Executive Compensation in Contemporary Corporate Governance: Why Pay for Performance is a Flawed Methodology

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In late 2004, law professors Lucian Bebchuk and Jesse Fried released a controversial new work, Pay without Performance: The Unfulfilled Promise of Executive Compensation*. In* Pay without Performance*, Bebchuk and Fried highlight that in recent times there has been a decoupling of pay and performance in the United States, and articulate a "managerial power" thesis to explain this trend.*

In this article, the author outlines the case for why pay for performance is not an "unfulfilled" promise, but rather is no promise at all. The author argues that agency theory, and pay for performance which is based upon agency theory, derives from a narrow, and ultimately false understanding of human motivation and behaviour. Drawing on an extensive range of literature in psychology, management and workplace relations, behavioural law and economics, sociology, philosophy and law, the author explains why the view of agency theorists regarding the importance of remuneration is misguided.

1. Introduction

In November 2004, prominent US law professors Lucian Bebchuk and Jesse Fried released a controversial new work, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*.[1]

As the title suggests, *Pay without Performance* concentrates on a principal area of concern in contemporary corporate governance, being the link between levels of executive compensation and executive and company performance. In this work, Bebchuk and Fried highlight that in recent times there has been a decoupling of pay and performance in the United States, and articulate a "managerial power" thesis to explain this trend.

According to Bebchuk and Fried's managerial power thesis, many contemporary features of executive compensation can best be explained as the result of the CEO (and perhaps other top-level executives) wielding enormous influence over the board of directors- who are ultimately responsible for determining executive pay. Due to this influence, the boards structure compensation arrangements with the interests of the CEO as the primary concern, with shareholder interests relegated to a secondary consideration.

This account of executive compensation arrangements, and corporate governance more generally, departs from the traditional 'arm's-length model' of executive compensation- ie that directors act independently of executives and have shareholder interests primarily in mind when determining executive compensation. The arm's-length model has been long adhered to and relied upon by financial economists and others. Due to executive compensation being influenced by managerial power rather than determined at arm's length by directors acting as stewards for the company, the cost- according to Bebchuk and Fried in their book- is weak incentives to reduce

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[1] Published in 2004 by Harvard University Press.

managerial slack ("shirking"), and perverse incentives for directors to implement compensation arrangements which do not tightly link pay and performance.

The important point to note regarding Bebchuk and Fried's thesis is that the authors are not in fact opposed to high levels of CEO/ top executive remuneration in absolute terms; rather, it is the techniques that companies use (as a result of managerial power) to "camouflage" the fact that executive pay is often unconnected to performance, that is of most concern. Indeed, Bebchuk and Fried note in their book that they would not mind executive compensation being increased even higher than the already extremely high levels experienced if this pay was sufficiently related to performance.

In light of the impact that managerial power is considered to have had on executive compensation, Bebchuk and Fried propose a series of compensation-specific reforms to make executive pay more transparent and more closely aligned to performance, and corporate governance reforms so that directors are made more dependent on shareholders- departing from the recent reform agenda worldwide to make directors as independent as possible.

In this article, I respond to the thesis developed by Bebchuk and Fried. What I wish to make very clear from the outset is that I do not dispute that managerial power is a factor which has led to the decoupling of pay from performance which we now see, nor will I be responding point by point to the arguments and examples used by Bebchuk and Fried in their work (other commentators have engaged in this exercise, with varying degrees of success, already).

What I wish to focus upon in this article is the assumptions which underpin the managerial power thesis, but which are not (I contend) adequately articulated or defended by Bebchuk and Fried in their work. Managerial power is perceived to be a problem due to the rather negative portrait of the typical CEO of a large public company painted by Bebchuk and Fried.

According to Bebchuk and Fried, top executives in the modern company cannot be trusted- and in the absence of external incentives are naturally inclined to pursue their own self-interest (by way of "shirking" and "rent-seeking"), rather than uphold and defend the interests of the company and its shareholders. That is, executives are best described as agents in the sense understood by financial economists, rather than stewards. Agency theorists have traditionally considered remuneration to be the most effective form of incentive to align the interests of top executives and shareholders. If remuneration is sufficiently linked to the performance of the particular executive and/or the company's performance, then executives will be encouraged to improve performance in order to enjoy higher levels of executive compensation. In stressing the importance of remuneration in this way, agency theorists obviously assume that the best way to motivate executives, and to appeal to their interests, is to "show them the money".

Bebchuk and Fried do not in any way question the emphasis placed upon money by agency theorists, or the "pay for performance" methodology for determining executive compensation. Indeed, even though the gap between pay and performance continues to expand (especially in the United States) due to sophisticated arrangements that have resulted in total remuneration for executives (salary, equity and non-equity components) escalating significantly, Bebchuk and Fried contend that pay for performance is a "promise", albeit "unfulfilled".

In this article, I outline the case for why pay for performance is not an "unfulfilled" promise, but rather is no promise at all. I argue that agency theory, and pay for performance which is based upon agency theory, derives from a narrow, and ultimately false understanding of human motivation and behaviour. Drawing on an extensive range of literature (a great deal of which is cutting edge) in psychology, management and workplace relations, behavioural law and economics, sociology, philosophy and law, I explain why the view of agency theorists regarding the importance of remuneration is misguided. This literature collectively makes it very clear that executives are not principally motivated by money in terms of their relationship with the company, nor is money the best mechanism to appeal to the interests of executives. Wealth maximisation and utility maximisation are not interchangeable concepts.

For executives money is, at most, a means to an end, with that end being personal happiness and doing what is best by the corporation(s) to which they are employed.

On this basis, corporations are best served by recognising and promoting the fact that their interests, and the interests of their various stakeholders, can be fulfilled by fostering the positive virtues and objectives that executives bring to their role, rather than assuming that executives are guided purely by their self-interest, and throwing money at the perceived "problem".

