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The Academic Tournament over Executive Compensation

Pay Without Performance: The Unfulfilled Promise of Executive Compensation, by Lucian Bebchuk and Jesse Fried

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PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION

By Lucian Bebchuk and Jesse Fried

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Executive pay brings out the worst in the corporate governance system. No economic theory tells us the terms of an "optimal" pay arrangement that combines rewards for effort and merit with bonuses for success and penalties for failure in just the right modes and amounts. Absent such a first best template, we must rely on contracting practice and experience over time to give us instruction about best practices on a trial and error basis. But the practice falls short as an economic laboratory. The firms herd to a small set of focal point arrangements.[2] Critics charge that the practice also falls short as an agency relationship. They complain that give aways abound despite an across the board shift to incentive pay arrangements, despite the transparency imported by a thick stack of regulations, despite the shaming strategies employed by institutional investors, and despite frequent reports of excess in the vigilant business press. And even as management has its defenders, none of them claim it to be underpaid.

Many find this unsatisfactory situation puzzling. Why should an undisciplined boondoggle persist in the teeth of the triumph of shareholder capitalism over the moribund managerialist model of the post-war period? Why, despite market controls, process protections, reporting requirements, and press reports, should compensation arrangements so clearly fail to satisfy the validation standard of arm's length contract? In *Pay Without Performance*, Lucian Bebchuk and Jesse Fried pose a short, direct answer to these questions: managers possess and effectively wield power, assuring that so-called incentive pay comes on easy terms.[3] Bebchuk

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[1]Professor of Law, Georgetown University Law Center; J.D., Columbia Law School, 1976; B.A., Columbia College, 1973. This essay greatly benefited from conversations with Joe McCahery.

[2]See Iman Anabtawi, *Overlooked Alternatives in the Pay Without Performance Debate,* UCLA School of Law working paper, January 2005, at 39-43 (suggesting that path dependence limits alternative pay arrangements).

[3]LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 4-5, 61-117 (2004).

and Fried also make a short, direct prescription, reasoning as follows: Given that (a) the victims of the imbalanced arrangement are the shareholders, and (b) the injury is due to management empowerment, it follows that (c) the only plausible cure lies in shareholder empowerment.[4] Restating their points, executive compensation practice shows that the separation of ownership and control identified by Berle and Means more than seven decades ago[5] still hobbles shareholder capitalism.

Bebchuk and Fried's intervention cuts against the grain of academic corporate governance. Berle and Means supposedly were long ago consigned to the dust bin of intellectual history. Their separation of ownership and control had its day as a corporate governance paradigm during the mid 20th century. It has long since been eclipsed by the high-tech, market-oriented constructs of titans of contemporary financial economics.[6] In *Pay without Performance*, Bebchuk and Fried address these very titans, dismissing their "official view of executive compensation" in addition to denouncing the corporate institutions that determine management pay.[7]

And the titans respond. Prime among them are Kevin Murphy, the leading academic analyst of executive compensation, and Michael Jensen, the progenitor of the nexus of contracts theory of the firm. Jensen and Murphy together provided crucial academic impetus for the 1990s movement to equity based executive compensation.[8] Bengt Holmstrom, Steven Kaplan,[9] and other economists[10] now join Jensen and Murphy in the push back against *Pay without*

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[4]*Id*. at 10-12, 189-216.

[5]ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1991). Appropriately, Bebchuk and Fried invoke Berle and Means at the book's commencement. See BEBCHUK & FRIED, *supra* note 2, at 15.

[6]See William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 760-69 (2001).

[7]BEBCHUK & FRIED, *supra* note 2, at 15-22.

[8]See Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990)[hereafter cited as Jensen & Murphy 1990]; Michael C. Jensen & Kevin J. Murphy, *CEO Incentives – It's Not How Much You Pay, but How*, HARV. BUS. REV. May-June (1990), at 138-53 [hereafter cited as Jensen & Murphy HBR].

[9] See Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* ECGI Finance Working Paper No. 23/2003.

[10]Two leading economic experts on pay, John E. Core and Wayne Guay have joined a legal academic, Randall Thomas, in commenting on Bebchuk and Fried. See John E. Core, et al., *Is U.S. Compensation Inefficient Pay without Performance?*, SSRN Working Paper, Jan. 2005.

Performance.

The debate holds out holds out intriguing lessons for students of corporate governance. This is not a conventional left v. right, anti-management v. pro-management academic debate. It is instead a contest over shareholder capitalism's high ground. Bebchuk and Fried come to the table with long and impeccable credentials as proponents of shareholder value maximization. But neither hesitates to criticize prevailing institutional arrangements. Nor does either display the reflexive aversion to regulatory solutions so common among contemporary observers of corporate institutions. Thus positioned, Bebchuk and Fried lay down the gauntlet, demanding that the economists either defend prevailing compensation practice, explaining how it plausibly can be described as a free market success story, or join them in condemnation. The economists have risen to the challenge, countering Bebchuk and Fried's management power description and offering theories to justify prevailing pay practices.

This essay reviews the state of play in this academic tournament. Three defenses have been mooted. First, much of what Bebchuk and Fried account for as results of executive power also can be explicated in terms of the economic relationship between risk and return – higher risks attending equity-based pay must be compensated with higher upside payouts. Bebchuk and Fried respond that the risks can be dealt with without sacrificing performance sensitivity. They concede the economists' base point that the amount paid to executives matters less than the mode of payment. It follows that enhanced performance sensitivity can indeed be compensated with higher payouts; the problem is the failure to draw in the first place on the long menu of available performance sensitive techniques. Second, the defenders posit an informational shortcoming: boards incorrectly believe that stock options are a bargain mode of compensation, overvaluing them in comparison to cash payments. Bebchuk and Fried find this implausible in a world where chief executive officers fill a majority of board seats. Third, the defenders point out that managers have on the whole done well for the shareholders since the early 1990s shift to performance pay. As to this, Bebchuk and Fried respond with the shareholder value norm itself. One takes it seriously or one does not; if one does, apologies fall short as justifications.

Both sides score points in this back and forth. But significant concessions have been accreting on the defensive side. There results a clear victory for Bebchuk and Fried. They win the match when the defense acknowledges that management power matters. That may not sound like much of a concession. But it changes the terms of discourse in a field that expunged the concept of power from its positive account more than two decades ago. The erasure accompanied the transition from social theory to economics as the primary language of description.[11] In recent years, what Bebchuk and Fried call power has been described by the more neutral, less threatening phrase, "influence costs."[12] With power back in the positive

[11] I can recall only one paper by a legal theorist published during the last twenty years that placed power at the center of its description of the large corporation. See Lynn L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L.REF. 19 (1988).

[12] See PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 269-78 (1992).

account, the burden of persuasion shifts from the critics to the defenders of prevailing practices. The question then turns to whether prevailing pay practice can be improved materially. When the answer turns out to be yes, the debate ends in favor of Bebchuk and Fried.

Part I sets out Bebchuk and Fried's power-based description of the framework in which boards determine the terms of executive employment contracts. Part II assays the descriptive alternatives put forward by the defense and Bebchuk and Fried's responses thereto. Given a positive account that focuses on a single element (power) in a complex institution (corporate governance), one would expect the defense to highlight other factors motivating the practice. It does so here, and a fair account must admit the complexity. But the critics do not succeed in falsifying Bebchuk and Fried's diagnosis. Indeed, as Part III shows, the distance between Bebchuk and Fried and their critics has so narrowed as to change the tenor of debate. It now devolves into a disagreement over subtle differences of perspective respecting generally acknowledged shortcomings in the practice. Part III also takes up Bebchuk and Fried's prescriptions. Here they confront political realities and so cannot be named victors. The significant law reform needed to effect shareholder empowerment will not occur anytime soon. This leaves Bebchuk and Fried playing a hortatory role in a self regulatory dialogue. That task retains importance, for boardroom practice will never change absent robust criticism like that advanced in *Pay without Performance*.

