Making directors accountable

FACULTY Q&A *In "Pay without Performance," Professor Lucian Bebchuk argues that the public is paying a high price for the disconnection between executive pay and corporate performance.*

PHIL FARNSWORTH

AFTER A DECADE OF soaring to unprecedented levels, executive compensation is the subject of an intense debate. In their just published "Pay without Performance: The Unfulfilled Promise of Executive Compensation," HLS Professor Lucian Bebchuk LL.M. '80 S.J.D. '84 and UC Berkeley School of Law Professor Jesse Fried '92 explore the causes and consequences of flawed compensation arrangements. Economics Nobel Laureate Joseph Stiglitz predicted that the book, which was recently the focus of a Columbia Law School symposium, "will shape debates on executive compensation and corporate governance for years to come." John Bogle, founder of the mutual funds giant The Vanguard Group, called it "a book that must be read ... by any citizen who cares about our society." Harvard Law Today interviewed Bebchuk about the book and his views on corporate governance reform.

Why did you and Fried write "Pay without Performance"?

We felt that there is still insufficient recognition of the scope and source of flawed compensation arrangements. We wanted to persuade readers that flawed arrangements have not been limited to a few "rotten apples." They have been widespread, persistent and systemic. Furthermore, they have stemmed from structural problems that enable executives to exert considerable influence over their boards. Indeed, studying executive compensation opened a window through which we could identify some basic problems of our corporate governance system. In addition to improving recognition of existing problems, we sought to help solve them. We put forward reforms that could improve both executive compensation and corporate governance more generally.

Lucian Bebchuk

EDUCATION:
University of Haifa B.A. 1977, Mathematics and Economics
University of Tel Aviv LL.B. 1979
Harvard Law School LL.M. 1980, S.J.D. 1984
Harvard University M.A. 1992, Economics, Ph.D. 1993, Economics

APPOINTMENTS:
Assistant Professor of Law, 1985
Professor of Law, 1988
Professor of Law, Economics, and Finance, 1994
William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, 1998
Director, Program on Corporate Governance, 2002

RESEARCH INTERESTS:
Corporate governance
Corporate law
Law and finance
Economic analysis of law

TEACHING (2004-2005):
Law and Finance
Seminar in Law, Economics and Organizations Research

REPRESENTATIVE PUBLICATIONS:
"The Case for Shareholder Access to the Ballot"
"What Matters in Corporate Governance?"
"Executive Compensation as an Agency Problem"
"A New Approach to Corporate Reorganization"

Do you examine the process of setting pay or its outcome?

Both. We show that directors have persistently failed to negotiate at arm's length with the executives they oversee. We identify myriad factors that lead directors to favor executives whose pay they set. And we go on to show how executives' influence on pay setting can explain a wide range of compensation practices and patterns. Executives' influence has led to decoupling of pay from performance. The link between pay and performance is less tight than is commonly recognized. We also show how pay schemes have been designed in ways that camouflage both the amount of compensation and its insensitivity to performance.

> **"Recent reforms, strengthening director independence. . .fall far short of what's necessary."**
> **Lucian Bebchuk**

Do flawed pay arrangements affect shareholders' bottom line?

They do. The amounts at stake are significant even relative to the large market capitalization of public firms. An empirical study I did with Yaniv Grinstein finds that aggregate compensation paid by public firms to their top five executives between 1993 to 2002 was about $250 billion. Aggregate top-five compensation was equal to 10 percent of aggregate corporate earnings from 1998 to 2002, up from 6 percent of aggregate corporate earnings from 1993 to 1997. Thus, if compensation could be cut without weakening managerial incentives, which we argue it could, the gain to investors would not be merely symbolic. It would have real practical significance.

In addition, the excess pay obtained by executives is not the only, and probably not even the primary, cost to shareholders. Executives' influence on pay arrangements has diluted and distorted incentives. These inefficiencies might well be the biggest costs arising from executives' influence on their own pay. Our proposals for eliminating the perverse incentives provided by current pay arrangements, and for tightening the link between pay and managers' own performance, could produce substantial benefits.

How much will recent corporate reforms address past problems?

Even though recent reforms, which strengthen director independence, are beneficial, they fall far short of what's necessary. We show that the new stock exchange listing requirements weaken executives' influence

over directors but do not eliminate it. Moreover, there are limits to what independence can do by itself. Independence does not ensure that directors will have incentives to focus on shareholder interests, nor that directors will be well-selected. Directors must be made not only independent of insiders but also dependent on shareholders. To this end, we should eliminate the arrangements that currently entrench directors and insulate them from shareholders. Such reforms offer the most promising route for improving executive pay and corporate governance.

Do you support the SEC proposal for allowing shareholders to nominate candidates for directors?

I have supported this proposal in a recent Business Lawyer article as well as in hearings the SEC held on the subject last spring. My article put forward evidence that the incidence of electoral challenges to directors has been practically negligible in the past decade. Shareholder power to replace directors is now largely a myth. To make directors more accountable, this power should be turned from a myth into a reality. The SEC proposal is thus a step in the right direction—a mild step that should be supplemented with other changes.

Such as?