2. Pay For Performance: An Unfulfilled Promise

The dominant methodology used in designing executive compensation in developed economies is pay for performance. As to the predominance of pay for performance, the comments of Michael Quinn are useful:

> [Performed linked remuneration] has been the fastest emerging issue in the composition of director remuneration. It has been viewed as a tool for aligning the interests of directors and shareholders. … In the United States, performance linked remuneration is actively encouraged by institutional investors, the Securities and Exchange Commission (SEC) and taxation laws. A more common occurrence in Australia is the granting of share options and share participation by directors.[2]

It is important to understand that the pay for performance methodology for determining executive pay is based on a certain assumption about the behaviour and motivations of executives in the modern corporation- an assumption derived from agency theory. The best explanation of agency theory comes from the classic work of Jensen and Meckling:

> We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest

> by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.[3]

In Chapter 1, 'The Official Story', of Bebchuk and Fried's book, the authors explain why the pay for performance methodology has emerged from agency theory:

> Economists have long believed that efficient compensation contracts should link pay with performance to provide executives with desirable incentives. Indeed, according to the standard view, the compensation arrangement is an important mechanism for reducing agency costs. And the significance of the agency problem makes it crucial to use this instrument effectively.
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> Directors have neither the time nor the information necessary to monitor all managerial actions to ensure that they benefit shareholders. Given the considerable discretion inherent in a CEO's position, inducing the CEO to focus on shareholder interests and avoid self-serving choices is therefore important. The board can influence the CEO to behave in this manner by designing a compensation arrangement that provides the CEO with an incentive to increase shareholder value. Thus, it is argued, a well-designed compensation scheme can make up for the fact that directors cannot directly monitor or evaluate many of their top executives' decisions. Such a well-designed scheme can substantially reduce agency costs, improve performance, and increase shareholder value.[4]

Similarly, Iman Anabtawi notes that:

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[2] Michael Quinn, *The Unchangeables- Director and Executive Remuneration Disclosure in Australia*, 10 AUSTRALIAN JOURNAL OF CORPORATE LAW 2, 4 (1999).
[3] Michael C Jensen & William H Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 3 (1976).

> Because managers of [large modern] corporations generally own only a small percentage of their companies' stock, they are not forced to bear the full costs of their actions. As a result, managers are likely to trade off the private costs of their actions against the profits that such actions generate at a different level than shareholders would choose. … Because it is impractical to monitor directly the behavior of managers, contracts cannot be entered into with managers that specify fully every action that managers should take. A more practical way for shareholders to control managerial behavior is through incentive contracts. Incentive contracts can condition managers' financial rewards on their creation of value for shareholders by making managers' pay depend on some measure of their performance that shareholders can observe.[5]

A number of commentators have already recognised the strong 'anti-management' sentiment which underpins agency theory. Australian academic Lex Donaldson has written extensively on what he sees as the negative view of management which agency theory puts forward. Donaldson has noted that:

> [A]gency theory … refers to the agents misusing the discretion which has been delegated to them by the principal to benefit the agents themselves while deceitfully harming the interests of the principal. … In organizational applications of agency theory, the principal is the owner while the agent is the manager who controls but does not own the corporation. Agency theory holds that losses to the principal can be stemmed by closely controlling the agent; through monitoring and sanctioning, or through bonding.[6]

In the same work, Donaldson highlights that the pay for performance methodology is very much based on economic assumptions about the need to align the interests of executives and shareholders, and to ensure corporate performance.

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[4] BEBCHUK & FRIED, *supra* note 1, at 19.
[5] IMAN ANABTAWI, 'OVERLOOKED ALTERNATIVES IN THE PAY WITHOUT PERFORMANCE DEBATE', 2005, WORKING PAPER. Available on-line via: <www.ssrn.com>
[6] From LEX DONALDSON, AMERICAN ANTI-MANAGEMENT THEORIES OF ORGANIZATION 3-4 (1995).

> When economists turn to the modern corporation they see a state in miniature with all its attendant problems. The economist's heroic role-model of the small-scale, owner-managed entrepreneurial firm has become a bureaucracy through growth and diffusion of ownership and is staffed by middle managers who blunt the natural direct control of the entrepreneur over labour and capital. … The existence of a managerial hierarchy between labour and top management, and also of professional non-owning top management between the firm and widely diffused owners, are recipes for economic inefficiency, since the owners are no longer the controllers and so incentives are blurred. …Non-owning managers … are a distinct new class with their own interests. …The managers are seen as seeking to minimize their productive efforts, to give the organization and its owners as little as possible and to extract the maximum returns from the organization in pay, perquisites and leisure. … This is the nature of managerial shirk. … *The solution to these problems of shirking managers and their guileful behaviour is to control them more through closer monitoring, stronger incentive systems and bonds …*[7]

Notwithstanding the (sometimes extensive) negative sentiment towards executives that agency theory articulates, Bebchuk and Fried implicitly endorse the theory. Indeed, the managerial power thesis put forward in *Pay without Performance* derives from an acceptance that an 'agency problem' exists in the modern corporation. According to Bebchuk and Fried:

> The dispersed owners of a typical publicly traded company cannot monitor or direct managers' actions, so the executives who exert day-to-day control in such companies often have considerable discretion. In such a situation, ownership and control are separated. Shareholders own the company, but the managers exercise a substantial amount of control over how it is run.
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> The separation of ownership and control creates what financial economists call an "agency relationship": a company's managers act as agents of its shareholders. The principals (the shareholders) cannot directly ensure that the

[7] *Id.* at 180-181 (emphasis added).

> agents (the managers) will always act in the principals' best interests. As a result, the manager-agents, whose interests do not fully overlap those of the shareholder-principals, may deviate from the best course of action for shareholders. This is called the "agency problem". Managers' departures from shareholder-regarding strategies in turn may involve "inefficient" behavior-behavior that reduces the size of the corporate pie. The reductions in aggregate company value caused by such deviations are called "agency costs".[8]

Given the attention that is paid among agency theorists to remuneration as an incentive to align the interests of managers and shareholders, what needs to be made clear and emphasised is that it is assumed that what motivates executives most is money, and that the interests of executives are best served by appealing to the hip pocket of executives.[9] On this latter point, it can therefore be taken that agency theorists equate utility maximisation with wealth maximisation. That 'utility' can be determined by one's level of material wealth- money is an end (utility) rather than a means to an end.