I
THE CHARGE

Bebchuk and Fried charge that governance structures empower top managers, who, subject only to loose normative constraints, use their power to extract rents disguised as incentive pay. This Part relates the details of the case.

Bebchuk and Fried's normative base point is a model of the arm's length bargain. Under the model, executive pay packages should reward an executive a sum in excess of his or her reservation price, should contain terms that encourage the executive to increase the value of the firm, and should avoid terms that reduce the value of the firm ("inefficient" terms).[13] Compensation packages, assert the authors, do not conform to the model because top managers possesses influence over independent directors. Restating the point, top managers use power to extract rents, defined as benefits better than those available under an arm's length bargain.[14] A prediction follows: The more power a manager possesses, the greater the rents in the pay

[13]BEBCHUK & FRIED, *supra* note 2, at 18-19. Jensen and Murphy describe a similar base point, noting that the firm faces a trade off in respect of the amount of pay conceded and attracting better motivated employees. Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them*, ECGI Working Paper No. 44/2004, at 20-21[hereafter cited as Jensen & Murphy 2004].

[14]BEBCHUK & FRIED, *supra* note 2, at 5.

package.[15] But an ultimate limit does constrain the rent yield – outrage costs. These are triggered when outsiders whose views matter to the board of directors disapprove of a pay give away. Outrage costs can negatively impact the firm in markets for labor and corporate control.[16] Managers in turn minimize the possibility of outrage by reducing transparency, camouflaging performance insensitive components of the pay package.[17]

Bebchuk and Fried use this framework to show that managers are overpaid. Significantly, they make this case in a tightly delimited, consequentialist framework. They reject the hypothesis that self-esteem motives managers[18] – in their account only money matters. They also disassociate themselves from complaints about the level of management compensation.[19] Their overpayment case does not turn on the fact that the average S&P 500 chief executive officer (CEO) made 30 times more than the average production worker in 1970 but 210 times more in 1996.[20] It is not the amount of pay that bothers them but the failure to make big payoffs contingent on the creation of shareholder value by the managers.[21] The debate over the book,

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[15]*Id*. at 63.

[16]*Id*. at 5, 65.

[17]*Id*. at 5, 70-71.

[18]*Id*. at 8. Nor do they confront alternative explanations of performance pay. For an example of a contrasting theoretical approach, see Edward P. Lazear, *Output-Based Pay: Incentives, Retention or Sorting?* SSRN working paper, April 2003. Lazear rejects the notion that performance incentives have anything to do with observed executive pay practices, citing the absence of downside penalties. He proposes that equity-based pay ameliorates information asymmetries. The executive, an informational insider, trades less risky cash compensation for riskier equity compensation so as to reassure outsiders. This leads to the prediction that equity based compensation is more likely to appear when the firm's production function is little understood and information is hard to glean. *Id*. at 2-3. Lazear makes perfect sense, but does not undercut Bebchuk and Fried, who in effect suggest that the insider gets more stock than is needed to rectify the information asymmetry and does everything possible to make the compensation package is as obscure as the production function.

[19]BEBCHUK & FRIED, *supra* note 2, at 5, 70-71. One result of this is that Bebchuk and Fried avoid direct confrontation with defenses of domestic pay practices directed to criticisms focused on foreign practice and the fact that U.S. executives are far and away the best paid in the world. See Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven*, 57 VAND. L. REV. 1171 (2004)(suggesting reasons to justify the transnational pay gap). There is indirect confrontation, however. See *id*., at 1198-1200 (describing weaknesses in board capture theory).

[20]Kevin J. Murphy, *Executive Compensation*, SSRN working paper April 1998, at 51.

[21]BEBCHUK & FRIED, *supra* note 2, at 6, 9.

then, amounts to family quarrel within the group that posits shareholder value maximization as the firm's objective. Those who view the firm from a different point of view, favoring stakeholder capitalism or the harmonization of the firm's financial reward system with that prevailing in outside society, will find no allies here.[22]

Bebchuk and Fried must make a two part proof, showing, first, that incentive pay arrangements are not keyed to shareholder value creation and, second, that their failure to do so stems from the exercise of management power. The sections that follow take up the proof in reverse order.

A. Power

Power is hard to prove. (This is part of the reason why it has disappeared from economically informed descriptions of corporate institutions.[23]) Payments of money, in contrast, are easily verified. Overall CEO compensation increased by a factor of six over the last two decades.[24] Average total remuneration of executives of S&P 500 companies (adjusted for inflation) went from $850,000 in 1970 to $14,000,000 in 2000, falling with the stock market to $9,400,000 in 2002.[25] Average base salaries just more than doubled from $850,000 to $2,200,000 during the period.[26] It follows that most of the increase came in the form of "incentive" pay.

To effect a causal connection between the unobservable factor of management power and the observed payoffs, Bebchuk and Fried draw on the arm's length bargain model. They make a crucial, but reasonable assumption – that an arm's length deal would tightly tie pay to performance. They then draw inferences from institutional arrangements. They first point out that governance institutions are ill-suited to foster arm's bargaining between top managers and their corporate employers. Four factors, all well-known to students of corporate governance, contribute to this debility. First, the board itself is weak because outside directors tend to be loyal to or dominated by the CEO due to process infirmities like large numbers and CEO chairmanship, interlocks, and financial dependence.[27] Second, most firms lack a substantial

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[22]Cf. Anabtawi, *supra* note 1, at 36-39 (suggesting a description of pay practice following a team production model).

[23]The other reason is political. Progressive critics of corporations assert that power implies responsibility; corporate power, once identified, justifies regulatory constraints. See William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, ECGI Law Working Paper No. 23/2004, at 23-24.

[24]Holmstrom & Kaplan, *supra* note __, at 10.

[25]Jensen & Murphy 2004, *supra* note __, at 24.

[26]*Id*.

[27]BEBCHUK & FRIED, *supra* note 2, at 80-82.

large outside shareholder, the financial interest of whom would influence bargaining over pay.[28] Third, oversight by large institutional shareholders tends to lead to more sensitive pay arrangements and some firms have fewer large institutional shareholders than do others.[29] Fourth, antitakeover arrangements insulate most managers from the discipline otherwise imposed by the market for corporate control.[30]

In Bebchuk and Fried's view, the checks built into the system do not suffice to correct this imbalance and assure that the shareholder interest dominates. Consider, for example, the shareholder vote. Reelection to the board remains a practical certainty for most independent directors, at least so long as they remain on the CEO's good side.[31] So the annual election does not amount to a significant threat. Nor do other shareholder votes much matter. Up-down votes on incentive compensation are a blunt instrument that the shareholders almost never wield and do not substitute for a real back and forth negotiation. Shareholder precatory proposals on accounting for stock options now have an impact, but this is a very recent phenomenon.[32] Meanwhile, the rewards and norms of the system encourage boardroom collegiality.[33] Back scratching prevails – there is a reason why 67 percent of outside directors are active or former CEOs.[34] Other outside directors may be free of this structural bias to favor the CEO. But they suffer no reputational loss when they go along with a lax pay deal – all the board needs to do to avoid loss of face is to stay in the range of acceptable compensation.[35] And even if an independent director had an inclination to get tough and were to find her way onto a compensation committee, constraints of time and information would limit her effectiveness. Captured compensation consultants continue to take the lead in pay-setting,[36] making everything look legitimate by camouflaging pay increases with reference to comparable firms, all of which concede raises on the same justification.[37]

