "Who decides?"

a. *Shareholders' Revealed Preferences.*—There is some not inconsiderable evidence that shareholders in fact prefer the current regime in which their powers to displace the board are quite limited. As my colleague Lynn Stout observes, for example:

> [W]hen the charters of public firms do depart from the default rules of corporate governance, they almost always move in the opposite direction through modifications that strengthen directors' power vis-à-vis shareholders. This pattern has been observable to some extent since the days of Berle and Means. It has become far more visible in recent years, however, as a result of several newly published studies of the charter provisions of firms selling shares to outside investors in IPOs.
>
> IPO studies have consistently found that, in the years following the takeover battles of the 1970s and early 1980s, a substantial and increasing percentage of firms "going public" have chosen to include provisions in their charters making it more difficult for either the firm's shareholders or a hostile acquirer to oust an incumbent board.[206]

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204. *See supra* notes 191–98 and accompanying text (noting the vast scope of control held by the board of directors).

205. ARROW, *supra* note 185, at 78.

206. Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 699 (2003); *see also*

We might draw similar inferences from the limited use that shareholders make of their existing control rights. Bebchuk and Fried are not the first scholars to advocate reuniting ownership and control by expanding shareholder voting powers. Indeed, during the 1990s, a number of scholars argued that institutional investor activism could give real teeth to shareholder control.[207] Acknowledging that the rational apathy phenomenon precludes small individual shareholders from playing an active role in corporate governance, even if the various legal impediments to shareholder activism were removed, these scholars focused their attention on institutional investors, such as pension and mutual funds. Institutional investors, at least potentially, may behave quite differently than dispersed, individual investors. Because they own large blocks and have an incentive to develop specialized expertise in making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks thus have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, might enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lags.

There is relatively little evidence, however, that institutional investor activism has mattered. Due to a resurgence of direct, individual investment in the stock market, motivated at least in part by the day trading phenomenon and the technology stock bubble, the trend towards institutional domination has stagnated. Although about 50% of equity securities are owned by institutions, large blocks held by a single institution are rare, and few U.S. corporations have any institutional shareholders who own more than 5%–10% of their stock.[208] Even the most active institutional investors spend only insignificant amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions.[209]

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Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 853–56 (2002) ("[S]hareholders have a 'revealed preference' (to employ the language of economics) for at least some degree of antitakeover protection. In other words, shareholders act as if they value corporate governance rules that insulate boards from hostile takeovers.").

207. *See, e.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

208. *See* Black, *supra* note 207, at 567–68 (summarizing data regarding the rise of institutional investors).

209. *See* Black, *supra* note 194, at 460 (noting that even "activist institutions spend less than half a basis point of assets . . . on their governance efforts").

They rarely conduct proxy solicitations or put forward shareholder proposals.[210] Not surprisingly, empirical studies of U.S. institutional-investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions."[211]

In sum, there is very little reason to think increased shareholder control would provide significant corporate governance benefits. The next question is whether the reforms Bebchuk and Fried propose would carry with them organizational costs that would outweigh these meager benefits.

b. *The Costs of Shareholder Democracy.*—We have seen that the system of rules vesting corporate control in the board of directors has had long-term survival value.[212] We have also seen that shareholders appear to prefer those rules to ones that would vest greater power in their hands.[213] In recent work advancing a model of the corporation called director primacy, I have explained these observations by showing that separation of ownership and control and the concomitant vesting of authority in the board of directors is essential for the corporation to function.[214]

The director primacy model is grounded in Kenneth Arrow's work on organizational decisionmaking, which identified two basic decisionmaking mechanisms: "consensus" and "authority."[215] Organizations use some form of consensus-based decisionmaking when each voting stakeholder in the organization has identical information and interests.[216] In the absence of information asymmetries and conflicting interests, collective decisionmaking can take place at relatively low cost. In contrast, organizations resort to authority-based decisionmaking structures where stakeholders have conflicting interests and asymmetrical access to information. In such organizations, information is funneled to a central agency empowered to make decisions binding on the whole organization.[217]

Small business firms typically use some form of consensus decisionmaking.[218] As firms grow in size, however, consensus-based

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210. *Id.*

211. *Id.* at 462.