While a negative perspective of executives has been at the forefront of academic commentary in management and economics for some years now, based on a simple assumption that finance and economics are more rigorous and sophisticated disciplines than (say) sociology and psychology, it is increasingly recognised that agency theory is too narrow and too far removed from reality.

3. The Managerial Power Thesis

As has already been noted, in *Pay without Performance* Bebchuk and Fried outline an alternative theory to explain the recent decoupling of executive pay from corporate performance- the managerial power thesis. This section will look more in depth at what this thesis entails, in order to engage in a proper critique of it (and specifically

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[8] BEBCHUK & FRIED, *supra* note 1, at 15-16.

[9] A good source discussing in detail various 'models' of human behaviour (and the importance of these models in understanding how organisations function), including the economic model of agency theory, is Michael C Jensen & William H Meckling, *The Nature of Man*, 7(2) JOURNAL OF APPLIED CORPORATE FINANCE 4 (1994).

the assumptions underlying the thesis) below. What is important to understand, and what will be the subject of critique later on, is that the managerial power thesis does not debase the potential of pay for performance as a pay-setting methodology, or the foundational assumptions upon which it is built (namely agency theory).

Indeed, the Bebchuk-Fried thesis is very much in line with traditional agency theory regarding how to perceive and respond to governance problems arising in the modern corporation. Perhaps the best summary of the points and intricacies of the managerial power thesis is contained in an article in the *University of Chicago Law Review*,[10] published prior to *Pay without Performance*. In that article, Bebchuk and Fried outline their thesis as follows:

> The dominant approach to the study of executive compensation among academics has for some time been what we call the "optimal contracting approach". Under this approach, executive compensation practices in large, publicly traded companies are viewed as designed to minimize the agency costs that exist between senior executives (the agents) and shareholders (the principals). The board is viewed as seeking to maximize shareholder value, with the compensation scheme being designed to serve this objective. …
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> We seek to contrast this optimal contracting approach to the study of executive compensation with an approach that we label "the managerial power approach". Analysis from this perspective focuses on the ability of executives to influence their own compensation schemes. According to the considered approach, compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation. As a result of such deviations from optimal contracting, executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents. More importantly, to camouflage or facilitate the extraction of rents, managerial power can lead to

[10] *See* Lucian 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).

> the use of inefficient pay structures that weaken or distort incentives and that thus, in turn, further reduce shareholder value. …[11]
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> …
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> …this approach can better explain certain significant features of the executive compensation landscape, including ones that have been long regarded as puzzling.
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> Our analysis indicates that managerial power and rent extraction are indeed likely to play a significant role in executive compensation in the United States. At the level of theory, we argue that a realistic analysis of the compensation-setting process indicates that its outcomes are likely to be much influenced by managerial power and by managers' interest in extracting rents. As an empirical matter, we argue that the extensive empirical evidence on executive compensation is consistent with the predictions of the managerial power approach. Indeed, this approach can better explain certain significant features of the executive compensation landscape, including ones that have been long regarded as puzzling.[12]
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> …
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> One important building block of the managerial power approach is that of "outrage" costs and constraints. That executives can exert influence on their pay does not imply that there are no constraints on their ability to do so. Although the need for board approval and the presence of market forces cannot be expected to produce compensation arrangements consistent with optimal contracting, they can and commonly do provide some constraints. … The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to improve the arrangement, and the more hesitant mangers will be to propose it in the first instance. …[13]

Bebchuk and Fried then go on to discuss in more detail the implications of 'camouflage' under the managerial power approach to executive compensation.

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[11] *Id.* at 753-5.
[12] *Id.*
[13] *Id.* at 756.

> The potential significance of outrage costs explains the importance of "camouflage", yet another building block of the managerial power approach. Because outrage resulting from outsiders' recognition of the presence of rent extraction provides a possible check on managers' power to extract rent, managers have an incentive to obscure and legitimize- or, more generally, to camouflage- their extraction of rents. … This concept of camouflage will turn out to be quite useful in explaining many of the patterns and puzzles provided by the executive compensation landscape.
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> The desire to camouflage might lead to the adoption of inefficient compensation structures that, compared with optimal contracting arrangements, fail to provide desirable incentives, or even supply perverse incentives. In our view, the reduction in shareholder value caused by these inefficiencies, rather than the excess rent captured by managers, might well be the biggest cost arising from the influence of managerial power on compensation practices. Thus, improvement in this area may provide considerable benefits to shareholders from better managerial incentives and performance.[14]

In *Pay without Performance*, once outlining the managerial power thesis that forms the foundation for their book, Bebchuk and Fried set out their views of why directors who are ultimately responsible for setting executive pay, are influenced by 'managerial power'- being the executives whose pay they are setting. According to Bebchuk and Fried:

> A director receives a number of benefits from serving on a board. First, a board seat provides direct financial benefits. In most cases, these benefits are likely to be economically significant to the director. Like executive pay, director pay rose dramatically with the stock market. In 2002, director compensation averaged $152,000 in the largest 200 companies and $116,000 in the largest 1,000 companies. There are often additional perks and indirect benefits; for example, directors of UAL Corp. (which owns United Airlines)

[14] *Id.* at 757.

> can fly United free of charge, and directors of Starwood Hotels get complimentary nights in company hotels. Moreover, a board seat often provides directors with prestige and with valuable business and social connections. The financial and nonfinancial benefits of holding a board seat give directors a strong interest in keeping their positions.
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> …
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> In reality … candidates placed on the company's slate by the board have been virtually assured of being reelected. Dissident shareholders contemplating putting forward their own director slate have confronted substantial obstacles. As a result, the director slate proposed by the company has almost always been the only one on the ballot.
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> …
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> The key to a board position is, therefore, getting one's name on the company slate. And, at least thus far, CEO's have had considerable and sometimes decisive influence over the nomination process. …
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> Even if the CEO had no influence over nominations, fighting with the CEO over the amount or performance sensitivity of compensation might be viewed unfavourably by independent directors on the nominating committee. These directors might prefer to exclude an individual whose poor relationship with the CEO undermines board collegiality. They might also wish to avoid the friction and unpleasantness likely to accompany disputes over the CEO's compensation.[15]

Later on in the book, Bebchuk and Fried recognise that there are social and psychological factors (namely friendship and loyalty, collegiality and team spirit, authority and cognitive dissonance) which encourage directors to go along with compensation arrangements that favour the company's CEO and other senior executives. They state:

[15] BEBCHUK & FRIED, *supra* note 1, 25-7.