Bebchuk and Fried also are unimpressed by market constraints. The stock market imports a check only against bigger, higher profile wealth transfers.[38] The executive employment market similarly falls short. Contrary to casual appearances, the rate of executive firing increased only slightly in the 1990s.[39] Further promotion within the firm holds out no incentive for the holder of the top job, while the possibility of moving on to another, bigger firm only strengthens the CEOs resolve to get a good package – the custom is that a new firm

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[28]*Id*. at 82-83.
[29]*Id*. at 83.
[30]*Id.* at 83-85.
[31]*Id.* at 25.
[32]*Id.* at 49-51.
[33]*Id.* at 27-28, 31-33.
[34]*Id.* at 33.
[35]*Id*. at 34-36.
[36]*Id*. at 36-39.
[37]*Id*. at 70-71.
[38]*Id*. at 53.
[39]*Id*. at 41-42.

compensates a new CEO for the value of any unvested equity compensation at the old firm.[40]

B. Rents

Bebchuk and Fried, having established that the governance framework invites slack, then show in detail that pay practices fall short of the arm's length standard. This presentation takes up most of the book. Much of it concerns stock option programs. More shocking to the reader are a long list of lucrative bells and whistles – retirement pensions, deferred compensation, post retirement perquisites, and consulting fees. All of these are performance insensitive and buried in disclosures of supplemental retirement plans rather than placed up front in the compensation table included in the annual proxy statement.[41]

Stock option plans, however lax their construction, have the great merit of conditioning rewards on the stock price, which in turn is determined by free market actors. Cash bonuses can be structured the same way, but tend not to be. Bonus rewards frequently depend on meeting targets within the payees' control that have no necessary connection with performance improvement at the bottom line – targets such as spending all the funds in an annual budget, or, worse, closing an acquisition. When performance targets are not met, they often are lowered ex post.[42] There also are bonuses on entry and exit. Bonuses for signing are unsurprising, assuming a competitive market for the best managers. Bonuses for leaving, whether by firing, retirement, or acquisition, are a little more disturbing,[43] competitive market or not. The average severance package equals three or more years of compensation, with only two percent of firms reducing it in the event the CEO finds new work. Firing, argue Bebchuk and Fried, should not be a cash bonanza.[44] This is course just what happened when Michael Ovitz was thrown out of Disney, a golden good-bye that has resulted in the rarest of cases – a fiduciary duty lawsuit concerning compensation that gets past the defense's motion to dismiss and goes on to trial on the question of the good faith of the consenting board.[45] Ironically, the defense in the case could very well cite to Bebchuk and Fried for the proposition that Disney did nothing unusual.

On stock options, Bebchuk and Fried question exercise prices, numbers granted, and vesting rules. Their main complaint goes to price. The almost universal practice is to fix the exercise price at the stock price at the time of the grant. Only five percent of companies price options out of the money, that is, below the market price of the stock at grant,[46] despite the give up in the incentive effect. The practice of leaving the price fixed for the life of the option also diminishes the incentive effect. A fixed price rewards the executive for market wide and sector

[40] *Id*. at 54.

[41] BEBCHUK & FRIED, *supra* note 2, at 95-99.

[42] *Id*. at 124-27.

[43] *Id.* at 89. The most recent front page ouster, that of Carleton S. Fiorina at Hewlett-Packard, entailed a package worth $21.1 million. Gary Rivlin, *Hewlett's Board Forces Chief Out after Rocky Stay*, N.Y. TIMES, Feb. 10, 2005, at A1.

[44] BEBCHUK & FRIED, *supra* note 2, at 132-35.

[45] See In re The Walt Disney Co. Derivative Litigation, 825 A.2d 275 (Del.Ch. 2003).

[46] BEBCHUK & FRIED, *supra* note 2, at 160.

wide upward price movement in addition to upward movement due to the company's own performance (said to account for only 30 percent of stock growth on average). Because the market tends to rise over time, a pay off is virtually guaranteed. Indexing would solve the problem. The exercise price would be reset upward and downward over time to filter out changes attributable to the market or sector. Alternatively, vesting could be conditioned on meeting a fixed performance target.[47] Neither palliative is seen in practice, despite the obvious opportunity cost in terms of incentive effect.

As to the numbers granted, Bebchuk and Fried think that fewer would be better. According to empirical evidence they cite, the positive incentive effect declines as the number granted increases, so that the benefits of the last option granted may be less than the cost.[48] They also criticize the practice of reloading. Under this, a new option automatically is granted every time an option is exercised. This lets the executive lock in protection against a subsequent decline in the stock price, perversely turning stock price volatility into a source of personal profit.[49]

Under the prevailing practice, once the option vests, the exercising executive is free to sell the underlying stock. And executives do sell 90 percent of the stock purchased upon exercise.[50] No nefarious intentions need be read in. They sell in order to diversify their portfolios, acting no differently from other rational investors. But Bebchuk and Fried object to the concession of free transfer, arguing that restraints on alienation and on hedging would tie the executive's interest more closely to long term value creation within the firm.[51] And, although bad motives need not be read in, nefarious deeds do occur. Executives use inside information to time their sales. Here too correction would be easy – executives should be forced to disclose their sales in advance.[52]

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[47] *Id*. at 139-42

[48] *Id*. at 138.

[49] *Id*. at 169-70. Bebchuk and Fried also disapprove of the practice of substituting new grants at a lower exercise price for grants that expire out of the money. Formerly that result also was accomplished by amending the plan to lower the price, a practice that ceased when the Financial Accounting Standards Board changed the accounting treatment in 1998. *Id*. at 165-67.

[50] *Id*. at 176-77.

[51] *Id*. at 174-77. The length of the strings would be subject to negotiation. *Id*. at 174-75. Bebchuk and Fried note that the practice is changing, with firms adopting target ownership plans. They complain that the targets are low, however. *Id*. at 176-77.

[52] *Id*. at 179-83, 191. Also disturbing are loans made to finance purchases of company stock, now prohibited by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204,§§ 402(a). These were often forgiven, with forgiveness implicating a 25 % gross up to cover the income tax payable on loan forgiveness. BEBCHUK & FRIED, *supra* note 2, at 116. Alternatively, the executive would borrow money from the firm to exercise stock options and later put the stock back to the firm to repay the loan, taking advantage of a pre-SOX loophole that permitted the executive's report of the stock sale to be delayed until 45 days after the end of the fiscal year. *Id*. at 117.

Bebchuk and Fried take a parting shot at restricted stock. This is being touted by many pay consultants and commentators as a healthy alternative to options. Because options gain in value as the firm's stock becomes more volatile, they perversely tie executive wealth to stock volatility. Awarding the stock outright avoids that problem. Bebchuk and Fried accept this reasoning, subject to the caveat that the executive be prohibited from selling the stock. But they also note that alienation can be restrained with options just as easily. And they enter a loud objection: Restricted stock is an option with an exercise price of zero and there is no reason to believe zero is an optimal exercise price.[53] To see their point, compare the award of an option to buy 100 shares at $100 and an outright grant of 100 shares, both awarded with the stock trading for $100. Assume that the stock price declines to $80 on the day after the grant and stays at $80 forever because the firm is badly managed. The holder of the option is wiped out; the holder of the stock emerges with 80 cents on the dollar despite poor performance. Thus does current movement to restricted stock rather than indexed options confirm Bebchuk and Fried's rent collection charge.

C. Summary

Bebchuk and Fried succeed with their prima facie case.[54] The practice implies a windfall, which in turn implies CEO influence at work. Significantly, Bebchuk and Fried make no claim to originality for these basic points. They build on a body of existing discussions.[55] The purpose of the book is to gather the learning together to put the onus in academic and policy discussions on management's defenders. The book's success or failure accordingly must be evaluated by reference to the defense.

II
THE DEFENSE

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[53]*Id*. at 170-71.