212. *See supra* notes 201–02 and accompanying text.

213. *See supra* notes 206–11 and accompanying text.

214. The model is most fully developed in Bainbridge, *supra* note 185. The discussion in this section is adapted from Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW. 45 (2002) [hereinafter Bainbridge, *Director v. Shareholder Primacy*].

215. ARROW, *supra* note 185, at 68–70.

216. *See id.* at 69 (proclaiming consensus is an adequate substitute for authority when an organization's "members have identical interests *and* identical information").

217. *Id.* at 68–69.

218. *See* Dooley, *supra* note 185, at 466–67 (applying Arrow's organizational-decisionmaking model to partnerships).

decisionmaking systems become less practical.[219] By the time we reach the publicly held corporation, their use becomes essentially impractical.[220] Hence, it is hardly surprising that the modern public corporation has the key characteristics of an authority-based decisionmaking structure.[221] Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions.[222] Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly.[223] Rather, shareholders should prefer to irrevocably delegate decisionmaking authority to some smaller group.[224] The revealed preferences of shareholders described in the preceding section presumably reflect a recognition by investors of that logic.

To be sure, vesting decisionmaking authority in a centralized entity distinct from the organization's stakeholders results in the foundational principal–agent problem. A narrow focus on agency costs, however, easily can lead one astray. Agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant.[225] We could substantially reduce, if not eliminate, agency costs by eliminating discretion; that we do not do so suggests that discretion has substantial virtues.

In attempting to answer Romano's call for a "normative theory of the corporation and its place in the polity,"[226] one must thus balance the virtues of discretion against the need to ensure that discretion be used responsibly.[227] Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, however, they also are antithetical—ultimately, as already noted,[228] the power to hold to account is the power to decide. Kenneth Arrow explained:

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219. Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1056 (1998).

220. *See generally id.* at 1055–75.

221. *Id.* at 1058; Dooley, *supra* note 185, at 467–68.

222. *See* Bainbridge, *supra* note 219, at 1057–60 (identifying the conflicting interests and access to information of corporate constituents).

223. *Id.* at 1056.

224. As Arrow explains, under conditions of disparate access to information and conflicting interests, it is "cheaper and more efficient to transmit all the pieces of information once to a central place" and to have the central office "make the collective decision and transmit it rather than retransmit all the information on which the decision is based." ARROW, *supra* note 185, at 68. In the dominant M-form corporation, the board of directors and the senior management team function as that central office. *See* Bainbridge, *supra* note 219, at 1009 (discussing characteristics of the M-form corporation).

225. For a discussion of agency costs and the agency problem in the firm context, seé Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

226. *See supra* text accompanying note 182.

227. *Cf.* Dooley, *supra* note 185, at 471 (arguing that the business judgment rule reflects a tension between "conflicting values" he refers to as "Authority" and "Responsibility").

228. *See supra* text accompanying note 205.

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[229]

Put another way, directors cannot be held accountable without undermining their discretionary authority.

While Mark Roe has argued that shareholder activism "differs, at least in form, from completely *shifting* authority from managers to" investors,[230] a claim Bebchuk and Fried presumably would echo, it is in fact a difference in form only. Shareholder activism necessarily contemplates that investors will review board decisions, step in when firm performance falters, and exercise voting control to effect a change in policy or board personnel. For the reasons identified above, giving investors this power of review differs little from giving them the power to make board decisions in the first place.[231] Even though investors under Bebchuk and Fried's proposal could not micromanage corporations, vesting them with the power to displace the board inevitably shifts some portion of the board's authority to them.