> These social and psychological factors reinforce the economic incentives to favour executives and can also affect directors who are not significantly influenced by such economic incentives.[16]

It is important to make clear that Bebchuk and Fried's managerial power thesis is a significant departure from the arm's-length bargaining theory (also described as the 'optimal contracting approach') upon which executive compensation has traditionally been discussed. In their book, Bebchuk and Fried do not support the arm's-length bargaining theory. According to Bebchuk and Fried:

> Managers, like most people, generally prefer to have more money rather than less, so we can expect executives to use their power to obtain higher pay than they would receive under arm's-length contracting. It is important to recognize, however, that compensation arrangements may also favour managers in other ways. For a given amount of compensation, managers prefer to bear less risk and feel less pressure to generate shareholder value. Managers wish to enjoy as much slack as possible. A primary objective of efficient compensation arrangements is to reduce slack, that is, to discourage managers from pursuing strategies, such as corporate empire building, that serve their interests but not shareholders' interests. When they can get away with it, managers like to have their cake and eat it, too; they prefer to receive a given amount of monetary compensation without cutting managerial slack.
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> …
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> Given a certain amount of expected compensation, managers would prefer to have that compensation decoupled from performance.
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> …
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> The more their compensation depends upon their performance, the more risk managers must bear, the more effort they must exert, and the more they must forgo self-serving strategies such as empire building.[17]

In the following two sections of this article, I outline the case for why the managerial power thesis is flawed. I contend that two of the key assumptions underlying Bebchuk

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[16] *Id.* at 31.
[17] *Id.* at 62-3.

and Fried's thesis, that executives are principally motivated by money and that the best way to please executives is via the hip pocket, are incorrect. I use a broad range of literature, from a variety of disciplines, to support my contention.

4. Naturally Motivated Executives: The Real Story

As has been discussed, agency theorists contend that there is a necessary divergence between the interests of executives and the company, and that some form of external incentive is needed to achieve a divergence of interests. In venturing outside the terrains of agency theory, there is a rich source of literature, from diverse range of disciplines, which suggests the opposite.

This section draws upon this literature to paint a more favourable- indeed positive- picture of executives in terms of their relationship with the corporation. What we will see is that there is indeed hope for a positive approach to corporate governance based on real human feelings and desires. This, of course, departs somewhat significantly from the gloomy picture which agency theory presents, a theory which has justified the continued- yet fundamentally flawed- existence of the pay for performance methodology for executive compensation.

4.1 Job Satisfaction and 'Calling'

In his book *Authentic Happiness*, University of Pennsylvania psychology professor Martin Seligman notes that there has been a progressive change from money to job satisfaction as the predominant motivator at work.[18] Professor Seligman refers to big New York law firms as an example- where there is now a much greater focus on retaining, rather than recruiting, young associates, despite the mega bucks offered at these firms.

Seligman refers to management literature on work orientation and 'callings' to dispel the commonly held view that employees- particularly high-level employees like top executives- are motivated predominantly by their level of income. According to

[18] MARTIN SELIGMAN, AUTHENTIC HAPPINESS 10 (2002).

Seligman, as a person becomes more senior in the company, money becomes less of an emphasis. According to Seligman:

> Scholars distinguish three kinds of "work orientation": a job, a career and a calling. You do a job for a paycheck at the end of the week. You do not seek other rewards from it. It is just a means to another end. … A career entails a deeper personal investment in work. You mark your achievement through money, but also through achievement. Each promotion brings you higher prestige and more power … as well as a raise. … A calling (or vocation) is a passionate commitment to work for its own sake. Individuals with a calling see their work as contributing to the greater good, to something larger than they are. …[19]

Seligman goes on to discuss how it is possible to "recraft" work so that it becomes a calling. 'Callings' require service to the greater good in addition to passionate commitment. He gives the example of the kitchen worker to emphasise his point:

> More and more restaurant cooks have transformed their identity from preparers of food to culinary artists. These chefs try to make the food as beautiful as possible.[20]
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> …
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> If you can find a way to use your signature strengths at work often, and you also see your work as contributing to the greater good, you have a calling. Your job is transformed from a burdensome means into a gratification. The best understood aspect of happiness during the workday is having flow-feeling completely at home within yourself when you work.[21]
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> …
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> In an economy of surplus and little unemployment, what job a qualified person chooses will depend increasingly on how much flow they engage at work, and less on small (or even sizeable) differences in pay.[22]

[19] *Id*, at 168.
[20] *Id.* at 171.
[21] *Id.* at 173.
[22] *Id.* at 176.

No doubt due to the time and effort spent climbing the corporate ladder to get to the 'top' executive positions in the organisation (particularly in large companies), and the money and security which has accrued along the way by having the top of the ladder as one's goal, most individuals in these top executive positions would consider their job to be a 'calling'. This would mean that money is not the primary motivating factor in performing the position.

Indeed, getting to the top of the corporate tree requires a certain personality- one that is to not only willing to put in the time and effort to get there, but also to be chosen by the board as someone capable and desired to perform the role. A person driven entirely by financial objectives, without this deeper sense of capability and willingness, would very really get to the top position in contemporary times- merit seems to be more highly valued than pedigree and 'old school ties'. According to Jeremy J Fox in his book, *How to Become a CEO: The Rules for Rising to the Top of any Organization* (1998), vision, persistence, integrity and respect for superiors, subordinates and peers is what is required of the modern day CEO. The board and shareholders would be able to see through *homo economicus* (someone that fits the rational actor model in agency theory). Furthermore, according to Fox most people want to become a CEO or top executive in order to grow professionally and to make a difference to the organization- no reference is made to the pay packet as a significant motivating force.