[54] It should be noted that Bebchuk and Fried do not prove beyond doubt that higher performance sensitivity would work exactly as projected. Prevailing practice has had perverse effects; more could be in the offing under a revised practice. See, e.g., Saul Levmore, Puzzling Stock Options and Compensation Norms, 149 U. Pa. L. Rev. 1922, 1930 (2001)(suggesting that indexed options could adversely affect investment policy). But Bebchuk and Fried do not have to make that proof. They acknowledge the problems and suggest plausible means of countering them in advance. Their showing suffices. What is needed is experimentation, which has been lacking for the reasons they identify.

[55]Professor Elson has been describing pay practice as a function of board capture in the legal literature for years. See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651 (1995); Charles M. Elson, *Director Compensation and the Management Captured Board–The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 156-64 (1996). A management influence hypothesis also has appeared in the economic literature. See Marianne Bertrand & Sendil Mullainathan, *Agents With and Without Principals*, 90 AMER. ECON. REV. 203 (2000); Marianne Bertrand & Sendil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J.ECON. 901 (2001).

Bebchuk and Fried's interlocutors from economics make three responses: (a) executive pay arrangements can be explained as rational employment contracts in which the employer must concede high returns to compensate for risks implicated by equity-based compensation; (b) any departure between actual compensation arrangements and those predicted by a model of arm's length bargaining can be traced to the perverse effects of regulation and informational shortcomings that impair the judgments of corporate decision makers; and (c) the quantum of overcompensation is modest and the system, left unregulated, will self correct. All three points are well-taken and prompt modification of Bebchuk and Fried's description. The interlocutors, however, neither succeed in displacing power from the positive account nor in recasting the windfall as an acceptable arm's length deal.

The discussion that follows takes up the three responses in turn, noting Bebchuk and Fried's responses to each. The principal interlocutor is Kevin Murphy, variously writing by himself and in collaboration with Brian Hall or Michael Jensen.

A. Risk, Return, and Optimal Contracting

Much of what Bebchuk and Fried account for as results of executive power also can be explicated in terms of the economic relationship between risk and return. Murphy and Hall take this as the base point for a sharply contrasting account.[56] From the firm's point of view, they note, the cost of an executive stock option is the cash consideration the firm would receive from a third party investor for the same contingent interest in the stock. But third party investors and firm employees differ in a critical respect as option buyers. Third party investors are fully diversified and positioned to hedge the risk attending the option position.[57] They accordingly are risk neutral, where employees are underdiversified and risk averse. It follows that the employee values the option less than does the third party.[58] It further follows that an option makes no sense when considered as pure compensation in comparison to cash: In order to constitute $1 of pay in the eyes of the employee, option compensation must be increased to make up for the employee's valuation discount. The option thereby costs the firm more than $1 in value the employee receives. An option nevertheless might make sense as incentive compensation. But the overall terms of an arm's length option package should be expected to reflect the employee's risk aversion. This explains terms that otherwise could be seen as giveaways, such as exercise prices set at the money rather than at a discount, the failure to index the exercise price,[59] and the allowance of both early exercise[60] and stock sales after exercise.[61]

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[56]See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, SSRN working paper, Nov. 2001 [hereafter cited as Hall & Murphy 2001]

[57]Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U.CHI.L. REV. 847, 859-60 (2002).

[58]Jensen & Murphy 2004, *supra* note –, at 38.

[59]Hall & Murphy 2001, *supra* note __, at 3.

[60]*Id*. at 13.

Stock options, then, may be an inefficient mode of compensation, but the inefficiency does not necessarily stem from management power. If power were the generative factor, then one would expect to see CEOs hired from within the firm paid more than outside hires, given that power accrues to insiders while outsiders deal more at arm's length.[62] In practice the opposite occurs. Outside CEOs earn more and industries where outside hiring is more prevalent pay more. Over all numbers of outside CEO replacements have risen from 15 to 17 percent in the 1970s and 1980s to just over 25 percent today.[63] The context accordingly has become better suited to arm's length contract.

The next rebuttal point shifts the perspective to the firm's overall compensation policy – to lower down executives and employees as well as the top team. If option practice stems from the power of top managers, then why are most employee options granted to those below the top team? In 1990, less than 85 % of option grants went to employees below the top five; in 2002, 90 percent went to lower down employees.[64] The egalitarian grant pattern compounds the inefficiency problem, and, according to Murphy, presents the more pressing problem of the two.[65] Since options are worth less to employees than their opportunity cost to the firm, option compensation makes sense only when it provides the best available means to import high powered incentives. This is not the case with subordinate employees -- for them the firm's internal advancement tournament and the prospect of equity compensation in the event of a tournament victory already provide incentives. In addition, within the general employee population it is impossible to tell whose effort improves the stock price, inviting free riding among the beneficiaries of an equity-based reward system.[66] To the extent that incentives need to be built into the pay structure of lower employees – to encourage them to stay at the firm, for example – cash bonus arrangements can be devised.[67]

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[61]John E. Core, Wayne Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, SSRN working paper 2003, at 30, points out that if the executive already holds the firm's stock at the time of the option grant and is allowed to sell on a one-to-one basis as options are exercised, the executive will place the same value on the option as a third party investor.

[62]Murphy, *supra* note __, at 853.

[63]Jensen & Murphy 2004, *supra* note __, at 32-33.

[64]*Id*. at 36.

[65]Murphy, *supra* note __, at 850.

[66]Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, SSRN working paper, May 2003, at 16-17[hereafter cited as Hall & Murphy 2003].

[67]*Id.* at 15-16.

Summing up this first phase of the defense, rent extraction at best explains rewards for the top executives, but not the practice as a whole.[68] Although something clearly has gone wrong with compensation policy, one need not draw an inference of abuse of power by management.

Bebchuk and Fried answer the risk return criticism by positing that risk can be dealt with without sacrificing performance sensitivity. Recall that Bebchuk and Fried do not question Jensen and Murphy's base point that the amount paid to executives matters less than the mode of payment.[69] For Bebchuk and Fried, as for Jensen and Murphy, high levels of compensation do not by themselves imply a departure from the shareholder value norm.[70] Manager risk aversion therefore does not by itself explain the absence of options with exercise prices set above the market price or exercise prices indexed to the wider stock market. To the extent risk aversion makes a given option less valuable to the executive, so as to cause the value of the overall pay package to fall below the compensation amount set through arm's length bargaining, adjustments can made. A larger number of "reduced windfall" options can be granted.[71] The shareholders will always prefer to concede the additional options in exchange for performance sensitive features.[72] Finally, if pay packages indeed stemmed from an arm's length risk return trade off, we would have seen reductions in cash compensation to make up for appearance of stock options in the 1990s.[73] The absence of such reductions rebuts the implication of a trade off.

Bebchuk and Fried concede to Murphy the point concerning outside CEO hires and bargaining power, noting that they never said that power determines pay all by itself.[74] It is a concession they must make, for if power were the only factor, then we also would expect to see

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[68]*Id*. at 29.

[69]Jensen & Murphy HBR, *supra* note __, at 138-39.

[70]BEBCHUK & FRIED, *supra* note _, at 20.

[71]*Id*. at 144.

[72]*Id.* at 157. Alternatively, performance sensitive contracting techniques can be applied in modified form – a standard index need not be used, the executive instead could be put in the money for outperforming 50 % or less of competing firms. *Id.* at 156.

One open question is whether outrage would contain grants of reduced windfall options in larger numbers. I tend to doubt it: The occasional high profile big pay off would go to a manifestly successful executive; simultaneously, less successful executives' options would lose their value in plain view. Shareholders never question winners and would be happy. In addition, fears of populist backlash are overdone in the present environment. See *infra* text accompanying note __.

[73]BEBCHUK & FRIED, *supra* note _, at 72-73.