Such a shift is intrinsically undesirable, without regard to the relative merits of directors and shareholders as decisionmakers, because it defeats the very purpose of authority-based decisionmaking structures—namely, to concentrate discretionary authority in the hands of a central agency with power to make decisions that are binding on the whole. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, as some have suggested,[232] but rather that it provides a hierarchical governance structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[233]

The basic argument against shareholder activism thus becomes apparent. Frequent investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable—namely, the vesting of authoritative control in the board of directors. The board of directors as an institution of corporate governance, of

229. ARROW, *supra* note 185, at 78.

230. ROE, *supra* note 207, at 184.

231. *See supra* text accompanying note 229.

232. *See* ROE, *supra* note 207, at 3–4 (summarizing this capital aggregation argument).

233. ARROW, *supra* note 185, at 69.

course, does not follow inexorably from the necessity for authoritative control. After all, an individual chief executive could serve as the requisite central decisionmaker. Yet, corporate law vests ultimate control in a board acting collectively rather than in an individual executive. I have elsewhere suggested two reasons for doing so: (1) under certain conditions, groups make better decisions than individuals and (2) group decisionmaking is an important constraint on agency costs.[234] In any event, the key point is that effective corporate governance requires that decisionmaking authority be vested in a small, discrete central agency rather than in a large, diffuse electorate.

The case for vesting authority in the board becomes even stronger once one admits to the analysis the relative merits of directors and shareholders. Whatever flaws board governance may have, they pale in comparison to the information asymmetries and collective action problems that lead most shareholders to be rationally apathetic. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs.[235] Given the length and complexity of corporate disclosure documents, especially in a proxy contest where the shareholder is receiving multiple communications from the contending parties, the opportunity cost entailed in becoming informed before voting is quite high and very apparent.[236] In addition, most shareholders' holdings are too small to have any significant effect on the vote's outcome. Accordingly, shareholders can be expected to assign a relatively low value to the expected benefits of careful consideration. Shareholders are thus rationally apathetic.[237] For the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile.[238]

The evidence put forward above on the revealed preferences of shareholders indicates that most shareholders recognize that they are better off pursuing a policy of rational apathy rather than an activist agenda.[239] They know that directors have better information and better incentives than do the shareholders. Accordingly, activist shareholders—the type likely to make use of the powers Bebchuk and Fried would create—have tended to

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234. Stephen M. Bainbridge, *Why a Board?: Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 54–55 (2002).

235. ROBERT C. CLARK, CORPORATE LAW 391–92 (1986).

236. *Id.*

237. *Id.* at 392.

238. *See id.* at 390–92 (analyzing shareholders' rational apathy through a cost–benefit analysis of making informed voting decisions).

239. *See supra* notes 206–11 and accompanying text.

come from a distinct subset of institutional investors—namely, union and public employee pension funds.[240] As I have observed elsewhere:

> The interests of large and small investors often differ. As management becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors. If the large shareholders with the most influence are unions or state pensions, however, the problem is exacerbated.
>
> The interests of unions as investors differ radically from those of ordinary investors. The pension fund of the union representing Safeway workers, for example, is trying to oust directors who stood up to the union in collective bargaining negotiations. Union pension funds have used shareholder proposals to obtain employee benefits they couldn't get through bargaining (although the SEC usually doesn't allow these proposals onto the proxy statement). AFSCME's involvement especially worries me; the public sector employee union is highly politicized and seems especially likely to use its pension funds as a vehicle for advancing political/social goals unrelated to shareholder interests generally.
>
> Public pension funds are even more likely to do so. Indeed, the LA Times recently reported that CalPers' renewed activism is being "fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a Calpers board member, who is considering running for governor of California in 2006." In other words, Angelides is using the retirement savings of California's public employees to further his own political ends.[241]

The deficiencies of shareholders as decisionmakers thus compounds the inherent undesirability of reposing ultimate control of an authority-based organization in the hands of a diffuse electorate rather than a central agency.