4.2 Motivations Other Than Money and Pure Self-interest

Contrary to the central argument of agency theorists that remuneration is needed as an incentive to motivate executives and align executive and company interests, an extensive amount of literature refers to other factors which work to motivate company executives. For example, in his recent *Wall Street Journal* article 'Nice Work If You Can Get It', Tyler Cowen suggests that:

> …[A]djusting pay may not be the way out of this problem. 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). In any case there is little evidence, as the economist Kevin Murphy has noted, that CEO's perform

> better even when their pay is closely tied to earnings or other corporate-performance measures.[23]

Donaldson has also suggested that there are factors which motivate executives other than money:

> Within the category of rational behaviour some behaviour is motivated by orientation, not to ends, but to means. … People working within the corporation may suspend their own personal interests or preferences and act to the conscious detriment of their self-interest out of loyalty to the organization, belief in the moral rightness of its aims or deference to the legitimate authority of those who give them orders. … There are many causes of human behaviour in addition to rational calculated self-interest. Like economics itself, organizational economics largely ignores these other causes of human behaviour and constructs its theories on a very narrow base.[24]

According to Deci, there are in fact two kinds of motivation- *extrinsic* and *intrinsic*. Extrinsic motivation relates to what is done by others to motivate employees- for example, paying them a performance-related bonus. Intrinsic motivations, on the other hand, relate not only to outside influences but also to the individual employee- derived from an individual's satisfaction in doing the job.[25] More specifically, Gavin J Nicholson and Geoffrey C Kiel refer to two forms of motivations operating in a corporate context: self-interested decisions and company-regarding decisions.[26]

In fact, this categorization of motives is not new. In a classic paper, 'A Theory of Human Motivation',[27] Maslow explains that motivation can be discussed in terms of a hierarchy of needs. Maslow suggests that we first need to satisfy our physiological needs then, in order, love needs, esteem needs (self-esteem and the esteem of others), and self-actualisation. As Bender has written:

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[23] THE WALL STREET JOURNAL, 23 December 2004, D8.
[24] DONALDSON, *supra* note 6, at 173.
[25] *See* E Deci, *The Effects of Contingent and Non-contingent Rewards and Controls on Intrinsic Motivation*, 8 ORGANIZATIONAL BEHAVIOR AND HUMAN PERFORMANCE 217-229 (1972).
[26] *See* GAVIN J NICHOLSON & GEOFFREY C KIEL, 'MOTIVATED ACTORS: AGENCY COSTS AND BURKEAN ACTS', WORKING PAPER, 2004. *Available* on-line at: <www.ssrn.com>
[27] A H Maslow, A THEORY OF HUMAN MOTIVATION, IN MANAGEMENT AND MOTIVATION 27-41 (V H Vroom & E L Deci, eds., 1970).

> [According to Maslow] a satisfied need is not a motivator of behaviour. For senior executives it seems unlikely that the sums of money being paid are necessary to meet the lower level needs, and there must be a supposition that a main function of the reward is to meet the executive's needs for self esteem and recognition.[28]

Bender also refers to so-called 'equity theory' in the motivation literature, and its relevance when looking at why pay for performance is the predominant pay-setting methodology.

> Equity theory … relates to equity between individuals, or, perhaps more correctly, inequity between individuals. It suggests that employees look to a relevant comparator other (for example, someone on the same grade within the company, or someone doing a similar job in a different company) and compare the ratio of their inputs (how hard they work) and outputs (what they get paid) with that relevant other's. If the ratio indicates that their input/output ratio is too high (which would occur if they were relatively underpaid) or too low (overpaid) then they will act to redress the inequity. The relevance of this to the research is that an equity theory explanation would place the emphasis of performance-related pay on a comparison with others, both internally and externally, rather than just considering the absolute monetary incentive.[29]

Bender goes on:

> It is a basic assumption of agency theory that paying individuals to achieve results will motivate them to work harder and result in better outcomes for the organisation. However, when this point was put to the interviewees [participants in the pay-setting process] their responses were mixed. Several took the view that pay did indeed motivate performance, whilst others argued that it did not.[30]

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[28] Ruth Bender, *Why Do Companies Use Performance-Related Pay for their Executive Directors?*, 12 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 521, 523 (2004).
[29] *Id.* at 522-3.
[30] *Id.* at 524-5 [my interpolation].

After interviews with a number of executives, HR directors and HR consultants, Bender goes on to state:

> I have demonstrated how these tenets are perceived by the individuals directly involved, and shown that companies adopt performance-related pay despite a widespread belief that *it does not necessarily motivate executives*.[31]

In *Intrinsic Motivation at Work: Building Energy and Commitment* (2002), Kenneth W Thomas discusses the concept of "new work"- the importance of introducing a feeling of purpose and self-management in the workplace, rather than work being considered in the strict scientific sense of being a means to an end- that end being wealth. According to Thomas, there are four "intrinsic rewards" that make work compelling, and thus motivates employees: (1) a sense of meaningfulness; (2) a sense of choice; (3) a sense of competence or quality; and (4) a sense of progress. Money does not rate a mention.

The discussion above on job satisfaction and motivation is also reflected in stewardship theory, which is specifically applicable to managers and top-level executives. Stewardship theory also departs from strict economic thinking on motivation and the relationship between executives and the corporation, and on this basis is raised as an alternative to agency theory.

Davis, Schoorman and Donaldson have provided the following useful explanation of stewardship theory:

> Stewardship theory has been introduced as a means of defining relationships based upon other behavioral premises … Stewardship theory defines situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals.[32]
>
> …

[31] *Id*. at 531.
[32] James H Davis, F David Schoorman & Lex Donaldson, *Towards a Stewardship Theory of Management*, 22 ACADEMY OF MANAGEMENT REVIEW 20, 21 (1997).

> The major distinction between agency and stewardship theories is the focus on extrinsic versus intrinsic motivation. In agency theory, the focus is on extrinsic rewards: tangible, exchangeable commodities that have a measurable "market" value. These extrinsic rewards form the basis for the reward systems that represent the control mechanisms of agency theory. … In contrast, in stewardship theory, the focus is on intrinsic rewards that are not easily quantified. These rewards include opportunities for growth, achievement, affiliation and self-actualization. Subordinates in a stewardship relationship are reinforced by these intrinsic, intangible rewards and are motivated to work harder on behalf of the organization.[33]

Thus, at the core of stewardship theory is a 'model of man' directed towards self-actualising behaviour rather than purely economic behaviour (which is the model of man presented and accepted by agency theorists), with the motivation (drawn from psychology and psychological mechanisms) being 'higher order' needs (growth, achievement, self-actualisation) rather than lower order/economic needs. This more humanistic model of 'man' has been explained by stewardship theorists as representing the instinctive desire of humans to grow beyond their current state and reach higher levels of achievement.