[74]*Id.* at 85.

radically different compensation practices in firms controlled by large shareholders, and we do not.[75] Bebchuk and Fried still manage to push back a couple of steps, however. A new CEO, they argue, still will have significant bargaining power because power is conceded to the newcomer on a prospective basis and the incumbent directors will be friendly due to a desire to retain their board seats. Tough bargaining yields them nothing.[76]

Bebchuk and Fried do not confront the point about option compensation to lower employees, limiting themselves to the top team pay package. But a partial response can be extrapolated from their camouflage description. The CEO, they say, will use his or her power to inflate the pay package of other top executives in order to obscure his or her own rent extraction.[77] There is no reason why these "spillover rents" should not trickle down the hierarchical ladder. But the extrapolation does not even begin to explain the use equity compensation to motivate lower employees. While Bebchuk and Fried may legitimately cabin their description to top team compensation, in the picture that emerges factors in addition to CEO power and greed shape the use of stock option compensation.

Note that one could take the risk and return reading of executive pay practice and infer an arm's length trade. According to Bebchuk and Fried, this is exactly what the financial economists have been doing: The "official view" of economics, they say, assumes an arm's length framework and then dismisses inconsistent practices as anomalies or puzzles.[78] The characterization does not neatly fit Murphy's analysis, however. Certainly, Murphy disputes Bebchuk and Fried's description of the bargaining context and talks of puzzles. But it is difficult to infer strong assumptions as to either the quality of the contracting framework or the evolutionary trajectory of the practice. After all, it was Jensen and Murphy, in the famous paper of 1990, who criticized the pay practice of an earlier day for inconsistency with the implications of formal models of optimal contracting.[79] Nor does their later writing assume that optimal incentive contracts have reduced agency costs to a minimal figure. For Jensen and Murphy, agency costs are a salient and persistent problem.

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[75]Robert Daines, Vinay B. Nair & Lewis Kornhauser, *The Good, the Bad and the Lucky: CEO Pay and Skill*, SSRN working paper Nov. 2004, at 4-6, establishes a statistical link between firms with large shareholders, high incentive pay, and successful performance. The link in turn supports the power hypothesis – to the extent firms with large shareholders have more defensible performance-based pay structures and lower pay levels, the inference of power is reinforced. BEBCHUK & FRIED, *supra* note 2, at 82-83, points this out.

[76]*Id*. at 39-41.

[77]*Id.* at 64.

[78]*Id.* at 2-3.

[79] Jensen & Murphy 1990, *supra* note __, at [3]. Of course, their then complaint was that CEOs were compensated like bureaucrats with only a trivial portion of their compensation being tied to increases of shareholder value.

But, if we put Jensen and Murphy to one side, Bebchuk and Fried's "official view" does prevail in a body of economic work on executive compensation. This school distinguishes the Jensen-Murphy approach for its very emphasis on a continuing agency problem and makes a qualified prediction of evolutionary convergence on efficient outcomes. In the near term rents can be extracted, but only because transaction costs prevent continuous recontracting in response to events. Significant agency costs thus can exist but will indeed be anomalous and will be reduced over time.[80] These writers draw an optimality inference from pay practice, citing empirical studies showing correlations between pay and "theoretically sensible factors" such as firm size and transparency.[81] But they also make an important admission: The studies show correlations without providing evidence of high or low points and have difficulty establishing a robust relationship between incentives and performance.[82]

Two economists from this school, John E. Core and Wayne R. Guay, writing with law professor Randall Thomas, have joined the debate with Bebchuk and Fried.[83] Interestingly, Core, Guay, and Thomas concede that corporate contract structures reflect executive power and that more power means more pay.[84] But they nonetheless hold to an optimality claim, at least in the sense of first best-second best. More particularly, given contracting costs, results will never the first best. Compensation contracts nevertheless can achieve optimal results within a second best framework, anticipating problems such as CEO power and adjusting in advance.[85] Core, Guay, and Thomas accuse Bebchuk and Fried of making an excessive demand with their normative base point of arm's length bargain. Bebchuk and Fried, they charge, complain about a Nirvana that does not exist,[86] seeking theoretical perfection in a second best world. A contract, they say, can be "optimal" without being arm's length.[87]

Core, Guay, and Thomas's concept of optimality is intelligible enough. It is harder to make sense of its deployment in the executive compensation context. Certainly, first best-second best makes sense as a policy objective in an imperfect world. But why, given the concession of management empowerment, should we assume that pay practice optimizes even in a second-best framework? A rational and empowered actor presumably takes more than a rational and unempowered actor would get. The excess is rent, and is not first best-second best within the

[80]See Core, *et al.*, *supra* note [60], at 2-3.

[81]*Id*. at 15-17.

[82]*Id*. at 24.

[83]See Core, *et al.*, *supra* note [10].

[84]*Id.* at 30.

[85]*Id.* at 30, 36. The authors view power as an inevitable concomitant of the top job. They predict that CEO contracts will be structured so as to contain the power accreting over time. *Id.* at 36. But the only real world example they point to is the term of years – the fact that the initial contract has a life of only three to five years. *Id.* at 36 n. 23.

[86]*Id.* at 60.

[87]*Id.* at 40.

normative framework of a competitive market. So the point carries only if arm's length contract and the competitive market are inappropriate bases for normative evaluation. From a legal point of view, that point cannot carry – arm's length contract is the time-honored normative yardstick of the fiduciary law of self dealing contracts. From an economic point of view things could be different. It certainly is conceivable that parties not at arm's length could contract optimally. For that, however, the parties need a theoretical template that shows them the way to the maximal payoff. Unfortunately, economics does not yet hold out such an objective optimality template for CEO compensation. So we are left with the question as to how the practice can be expected to evolve in a first best-second best direction on a trial and error basis when the bargaining parties do not deal at arm's length. That calls for marketplace magic of a high order.

If we extend Core, Guay, and Thomas's concept of robust governance practice out to a logical end point, then Jensen and Murphy were out of line when they criticized pay practice for performance insensitivity back in 1990. But, it being hard to imagine that Core, Guay, and Thomas intend that implication, their defense of pay practice must come down to an expertise argument. To wit, Bebchuk and Fried, unlike Jensen and Murphy, have no business attacking pay practice despite their accurate diagnosis of executive power. The implicit assertion is unpersuasive. Bebchuk and Fried have standing to call a windfall a windfall. Finally, Core, Guay, and Thomas's "Nirvana fallacy" charge misses the mark. That accusation made sense forty years ago when post New Deal public interest regulators posited that real world imperfections automatically justified regulation. Invoking the Nirvana fallacy was a way of saying that leaving things alone was cost beneficial. Bebchuk and Fried argue that cost beneficial changes are within easy reach through free bargaining and make no plea for direct regulation of contract terms.

B. Perceived Costs

Recall Murphy's criticism of stock option compensation for lower-down employees. For Murphy, the persistence of pay arrangements that fail to pass the cost benefit test reflects a lack of appreciation of the costs. Board members incorrectly believe that stock options are a bargain mode of compensation, overvaluing options in comparison to cash payments by underestimating the options' economic cost to the shareholders whose stakes they dilute.[88] Jensen and Murphy use this point to account for a number of practices. For example, during the 1990s, firms continued to grant the same number of stock options year after year even as their stock prices doubled, causing the value of incentive grants to balloon. Had pay plans been laser focused on performance sensitivity, numbers of options would have been cut back as the market rose. Contrariwise, when the market fell after 2000, option value went down in lockstep with it. Had the value rather than the numbers been the center of attention, further adjustments would have been required.[89] (Indeed, if management were all powerful, the market decline by itself should have caused a gross up in the numbers.) For Jensen and Murphy, this "free money" fallacy does a better job of accounting for the numbers across the past decade and a half than does power.

[88]Jensen and Murphy 2004, *supra* note __, at 37-39.
[89]*Id.* at 37.