The analysis to this point has depended on the proposition that the power to review is the power to decide. Because not everyone will accept that proposition,[242] I now suggest an argument against active shareholder oversight not dependent thereon.

Because outside directors make relatively small investments in firm-specific human capital, it seems unlikely that they will be as risk averse as

240. As I have noted elsewhere, "activism is principally the province of a very limited group of institutions. Almost exclusively, the activists are union and state employee pension funds. They are the ones using shareholder proposals to pressure management. They are the ones most likely to seek board representation." Stephen M. Bainbridge, *Pension Funds Play Politics*, TECH CENT. STATION, Apr. 21, 2004, *at* http://www.techcentralstation.com/042104G.html.

241. *Id.*

242. Indeed, in the related context of the market for corporate control, I once observed that: "The right to fire is not the right to exercise fiat—it is only the right to discipline." Bainbridge, *Director v. Shareholder Primacy*, *supra* note 214, at 49.

officers.[243] Instead, all else being equal, outside director's incentives may well be more in line with shareholder preferences than with those of managers. If adopted, however, Bebchuk and Fried's proposals may induce outside directors to become more risk averse. As a result, adoption of their proposal might actually increase the extent to which outside directors' interests are aligned with those of management.

Bebchuk and Fried's proposals are intended to facilitate the process by which shareholders could undertake a campaign to replace an incumbent board of directors.[244] If adopted, their proposal thus will increase the risk to a director of losing his position and the compensation and various perks it affords. In addition, losing such a contest likely will have a negative impact on the defeated director's reputation.

Indeed, the negative publicity associated with even an unsuccessful effort by the shareholders could negatively impact the incumbent director's reputation and prospects for further employment. Because Bebchuk and Fried would allow a mere 5% block of shareholders to trigger a contested election,[245] the number of such election contests is likely to increase significantly. Even if directors are objectively likely to prevail in most such contests, moreover, the well-established behavioral phenomena of loss aversion and regret avoidance likely will encourage risk aversion by directors.

Board decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly. At this point, the well-known hindsight bias comes into play.[246] As the Second Circuit wrote in *Joy v. North*, "business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge."[247] By virtue of the hindsight bias, shareholders thus will find it difficult to distinguish between competent and negligent management. Bad outcomes often will be regarded, ex post, as foreseeable and avoidable ex ante. If bad outcomes result in the various reputational costs associated with a contested election, however, directors will be discouraged from taking risks. Rational shareholders therefore should prefer a regime that encourages

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243. BAINBRIDGE, *supra* note 29, at 263.

244. BEBCHUK & FRIED, *supra* note 5, at 208–12.

245. *Id.* at 210.

246. The hindsight bias results in decisionmakers tending to assign an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1523 (1998).

247. 692 F.2d 880, 886 (2d Cir. 1982).

risk-taking by, among other things, precommitting to a policy that limits their ability to displace directors.

In sum, given the significant virtues of discretion, one ought not lightly interfere with the board's decisionmaking authority in the name of accountability. The separation of ownership and control mandated by U.S. corporate law is well suited to preventing just such interference by the shareholders. By empowering shareholders to review board decisions and displace boards, Bebchuk and Fried's proposals thus would weaken the very foundation of U.S. corporate law—namely, the principle of director primacy.

*c. Relevance to Judicial Review.*—Note that the analysis in the preceding section also explains something Bebchuk and Fried find puzzling: namely, the very limited extent to which courts review executive compensation decisions by the board of directors. The Delaware Supreme Court, for example, recently stated that a "board's decision on executive compensation is entitled to great deference. It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions."[248] Accordingly, provided the relevant preconditions are satisfied, most notably the requirement that the board make an informed decision, the business judgment rule protects board decisions on setting executive compensation.

Bebchuk and Fried complain that the business judgment rule has resulted in judicial abnegation so long as "nominally independent and informed directors" approved the pay package in question.[249] They make no effort to evaluate why courts defer to such directors. And they thus fail to consider that courts might have very sound policy reasons for doing so.