It would be desirable to get rid of staggered boards, which most public companies now have, and have all directors up for annual election. Staggered boards provide a powerful protection from removal in either a proxy fight or a hostile takeover. In a recent empirical study, Alma Cohen and I found that staggered boards bring about economically significant reduction in firm value. In a subsequent study with [HLS Professor] Allen Ferrell ['95], we identified that several additional governance provisions that insulate boards from shareholders (such as limits on bylaw amendments) are negatively correlated with firm value.

In addition to making director removal viable, "Pay without Performance" advocates that shareholders be given the power to initiate and adopt charter amendments. I further develop the case for such a change in an article that will come out in the Harvard Law Review this winter. The article provides evidence that using their monopoly power over initiating charter amendments, boards have been avoiding some governance changes that shareholders view as value-maximizing. Allowing shareholders to set governance arrangements would operate over time to improve the whole range of governance arrangements without outside regulatory intervention.

How likely are the changes you advocate to be made?

There are powerful vested interests that would resist any reforms that reduce management insulation and increase shareholder power. Fierce opposition has been mounted even to the mild SEC proposal for limited shareholder power to nominate directors. Clearly, fundamental legal reforms in the allocation of power in public companies will not be possible unless investors and public officials come to fully appreciate how pervasive and costly are the flaws in our corporate governance system. I hope that "Pay without Performance," and the other work I am doing on corporate governance, will help bring about such an understanding. ❋

HLS leads other schools with nine U.S. Supreme Court clerkships

In the U.S. Supreme Court's 2004-05 term, nine of the 35 law clerks to the justices are graduates of Harvard Law School. The HLS contingent is the largest from a single school this year.

The HLS clerks this term are: D. Hein Tran '03, clerking for Justice Ginsburg '56-'58; Michael Scoville '03 and Matthew Stephenson '03, both clerking for Justice Kennedy '61; Tara Kole '03 and William Jay '01, clerking for Justice Scalia '60; Matt Hellman '02 and Daniel Volchok '03, clerking for Justice Souter '66; Mike Gottlieb '03, clerking for Justice Stevens; and Henry Whitaker '03, clerking for Justice Thomas.

"The job requires a clerk to come to grips time and again with the reality that your justice, and sometimes all of the justices, will rely on your recommendation about issues of major significance," said Scoville. "This is exhilarating, because it is a once-in-a-lifetime opportunity. But it is also terrifying, because you've got to get it right."

In recent years, most of the justices have hired four clerks. Chief Justice Rehnquist and Justice Stevens have sometimes hired only three.

The University of Chicago Law School placed the second-highest number of graduates in clerkships this term with seven. Yale Law School has five alumni among this year's clerks.

The last time HLS graduates took nine of the clerkships was in 2002. Harvard also led in 2001, with eight.

Election round up

continued from page 1

Bush nominated Alberto Gonzales '82 to be the next U.S. attorney general, the nation's top law enforcement officer. If confirmed by the Senate, Gonzales will be the 10th Harvard Law graduate to assume that position. He has served as White House counsel for the past four years.

"As a former judge, I know well that some government positions require a special level of trust and integrity," said Gonzales, who previously served as a justice on the Texas Supreme Court. "The American people expect and deserve a Department of Justice guided by the rule of law, and there should be no question regarding the department's commitment to justice for every American. On this principle, there can be no compromise."

AP PHOTO/LAWRENCE JACKSON

White House Counsel Alberto Gonzales '82 is nominated as next U.S. attorney general

Dean Elena Kagan '86 welcomed the success of HLS alumni in government and politics across the political spectrum. "As someone committed to public service, it gives me great pride to know that Harvard Law graduates are succeeding at the highest levels of the federal government," she said. "These alumni will help guide the nation through a time of great legal and political challenges."

Other HLS graduates to serve as attorney general include Janet Reno '63, Elliot Richardson '44 ('47), William F. Smith '42 and Francis Biddle '11. Alumni have also held several other cabinet posts, including defense (Caspar Weinberger '41), state (Dean Acheson '18) and interior (Bruce Babbitt '65).

All 10 of the HLS alumni currently serving in the House who sought re-election won. They are Tom Allen '74 (D-Maine), James Cooper '80 (D-Tenn.), Christopher Cox '76 ('77) (R-Calif.), Artur Davis '93 (D-Ala.), Barney Frank '77 (D-Mass.), Jane Harman '69 (D-Calif.), Sander Levin '57 (D-Mich.), Thomas Petri '65 (R-Wis.), Brad Sherman '79 (D-Calif.) and Adam Schiff '85 (D-Calif.).

One graduate, John Barrow '79 (D-Ga.), defeated an incumbent to win a seat in the House.

Although none was on the ballot in November, four HLS alumni currently serve as governors. They are James Doyle '72 (D-Wis.), Jennifer Granholm '87 (D-Mich.), Mitt Romney '75 (R-Mass.) and Mark Warner '80 (D-Va.). Two weeks after the election, Romney was named vice chairman of the Republican Governors Association.

Another Bush ally, Ken Mehlman '91, will become chairman of the Republican National Committee. Mehlman served as Bush's reelection campaign manager. ❋