They also look to lack of sophistication to explain the absence of indexing: Prior to 2005,[90] firms were required under GAAP to expense the value of indexed options from their earnings, while no deduction was required for fixed price, unindexed options. Boards thus gave up performance sensitivity not because they were dominated but because they were poorly regulated and naively fixated on earnings per share (EPS).[91]

Murphy combines the perceived costs point with his risk-return description to describe a more robust deal than do Bebchuk and Fried. The firm grants options not to incentivize but because it mistakenly believes them to be cheap compensation.[92] It follows that concessions keyed to the managers' risk aversion – the fixed price set at market and the absence of restraints on alienation – bother the firm little because it does not view them as costly. The manager would prefer an exercise price set below market; the firm would prefer an exercise price above market; and they split the difference when they set the price at the market.[93]

Note that Murphy has smuggled in a normative assertion. In his account of a robust deal, the mistaken perception of low cost undergoes a transformation. It starts out as a positive observation but ends up as a statement of purpose: For Murphy, equity compensation and cash compensation have the same purpose – to compensate. Bebchuk and Fried see things differently. For them the purpose of equity compensation is to incentivize; absent an incentive effect, big upside payoffs at the shareholders' expense have no justification. With incentives as the sole purpose for equity based pay, the positive account takes on a different coloration: an implication of empowerment arises from the observation of performance insensitive equity compensation.

What then is the purpose of equity based pay: Compensation or incentive? In a strictly positive sense, the answer is both. In a normative sense, the answer must be incentive under Murphy's own analysis. Since Murphy sees stock options as an intrinsically inefficient form of compensation, they only can be justified if they import incentives more valuable than the opportunity cost. It follows that management power can be excluded from a plausible positive account only if ignorance satisfies as a stand alone explanation.

Bebchuk and Fried find the "honest stupidity" explanation implausible. They offer four reasons. First, if lack of sophistication was the root cause, we would see firms use a wider range of techniques – some firms, more sophisticated than the others, would adopt plans more unfavorable to managers; plans in the least sophisticated firms would be even more favorable. Second, if lack of sophistication was the cause, education by itself would solve the problem, something they would not predict. Third, most independent directors are themselves CEOs and presumably not unsophisticated in these matters. Fourth, given the prevalence of CEOs within the ranks of independent directors, any residual boardroom misunderstanding amounts to

[90]See Financial Accounting Standards Board, *Financial Accounting Statement No. 123, Share-Based Payment* (revised 2004).

[91]Jensen and Murphy 2004, *supra* note __, at 37-39.

[92]Murphy, *supra* note __, at 865.

[93]*Id*. at 863-64.

additional evidence supporting the power explanation.[94] As to the perverse effects of the old GAAP rule on the expensing of options, Bebchuk and Fried ask why an independent board would privilege an EPS concern implicating only numbers on a page over a value enhancing strategy. Putting EPS first would make sense only if the stock market very inefficiently punished the stock price for the EPS sacrifice and that short term cost outweighed the performance benefit of indexing.[95]

These are strong points, but not strong enough to wipe lack of sophistication out of the description. Business people do react differently to cash and scrip; EPS matters a lot in the boardroom in part because it matters a lot noise traders in the markets. (Of course, EPS also matters to the pocketbooks of many executives whose cash bonus schemes reward EPS increases.) In addition, there is nothing new about management using options to write scrip for itself, thereby exploiting a lack of appreciation for long-term economic costs in the form of dilution. Delaware amended its corporate code to facilitate the practice in the late 1920s. In those days exploitation came when warrants were distributed to insiders in connection with new equity offerings.[96] But the economics differ not at all from those underlying stock option compensation. The persistence of the practice suggests that a boardroom seminar on basic financial economics would fall short as a cure. For whatever reason, the economic costs of equity kickers are not perceived as equivalent to those of cash payments.

But admitting lack of sophistication into the picture detracts from a power explanation only if we define power narrowly as the authority to direct the actions of others – the power possessed by a sovereign or a military superior. If we relax the definition slightly and describe power in terms of a position to exploit others economically, persistent lack of sophistication fits neatly into the description. The unequal bargaining power described in contract law is power in this lesser mode. It is also the mode of empowerment referenced by Bebchuk and Fried. In the end, then, Bebchuk and Fried are quite right when they point out that lack of sophistication and accounting concerns dovetail with their management power explanation. A unitary account emerges.

Now that GAAP requires the expensing of option costs we will get a real world test of these explanations. Bebchuk and Fried would predict no general move to indexing. I join them, and suspect that Murphy and Jensen would make the same prediction.

C. Normative and Political Environment

Just as management power is hard to prove, so is its presence is hard to deny. Bebchuk

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[94]BEBCHUK & FRIED, *supra* note 2, at 76-78. I fully accept (2) through (4). I am less sure about (1): Given the firms' tendency to herd around focal point practices, I suspect that ignorance could prevail without diversity in the practice.

[95]*Id*. at 147-48.

[96]See Bratton & McCahery, *supra* note __, at 19.

and Fried's interlocutors have by now conceded it a place in the description.[97] The dispute goes to its normative implications, and that debate quickly expands to cover the governance system as a whole. Here is the question: To what extent does the system succeed or fail in cost effectively channeling the energy of empowered managers to productive ends that serve the shareholder interest? To answer the question is to make a judgment call.

Bebchuk and Fried's interlocutors stress the bright side. Here a prominent contribution comes from Bengt Holmstrom and Steven Kaplan. They concede that some managers take excessive rewards, that equity compensation is more liquid than shareholders would want, and that perverse incentives have cropped up in the form of accounting manipulation.[98] But they take a broad view, contending that shareholders should overall be pleased with the way things have gone in the last decade and a half. Returns, measured net of the cost of executive compensation, have been generally higher since the switch to option-based compensation. And the shift did succeed in aligning management interests with those of the shareholders to a greater extent than in the past. Meanwhile, from 1992 to 2000, growth of gross domestic product in the U.S. was higher than in any of Italy, France, Britain, Germany or Japan. Finally, problems with executive compensation post 2000 mainly concern a few cases of abuse, and any breakdowns due to the strain of the 1990s boom market have been addressed quickly.[99] Core, Guay and Thomas, second this view. They note that cases where high pay and poor performance coincide can be identified statistically and dealt with accordingly. The existence of bad apples, they argue, does not compel the conclusion that the whole economy suffers from governance problems.[100]

Murphy, variously writing with Brain Hall and Michael Jensen, also follows this line of reasoning, pointing to governance improvements initiated in the 1990s – boards became smaller and more independent, shareholders became more vigilant, compensation committees became the norm, and federal disclosure regulations required greater transparency than ever before.[101] Shareholders apparently welcomed the shift to option compensation as they enjoyed the bull market of the 1990s. In contrast, a much smaller net pay increase to management during the 1980s triggered a populist backlash, due to the association of high salaries with layoffs, plant closings, and downsizing.[102] For Murphy, outrage is more notable for its absence than for a

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[97]See Hall & Murphy 2003, *supra* note __, at 27-28 (reporting sympathy with the view that pay decisions are not made by truly independent boards, but contending that rent extraction is not a compelling explanation); Holmstrom & Kaplan, *supra* note __, at 13 (agreeing that the biggest payees use positions of power to command excessive awards); Jensen & Murphy 2004, *supra* note __, at 54 (recommending changes in structural and psychological environment and noting that "changes in practices will require a major change in the power relationship between the board and the CEO"); Core, *et al.*, *supra* note __, at 30 (agreeing that pay structures reflect power and a positive correlation between power and pay).

[98]Holmstrom & Kaplan, *supra* note –, at 3-4, 12-14.

[99]*Id*. at 3-4.

[100]Core et al., *supra* note __, at 38-39.

[101]Hall & Murphy 2003, *supra* note __, at 27-28.