I have argued elsewhere that the business judgment rule rests on the same considerations as do the limits on shareholder control—namely, a recognition that authority and accountability cannot be reconciled.[250] Just as shareholders apparently recognize that exercising the power to review would constitute an exercise of the power to decide, so too do courts. Put another way, that courts generally do not expose director decisions to judicial scrutiny suggests that the law finds a value in the board's authority that might be lost if director decisions were routinely subject to review.

As such, Bebchuk and Fried erred when they claimed that judicial deference to board decisionmaking rests on the purported "official theory" of

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248. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (citations and internal quotation marks omitted).

249. BEBCHUK & FRIED, *supra* note 5, at 46.

250. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 102–09 (2004).

executive compensation as propounded by financial economists.[251] Instead, judicial deference rests on precisely the same, sound, policy concerns as do the rules limiting shareholder voting power. In turn, this realization provides further confirmation that Bebchuk and Fried's proposed reforms should not go forward.

*3. Why Mess with Success?*—Because Bebchuk and Fried have not provided a metric for estimating the portion of executive compensation constituting rents, we do not know what the stakes are. Because Bebchuk and Fried have not provided an estimate of the extent to which their proposed reforms would reduce the extent of those rents, we do not know what the benefits of the proposals would be. Because we do know that shareholders do not make much use of the powers they already have, however, we might doubt that the benefits would be significant. Finally, as we saw in the last section, the costs in terms of interfering with the basic structure of corporate governance would be high. As such, even a back-of-the-envelope cost–benefit analysis suggests that Bebchuk and Fried's proposals should be consigned to that large dust bin of history in which most academic proposals end up.

In closing, however, it is worth noting that Bebchuk and Fried have not limited their proposal to dealing with executive compensation. Instead of limiting shareholder intervention to firms in which managerial power is high or executives receive vast rents, they propose to remake the entire structure of corporate governance for all firms. Bebchuk and Fried, however, simply have not made a case for doing so.

The director primacy-based system of U.S. corporate governance has served investors and society well. John Micklethwait and Adrian Wooldridge recently opined, for example, that the corporation is "the basis of the prosperity of the West and the best hope for the future of the rest of the world."[252] A comprehensive review of the evidence by Holmstrom and Kaplan is temperate only by comparison:

> Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad

251. *See* BEBCHUK & FRIED, *supra* note 5, at 18 ("Under the official theory of executive compensation, the board is assumed to bargain at arm's length with executives over their pay, solely with the interests of the corporation and its shareholders in mind. That premise underlies corporate law's treatment of board compensation decisions.").

252. JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA xv (2003).

evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average.[253]

Indeed, at least outside the executive compensation area, the managerial power phenomenon seems less valid today than it once was. During the 1980s and 1990s, several trends coalesced to encourage more active and effective board oversight. Much director compensation is now paid in stock, for example, which helps align director and shareholder interests.[254] Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to management buyouts).[255] Third, director conduct is constrained by the market for corporate control, shareholder litigation, and, perhaps to some extent at the margins, activist shareholders.[256] As a result, modern boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information.

The claim is not that the principal–agent problem has been solved. Obviously, the principal–agent problem is intractable. The claim here is only that the system functions well despite that problem.[257] Accordingly, the theory of the second best comes into play. In a complex, interdependent system, it holds that inefficiencies in one part of the system should be tolerated "if 'fixing' [them] would create even greater inefficiencies [elsewhere] in the system as a whole."[258]

We have seen that U.S. corporate governance is based on a sound economic theory, which not only explains—but actually requires—the

253. Holmstrom & Kaplan, *supra* note 98, at 1.

254. Elson, *supra* note 78, at 130–31.

255. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1068–81 (1993) (describing how judicial review of management buyouts and other conflict of interest transactions focuses on the role of independent directors).

256. Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489 (1999).