Agency theory has been a cornerstone principle in the so-called 'law and economics' movement- applying economic literature and thinking to understand and develop the law. While the economic analysis of law dominated legal scholarship in the United States for many years, it was obvious that there were some limitations with the 'rational actor model' (ie, that individuals are principally motivated by self-interest, with wealth maximization encapsulating that self-interest) of human behaviour which provided the basis for strict law and economics analysis. Even though human beings cannot accurately be described as irrational creatures, nor are we machines—programmed to pursue the most efficient outcome in every possible situation.[34]

In the second half of the 1990's a trend slowly emerged of legal scholars seeking information from outside neo-classical economics to better understand how human

[33] *Id.*, at 27-8.
[34] *See* for example the collection of papers in CHOICES, VALUES AND FRAMES (Daniel Kahneman & Amos Tversky, eds., 2000).

beings *truly* behave.[35] Studies in other fields, primarily behavioural economics, had shown that rather than being rational self-actors at all times, people are frequently unselfish. So began the 'behavioural law and economics movement', or what is often referred as the 'second synthesis' of law and economics.[36]

Behavioural law and economics also emphasises that corporate participants, and especially directors and top executives, are motivated by factors other than pure wealth maximization. Behavioural law and economics raises similar points about human behaviour and motivation to stewardship theory, but applied in a legal context, rather than being confined to management literature as has been the case to date with stewardship theory.

Behavioural analysis of the law is increasingly standing on its own as a field of inquiry outside of law and economics scholarship. Legal scholars now feel confident enough to apply findings on human and social cognitive and emotional biases, which are central to behavioural analysis, without framing the analysis in strict economic terms. Corporate law scholars have applied understandings about real, personal human traits such as trust and sensitivity to dismantle the self-interested actor model of the individual.[37]

Professor Lynn Stout, together with Margaret Blair, have been particularly prominent in exploring the implications of research into trust and trustworthiness for corporate law and governance. Both have explored and analysed important empirical evidence derived from social dilemma games including the prisoner's dilemma[38] (based in

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[35] *See* Christine Jollis, Cass R Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1471 (1998)

[36] *See* generally BEHAVIORAL LAW & ECONOMICS (Cass R Sunstein, ed., 2000).

[37] *See* Margaret Blair & Lynn Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001). *See also* Brian Cheffins, *Trust, Loyalty and Cooperation in the Business Community: Is Regulation Required?*, in THE REALM OF COMPANY LAW 53 (Barry AK Rider, ed., 1998), for a discussion on the place of trust and cooperation in corporate law, and the issues that this raises.

[38] The prisoner's dilemma is defined as a 'situation in which the noncooperative pursuit of self-interest by two parties makes them both worse off' (*see* <http://www.wwnorton.com/college/econ/stiglitz/glossp.htm>). In the prisoner's dilemma, in each game the prisoner has to decide whether to 'cooperate' with an opponent, or otherwise defect. The prisoner and the opponent must make a choice, and then their decisions are revealed. The prisoner's dilemma demonstrates that the 'rational' choice in each instance is not the one which maximises personal self-interest as neo-classical economists suggest, but rather the one which maximises the collective good of the two or more persons who are each making the decision. In other words, the most rational decision or strategy is the one which promotes cooperation between the participants in the game. Thus, the prisoner's dilemma is studied in a range of different contexts to try and find, and understand, strategies which promote cooperation.
This example demonstrates that it is best to cooperate and confess, instead of choosing to defect by not confessing based on the hope that you won't get caught and will not personally serve time in prison (which would of course be in one's self-interest).
For an explanation of the prisoner's dilemma, *see* A W TUCKER, CONTRIBUTIONS TO THE THEORIES OF GAMES (2001); WILLIAM POUNDSTONE, PRISONER'S DILEMMA (1993).

game theory[39]) which lend support to the proposition that there are many ways in which we- as homo sapiens- act as though we care about the costs borne and the benefits enjoyed by others, as opposed to being driven purely by economic self-interest (*homo economicus*). Consider, for example, the following statement of Professor Stout:

> Extrinsic empirical evidence supports the claim that most people shift freely between self-regarding and other-regarding models of behaviour, depending on their perceptions of social context and relative personal cost. This phenomenon is neither rare nor capricious. To the contrary, it is endemic and predictable. And as a result, it will often be of vital importance to a sound understanding of many phenomena, including norms.[40]

The existence of other-regarding preferences, as well as the importance of the phenomenon of 'trust' and 'trustworthiness' (and the related concept of 'altruism') to corporate law and governance have been emphasised by Stout and Blair in a number of articles.[41] For example, in a collaborative piece, Stout and Blair noted:

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[39] Game theory encompasses an interdisciplinary approach (covering, for example, mathematics, economics, sociology and information technology) to the study of the behaviour of humans. A 'game' in this context is a scientific metaphor for a wide range of human interactions between two, or more than two, persons, such persons possessing opposing (or at least mixed) motives. In constructing these games, game theorists contend that the rational choice of game participants involves maximizing the rewards of the group of decision-makers involved in the game. *See* MORTON DAVIS, GAME THEORY: A NON-TECHNICAL INTRODUCTION (1997), OSKAR MORGENSTERN & JOHN VON NEUMANN, THE THEORY OF GAMES AND ECONOMIC BEHAVIOR (1944).

[40] *See* Lynn A Stout, 'Other-Regarding Preferences and Social Norms', Georgetown Law and Economics Research Paper No. 265902. *Available* on-line at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265902>

[41] In fact, these concepts (trust in particular) are integrated into Stout and Blair's widely-disseminated and accepted 'team production' theory of the corporation: *see* Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). Blair and Stout's team production theory has generated a great deal of interest in academic circles as it challenges the dominant view of shareholder primacy by suggesting that the role of the corporation is not limited to maximising economic returns for shareholders, but rather is intended to resolve team production problems. As a result, neither shareholders nor other stakeholders are the primary concern, rather the corporation and the legal rules regulating corporations treat shareholders and stakeholders as a 'team', each contributing to the corporation in different ways.