[102]Murphy, *supra* note __, at 1. Jensen & Murphy 2004, *supra* note __, at 1 point out the resurgence of outrage directed to the amount of pay in connection with recent scandals. They are

limiting role in respect of current practices.[103]

Bebchuk and Fried do not deny any of this. But they are not impressed by apparent shareholder acquiescence. Outrage costs, they contend, do not register in respect of equity based compensation because it is based on a sound basic idea.[104] In any event, investors do not find excessive or distorted pay arrangements bothersome during bull markets. Meanwhile, taking management rent seeking together with the business world's tendency to follow a norm of conformity, movement toward a more shareholder responsive equilibrium can be expected to be sticky.[105] Their very purpose is to destabilize the equilibrium so as so to jump start the process of change.

This is a debate over the most appropriate normative inferences to be drawn from a commonly held positive account. There is no objective way to resolve it. What is worth noting is its institutional posture. Bebchuk and Fried, the law professors, come forth as the pit bull monitors of boardroom practice, relentlessly making the case for shareholder value. Murphy and the other economists make the apology, taking a circumspect approach to criticism of boards even as they share the shareholder value norm. How should we account for the contrast?

Fear of regulation probably has something to do with this law-business split. Jensen and Murphy suggested in their famous paper of 1990 that political forces had led to performance insensitive pay structures. The upper tail of distribution of rewards trailed off because employees, labor unions, consumer groups, Congress, and the media, all well-informed due to mandatory public disclosure, combined in the political milieu to constrain the effectiveness of boards.[106] Writing in 2004, Jensen and Murphy recall in detail the populist outburst of the early 1990s, mentioning not only legislation enacted at the time but an initiative that died in the House, a bill disallowing a corporate tax deduction for any compensation exceeding that of the lowest paid worker by a factor of 25.[107] Murphy, looking back on the period, has noted an overlap between academic and populist attacks on pay – the academics, then as now, wanted performance sensitivity and did not worry about level of pay; the populists, who care only about the level, mimic the performance sensitivity critique as a means to the end of an executive pay cap.[108] One gets a sense that the specter of populist intervention remains in the minds of those who resist Bebchuk and Fried's reform initiative: Reform talk rouses populism and populism means deadweight costs as it lowers both pay levels and pay to performance sensitivity.[109]

The impact of politics, the force of populism, and the likelihood of constraining

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impressed by the negative publicity attracted by the Jack Welsh and Richard Grasso retirement packages, noting that nobody questioned the quality of the performance of either.

[103]Murphy, *supra* note __, at 855-56.

[104]BEBCHUK & FRIED, *supra* note 2, at 145.

[105]*Id*. at 72, 74-76.

[106]Jensen & Murphy 1990, *supra* note __, at 37.

[107]Jensen & Murphy 2004, *supra* note __, at 30.

[108]Murphy, *supra* note __, at 22.

[109]*Cf. id*. at 51.

legislation all resemble power – they are unobservable and difficult to gauge. But general agreement can be expected on the proposition that the likelihood of political intervention increases with the level of outrage over management misbehavior. Thus does the absence of outrage over recent pay practice, emphasized by Bebchuk and Fried's opponents, come back to suggest that the populist threat is easily overstated at this moment in history. Shareholder capitalism is a public as well as private phenomenon. Median voter demands have moved away from early and mid twentieth century populist concerns like corporate bigness and labor relations. The politics triggered by the Enron scandal show that national political demands tend to be driven by shareholder value. We indeed have seen a recent spate of popular outrage, but it was triggered by reporting breakdowns. Today's populist agenda concerns compliance with laws designed to assure accurate market prices. Unlike the outrage of ten years earlier, it only indirectly implicated executive pay. Incentive compensation came into question because it contributed to short term focus on the stock price and reporting failures, not because it implicated a wealth transfer from working people. The legislative response was to build in more shareholder responsiveness by strengthening the committee system and extending shareholder ratification requirements.[110] Only two sections of the Sarbanes-Oxley Act clamp down on pay – the prohibition of loans to executives and the disgorgement of incentive compensation triggered by accounting restatements.[111] Neither inhibits the level of pay. And, in any event, the surge of neo-populist political energy has abated. Management is returning to its accustomed place of political influence in Washington.[112] Those who take shareholder value really seriously should shake off this refractory fear of populist hordes and get with the program.

III
RETRENCHMENT

Everyone agrees that slack in the governance system lengthens during bull markets. When the stock price goes up, few investors question generous pay deals. Contrariwise, market reverses trigger heightened scrutiny of governance practices, and not just in the financial community. Scrutiny becomes especially exacting when market reverses and well-publicized cases of executive noncompliance with law coincide in time. But when the market recovers and memories of scandal fade, management regains political influence and good governance loses its place on the political agenda.

And so it has been with executive pay in recent years. Some significant adjustments have crept into the financial economic defense in the prevailing critical environment, at least as presented by Professor Murphy in a 2004 paper co-written with Michael Jensen. At the same

[110]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204,§§ 202(i)(1)(A), 204 (requiring audit committee approval and reports to audit committee); New York Stock Exchange Manual, §§ 303A.05, 303A.8 (requiring independent compensation committee and shareholder ratification of all equity compensation plans).

[111]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204,§§ 304, 402(a).

[112]See Kurt Eichenwald, Reform Effort at Businesses Feels Pressure, NY Times, Jan 14, 2005, at A1, C2 (describing changes in the political environment).

time, the political environment after the election of 2004 looks more friendly to management. Negative implications follow for Bebchuk and Fried's reform agenda.

A. Jensen and Murphy and the Normative Cycle

Murphy has long been a critic of the boardroom negotiating environment, even as he has defended it against Bebchuk and Fried. He has acknowledged that CEOs exercise influence over the pay setting process, pointing out that recommendations emanate from the firm's human resources department (working in tandem with outside consultants), and pass through a management approval stage before going on to the board.[113] Murphy has sharply criticized the survey evidence presented to justify pay increases, pointing out the ratchet effect of pay increases across given industries and the narrow compass of criteria referenced in the determination of levels of pay.[114] Despite these criticisms, Murphy made no concessions on the bottom line question of legitimacy, at least prior to 2004. Although compensation committees err on the high side and always defer to management given the choice of a sensible plan and a slightly inferior plan favored by the CEO, he rejected the "cynical scenario" of an entrenched committee rubber stamping increasingly lucrative packages.[115] For Murphy, the approving directors were "keenly aware of the conflicts of interest between managers and shareholders over the level of pay," and management influence did not mean a corrupt process or systemic failure.[116] Even though decisions were not made at arm's length by truly independent boards, rent extraction did not afford a compelling explanation for the practice.[117]

Writing with Jensen in 2004, Murphy describes the same process infirmities and continues to stress the good faith of compensation committee members.[118] But negative characterizations have crept into the normative bottom line: "the governance system itself is corrupted and tilted in the direction of management in a way that will almost inevitably lead to excesses in executive pay levels;"[119] the very structure of the evaluation and pay setting process needs change.[120] Lucrative termination agreements earn Jensen and Murphy's strongest condemnation – these are so "extreme" and "abusive" as to "call into question the integrity of important parts of the remuneration process."[121] Jensen and Murphy also are highly critical of the expertise and negotiating skills of compensation committees, which are seen as particularly likely to give away the store when hiring new outside executives. It seems that skilled professional negotiators represent incoming CEOs and run rings around the hiring company, which of course pays the negotiator's fee. Jensen and Murphy recommend that boards refuse to

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[113]Murphy 1998, *supra* note __, at 24.
[114]*Id.* at 9.
[115]*Id*. at 25.
[116]*Id.* at 24.
[117]Hall & Murphy 2001, *supra* note __, at 27-28.
[118]Jensen & Murphy 2004, *supra* note __, at 50.
[119]*Id*. at 51.
[120]*Id*. at 54.
[121]*Id*. at 29.