257. Bebchuk and Fried contend that market mechanisms do not deter management misconduct consisting of a wealth transfer in which the benefits received by the managers are "not much smaller" than the corresponding loss to the shareholders. BEBCHUK & FRIED, *supra* note 5, at 53. They claim that executive compensation is an example of just such a transfer. *Id.* Note that this argument undercuts the claim that executive compensation has systemic effects on shareholder value. If inefficient executive compensation causes ripple effects throughout the firm, destroying shareholder value widely, the losses to the shareholders will significantly exceed the benefits to management. In turn, according to Bebchuk and Fried, management therefore would be vulnerable to punishment by market forces. *Id.* at 54. Ergo, we can infer that inefficient executive compensation does not have systemic effects.

258. Dooley, *supra* note 185, at 525.

separation of ownership and control despite the consequent agency costs.[259] We have seen that shareholders apparently recognize that they benefit very considerably from that system.[260] In order to fix perceived problems with executive compensation, Bebchuk and Fried advocate dramatic changes in that system that would have the effect of considerably strengthening the power of shareholders vis-à-vis directors. Yet, they have not made an adequate case for proceeding with sweeping reforms until we know more about the impact of the substantial changes enacted by Sarbanes–Oxley and the SRO listing standards.[261]

Before blowing up a system of corporate law that has worked well for generations, it would be appropriate to adopt a wait-and-see approach to give the new changes time to work their way through the system. To the extent additional change or reform is thought desirable at this point, surely it should be in the nature of minor modifications to the newly adopted rules designed to enhance their performance, rather than radical and unprecedented shifts in the system of corporate governance that has existed for decades.[262]

## IV. Conclusion

Bebchuk and Fried take issue with the standard academic account of executive compensation, which goes something like this: Executive compensation is a classic agency-cost problem. Although CEOs and other executives are agents of the corporation and its shareholders, they have incentives to shirk. Indeed, they have incentives to behave opportunistically—i.e., to maximize their own wealth and perks at the expense of their shareholder principals. Accordingly, executive compensation schemes must be designed in ways that constrain shirking and opportunism; in other words, executive compensation schemes should strive to align executives' interests with those of the shareholders. In the literature, this usually leads to a recommendation of some sort of performance-based pay scheme, typically entailing the use of stock options.

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259. *See supra* notes 214–51 and accompanying text.

260. *See supra* notes 206–11 and accompanying text.

261. *See supra* notes 129–65 and accompanying text.

262. In particular, the tax code provisions that deny firms a deduction for non-performance-based compensation paid to an executive in excess of $1 million a year should be repealed. This change would reduce the incentive to camouflage fixed compensation as being performance-based. Additional incremental reforms also could be considered. Because CEO compensation tends to be higher as board size increases, perhaps rules creating incentives to limit the size of the board of directors should be considered. Because CEO compensation tends to increase when members of the board sit on three or more other boards, perhaps stock exchange listing standards should limit the number of boards on which a director may sit and still be considered independent. Because CEOs who also serve as chairman of the board of directors generally exercise more power, perhaps the British system of requiring non-executive board chairmen should be considered.

Bebchuk and Fried do a good job of explaining why executive compensation schemes fail adequately to align managerial and shareholder interests. In brief, they make the very plausible point that managerial influence over the board of directors taints the process by which executive compensation is set. In other words, the system by which agency costs are to be checked is itself tainted by an agency-cost problem.

Unfortunately, they have not persuasively made the case that the stakes justify the dramatic reforms they propose. Bebchuk and Fried want to replace the time-tested corporate governance system of director primacy with an untested new system based on shareholder primacy. The case for doing so was not made in this work, however.

Having said that, Bebchuk and Fried are to be praised for having written a book that makes highly technical doctrinal and economic analysis accessible to the educated lay reader, while not dumbing down some very sophisticated analysis. They have laid out a provocative argument and, in many respects, offered considerable supporting evidence. Unquestionably, they have made a valuable and provocative contribution to the literature.

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