Team production, and in particular the problems arising from team production, has been a popular area of research in economic literature for years, and this literature was the source of Blair and Stout's theory of the corporation. According to Blair and Stout, team production problems arise in situations where a productive activity requires the combined investment and coordinated effort of two or more individuals or groups. The problems arise because if the investment of members of this 'team' is firm-specific (meaning difficult to recover once committed to the project), and if output from the enterprise is non-separable (meaning that it is difficult to attribute any particular portion of the joint output to any particular member's output), it becomes very difficult to determine how any 'surpluses' generated by this production should be divided. This is because surpluses invite both 'shirking' (which essentially means free-riding off the efforts of others) and 'rent-seeking' (whereby individuals waste time and money competing for a share of a fixed amount of wealth). Blair and Stout suggest that as trying to prevent these team production problems through the mechanism of explicit contracts is next to impossible, this function can be achieved by the corporation as an 'institutional substitute' for explicit contracts. The structure of the corporation, along with the legal rules regulating the corporation, act as a 'mediating hierarchy' by which team members give up important rights (including property rights over the team's joint input) to the corporation as a separate legal entity. At the top of this hierarchy is the board of directors, whose authority over the use of corporate assets is virtually absolute. For more information on team production theory, one good source is the website: <www.teamproduction.us>

> Economic theory has yielded great insights into the nature of the business form and the role the law plays in shaping it. At the same time, conventional economic analysis has proven inadequate to resolve a number of important debates and questions in corporate law. … Our approach does not reject economic reasoning. It does, however, re-examine one of its standard assumptions: the assumption that people always behave like *homo economicus*. We argue to the contrary that people often behave as if they care about costs and benefits to others. In support of this claim, we review the extensive empirical evidence that has been developed on human behaviour in social dilemma experiments. This evidence demonstrates that most people shift readily from purely self-interested to other-regarding modes of behaviour depending on past experience and social context.[42]

4.3 The Importance of Trust

Recognising that executives can be motivated by factors other than money does not mean sacrificing the financial performance of the company. Indeed, cultivating trust and cooperation in the corporation, by fostering genuine motivation rather than motivation based on external motives, is considered to enhance company performance.

In *Happiness: Lessons from a New Science* (2005), London School of Economics professor Richard Layard points to a number of studies which highlight that trying to stimulate motivation by way of external incentives (eg executive pay and formal sanctions) can actually reduce the internal motivation (ie, the desire to do a good job) that would otherwise have existed. Professor Layard comments that:

> …[W]e have to consider quite seriously the argument that by upping financial incentives, we diminish a person's internal incentives to give of his best and to live up to the name of his profession …

[42] Blair and Stout, above n 32, 1807.

> The professional ethic is a precious motivator that should be cherished. If we do not cultivate it, we may well not even improve performance, let alone produce workers who enjoy their work.[43]

Moreover, in *Making Happy People: The Nature of Happiness and its Origins in Childhood* (2005), Paul Martin refers to empirical data which suggests that cultivating trust produces favourable social and commercial outcomes. According to Martin:

> Experiments … have repeatedly found that most people respond better when they are trusted than when they are treated with suspicion. Trust breeds trust, whereas sanctions that are intended to prevent cheating can actually make people more inclined to cheat, if they think they can get away with it. *Trusting others really does pay dividends*.[44]

Importantly, embracing the internal motivations of executives is likely to cultivate trust within the corporation and make executives feel more trustworthy. Being perceived as trustworthy and worthy of respect, has been shown to enhance the well-being of executives, much more so than a big pay cheque ever could!

That individuals are likely to be happier if they feel that they are trustworthy and are respected is important from a regulatory perspective- at least in terms of shaping the relationship between the company and executives. If corporate governance regulation is structured to foster trust and respect in executives, rather than representing that executives are inherently untrustworthy and thus external incentives (including high rates of executive pay) are needed to align the interests of executives and the company, corporate governance is going to be better attuned to facilitating enhanced well-being for executives (more so than by appealing to their hip pocket through executive pay).

According to Professor Layard in his book, behaving well- that is, being guided by internal motivations and promoting trust and cooperation, can be its own reward.

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[43] RICHARD LAYARD, HAPPINESS: LESSONS FROM A NEW SCIENCE 159 (2005).

> Behaving well can of course make you feel good. Though the philosopher Immanuel Kant believed that doing the right thing should give no pleasure, the MRI scanner [measuring activity in the brain] shows that it does. In one experiment [people were asked to perform a prisoner's dilemma game- where mutual trust and cooperation is the most optimal situation]. … As we have seen, cooperation is risky because the other person may cheat. But when people cooperated in response to previous cooperation by the other player, their brains lit up in the standard areas that light up as a result of a rewarding experience. And this was before they knew whether the other player would play fair at the same time and thus whether they would themselves benefit. *In this sense, virtue was its own reward. So, at least sometimes, our wiring makes us feel better when we behave well.*[45]

In an article by J Rilling, Gutman, Zeh, Pagnoni, Berns and Kilts, 'A Neural Basis for Social Cooperation',[46] the authors examined cooperation based on 'reciprocal altruism' in human species (often examined through the use of the prisoner's dilemma game which acts to model this form of cooperation). In their study, the authors used fMRI to scan 36 women as they played an iterated prisoner's dilemma game with another woman to investigate the neurobiological basis of cooperative social behaviour. According to the authors, mutual cooperation (based on trust in each other- at least in this particular context) was associated with significant and on-going activation in brain areas linked with 'reward processing': nucleus accumbens, the caudate nucleus, ventromedial frontal/orbitofrontal cortex, and rostral anterior cingulate cortex. The authors propose that activation of this neural network positively reinforces reciprocal altruism, thus motivating subjects to resist the temptation to selfishly accept but not reciprocate favours.