pay the fee and hire their own professional contracting agents.[122] But nothing is conceded to Bebchuk and Fried in terms: Jensen and Murphy insist that "poor negotiating expertise" provides a better explanation than board captivity.[123]

Shifts in Murphy's views also can be noted on the crucial matter of stock option design. Some years ago, Murphy viewed prevailing stock option practice favorably when compared to alternatives importing greater performance sensitivity. Overall evidence, he said, supported the basic hypothesis that equity incentives were important drivers of management performance. But little evidence supported the proposition that more aggressive performance based plans would enhance expected shareholder returns.[124] Indexing by itself was not a Pareto improvement because the increased risk had to be compensated with an increased payoff to the executive.[125] The recent Jensen and Murphy paper, in contrast, strongly advocates indexing, backing a formula tied to the firm's cost of equity capital net of the dividend yield.[126] Jensen and Murphy also now support restraints on alienation, calling for ongoing monitoring of executives' portfolios and a ban on the hedging of risk in the capital markets.[127] They also concede the danger of insider trading, endorsing Fried's suggestion of pre-trading disclosure.[128]

We see a similar shift on the restricted stock alternative. Murphy formerly made a counterfactual projection favorable to restricted stock: If executives and firms were left free to bargain in a space undistorted by the accounting and tax regimes, then restricted stock would replace stock options.[129] Restricted stock better addressed executives' risk aversion; it imported more stable incentives, holding out gain on both the upside and the downside; and it held out no perverse incentives for investment policy.[130] Now, writing with Jensen, Murphy denounces restricted stock as a give away, citing the same problem noted by Bebchuk and Fried.[131] For Jensen and Murphy the cure lies in making sure that the executive really does make a trade off rather than receiving equity compensation as a free add on to cash salary. Thus, salary and bonus payments should be formally exchanged for options or restricted stock.[132] Bebchuk and Fried would not disagree.

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[122]*Id*. at 52. The most successful agent is a gentleman named Joseph Bachelder. *Id*. Jensen and Murphy also recommend that the firm hire different compensation consultants for to assist with lower level employee and top team compensation. *Id*. at 56.

[123]*Id*. at 53-54.

[124]Murphy 1998, *supra* note __, at 44.

[125]Hall & Murphy 2001, *supra* note __, at 17-18. They predicted that if GAAP were changed so that indexed options were not punished, they would only appear in tandem with below market exercise prices. *Id*.

[126]Jensen & Murphy 2004, *supra* note __, at 61-63.

[127]*Id*.at 66-67.

[128]*Id*. at 68.

[129]Hall & Murphy 2001, *supra* note __, at 24.

[130]*Id*. at 19.

[131]Jensen & Murphy 2004, *supra* note __, at 58. Jensen and Murphy also denounce the design of bonus plans. *Id*. at 69-73.

[132]*Id*. at 59.

Jensen and Murphy do stick with Murphy's earlier information-based characterization of the problem, even as they dial up the criticism of the practice and acknowledge management influence. They avoid using the term "rent" and at the bottom line attribute the mess to lack of bargaining expertise and information. Jensen and Murphy underscore this position at the prescriptive level: Since the problem results from technical deficiencies, enhanced board independence will not, by itself, import a solution.[133]

One gets the point. But a question arises: How, absent enhanced independence, can we expect boards to be sufficiently motivated to invest in the expertise and information necessary to solve the problem? If the economics of corporate governance teach us anything, it is that agency problems will not be solved unless actors have an incentive to do so. Here the necessary technologies are there on the shelf and the compensation consulting firms would be happy to sell them. There is no supply side problem. What is missing is demand, and nothing provides a more cogent explanation for its absence than the Berle and Means separation of ownership and control. We can select from a whole palette of terms in filling in the description – influence, dominance, imbalance, tilt, skew, agency cost, and, yes, power.

B. Bebchuk and Fried and the Political Cycle

Bebchuk and Fried offer a menu of governance improvements. Some of these would tweak the present system so as to make it more likely that the shareholder voice registers inside boardrooms. For example, transparency could be enhanced – all compensation should be reported with a dollar value attached; executive stock sales could be directly reported by the company.[134] In addition, the shareholder vote could be made more meaningful, with separate votes on different segments of compensation plans giving shareholders the opportunity to pinpoint objectionable provisions.[135] Other proposals on the menu are more radical and would empower the shareholders, fundamentally changing the system. For example, binding shareholder initiatives on compensation could be permitted.[136] More than that, the board could lose its legally vested agenda control over important corporate legislation so that shareholders could remove entrenching provisions.[137] Finally, shareholders could have access to the ballot on terms broader than those recently proposed by the Securities and Exchange Commission.[138]

The costs and benefits of shareholder empowerment measures are being debated elsewhere.[139] Here let it only be noted that today political feasibility presents a more

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[133]*Id*.
[134]BEBCHUK & FRIED, *supra* note 2, at 192-94.
[135]*Id.* at 197.
[136]*Id*. at 198.
[137]*Id*. at 211-12.
[138]*Id*. at 210.
[139]For Bebchuk's intervention, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*,118 HARV. L. REV. 833 (2005). For a review of the book that focuses

monumental stumbling block than it did only two years ago. The post Enron political climate has faded and management influence again registers.[140] Just as corporate directors lack incentives to appreciate the opportunity costs when they pay employees in equity scrip, so, absent the shock of scandal and losses lying in plain public view, do politicians lack incentives to appreciate the opportunity costs of poor governance institutions. *Pay without Performance*, appears late in the reform cycle. The book already has jolted actors at the SEC into rethinking their disclosure mandates toward the end of stripping the camouflage.[141] Disclosure reform still may have a reasonable chance of success. But the more radical proposals on the menu look more visionary every day. Thus does the separation of ownership and control return at the end of the discussion not only to help us diagnose the problem but to explain why it remains unsolved.

CONCLUSION

Just as Bebchuk and Fried make no attempt to deny the presence of the factors emphasized by their interlocutors, so have the interlocutors moderated their objections. Jensen and Murphy, in their recent writing, go so far as to note that their account is consistent with that of Bebchuk and Fried. They only object that Bebchuk and Fried's account is "somewhat overstated" because it does not explain why stock options exploded in the 1990s.[142] But an explanation can be offered. As all agree, an historical shift toward shareholder responsiveness occurred in the wake of the takeover wars of the 1980s, due in not small part to the influence of writers like Jensen and Murphy. Management incorporated shareholder value maximization into its own job description, pursuing voluntarily matters like unbundling and cost reduction once forcibly imposed by the market for corporate control. But the normative shift to shareholder capitalism occurred within familiar and comfortable precincts. Management retained considerable boardroom influence and took the occasion to extract a substantial raise, a raise that would not have been forthcoming to a party lacking bargaining power. To take the shareholder value norm seriously is to recommend reform.

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critically on the shareholder empowerment proposals, see Stephen M. Bainbridge, *Executive Compensation: Who Decides?* 83 TEX. L. REV. ___ (forthcoming 2005).

[140]See, e.g., William H. Donaldson, *U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers*, Jan. 25, 2005, http://www.sec.gov/news/speech/spch012505whd.htm (signaling relaxation of Sarabanes-Oxley requirements on foreign isssuers); Roel C. Campos, *The SEC's Shareholder Access Proposal*, Jan. 10, 2005, http://www.sec.gov/news/speech/spch011005rcc.htm (describing objections to SEC access proposal and terming it a "long shot"); Eichenwald, *supra* note __, at C2.

[141] See Jesse Eisinger, *Follow the CEO's Money*, WALL ST. J., Feb. 16, 2005, at C1 (reporting on comments of William Donaldson and Alan Beller).

[142]Jensen & Murphy 2004, *supra* note __, at 53.