The authors provide the following important statement regarding their research:

> Postscan subject interviews revealed that mutual cooperation was typically

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[44] PAUL MARTIN, MAKING HAPPY PEOPLE: THE NATURE OF HAPPINESS AND ITS ORIGINS IN CHILDHOOD 83 (2005) (emphasis added)
[45] LAYARD, *supra* note 43, at 101-2 (emphasis added) [author's interpolation].
[46] 35 NEURON 395-405 (2002).

> considered the most personally satisfying outcome. The more profitable DC outcome [where player A cooperates and player B defects, or vice versa] was typically described as less desirable than CC outcomes [where player A and player B cooperates] either because it provoked guilt over having profited at the partner's expense, or because subjects realized that the outcome would likely provoke defection by the partner, thereby destabilizing the relationship and leading to lower cumulative earnings.[47]

As the authors state, prisoner's dilemmas demonstrate that cooperation and trust is vital to personal well-being and the well being of society.

> …[I]f we trust each other, we have better possibilities open to us- the total take will be higher. The result of the cooperation is not zero sum; it is a win-win activity. If human beings had not been able to cooperate in this way, they would probably not have survived the rigours of the savannah- or subsequently of regions a lot colder. … We survived because our genes gave us the ability to cooperate.[48]

Accordingly, there are a range of sources that put to rest the contention of agency theorists that money, and the accumulation of wealth, is the primary motivator of company executives and that there is a necessary divergence between company and executive interests. In fact, what this section has shown is that there is a close and interdependent relationship between enhancing the interests of the company, and the interests of executives. The following section responds to the second key contention of agency theorists that the 'utility' (ie happiness) of executives is most effectively enhanced by appealing to their hip pocket. That is, money buys happiness.

5. Happy Executives: What a New Science Tells Us

Agency theorists consider remuneration (principally money) as an important 'control mechanism' to align the interests of executives and the company. In other words,

[47] *Id.* at 399 [author's interpolation].
[48] *Id.* at 398.

money is the best avenue for enhancing the 'utility' of executives. Utility maximisation is equated with wealth maximisation. 'Utility' is closely associated with one's happiness, indeed many believe that 'utility' is simply a neutral and scientific equivalent of 'happiness'.

Recent empirical studies into happiness demonstrate that happiness may indeed be a definable concept, and as human beings we are remarkably similar when it comes to the things that make us happy- and the things that do not.

Happiness as a self-contained concept up until recently failed to have any significance influence in the development of policy or regulation as it was considered too subjective to have any real legitimacy. This is, however, unsound given that happiness is our most fundamental objective as human beings.[49]

As Aristotle wrote in Book 1 of *The Nicomachean Ethics*,[50] happiness is a first principle or ultimate starting point- everything we do we do for happiness. According to Aristotle:

> Happiness is an activity; and activity plainly comes into being and is not present at the start like a piece of property . . . happiness is good activity, not amusement . . . for, in a word, everything that we choose we choose for the sake of something else--except happiness, which is an end . . . for happiness does not lie in such occupations, but, as we have said before, in virtuous activities . . . Happiness extends, then, just so far as contemplation does, and those to whom contemplation more fully belongs are more truly happy, not as a mere concomitant but in virtue of the contemplation; for this is in itself precious. Happiness, therefore, must be some form of contemplation.

More recently, Paul Martin has written in *Making Happy People: The Nature of Happiness and its Origins in Childhood* that: 'With the sole exception of happiness, everything we humans desire can be regarded as a means to an end- and that end is

[49] According to John Stuart Mill in his classic work UTILITARIANISM, we ought to pursue happiness because we do pursue happiness.
[50] William David Ross, trans., 1908.

usually happiness.'[51] Similarly, in *Happiness: Lessons from a New Science*, Layard speaks of happiness as our 'overall motivational device'.[52]

Because of the traditional perception of happiness as incapable of being defined, the concept of 'utility' has continued to adhere to the traditional textbook perspective of what is in the interests of a rational, selfish actor (*homo economicus*), rather than embracing scientific evidence directly concerned with human happiness.

What follows in this section is a discussion of some of the findings that have emerged from the scientific study of happiness. The particular focus will be on research highlighting a (very) weak link between making money for the sake of it (that is, beyond the satisfaction of basic human needs) and happiness. What this recent work shows is that the contention of agency theorists (and underpinning Bebchuk and Fried's arguments in *Pay without Performance*) that money (through remuneration) is the best means of enhancing the 'utility' of executives is misguided.

5.1 Happiness as a Science

In the past few decades, there has been an explosion in the amount of studies conducted into human happiness. Most recently, this has included conducting brain scans of individuals (using MRI technology) to record how certain events or sensations impact upon those parts of the brain that generate feelings of happiness, or sorrow. While noting the diversity in the range of activities through which people choose to express themselves, what the happiness research to date has shown is that at the base we are not that different after all. At the core, humans are `wired' pretty much the same. While some people prefer singing in a choir as opposed to boxing in a ring, and others prefer repairing motor vehicles to writing poetry we should not allow these superficial differences to divert us from the fact that we have the same basal needs, and our well-being is promoted by the same basic type of things.

We can now confidently identify the things that make us happy. These include a high degree of liberty, so that we are free to pursue our individual goals, a sense of participation and control in the activities we engage in, close personal relationships,

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[51] MARTIN, *supra* note 44, at 2.
[52] LAYARD, *supra* note 43, at 24.

good health and the pursuit of challenging projects and activities. We also know some things that do not make us happy. One of these, generally speaking, is money; another is engaging in passive forms of "activity" such as watching television.

In writing about the emerging science of happiness in his book, Professor Layard states:

> Happiness is an objective dimension of all our experience. And it can be measured. We can ask people how they feel. We can ask their friends or observers for an independent assessment. Also, remarkably, we can now take measurements of the electrical activity in the relevant parts of a person's brain. All of these different measurements give consistent answers about a person's happiness. With them we can trace the ups and downs of someone's experience, and we can also compare the happiness of different people. …*so happiness is a real, objective phenomenon*.[53]

Similarly, in *Making Happy People*, Paul Martin explains that:

> Within the fairly recent past, scientists have begun to gaze at happiness and they are formulating tentative answers to questions about its nature and causes. …[A] fair amount can now be said about happiness that is based on verifiable evidence rather than folklore or opinion.[54]

This development is very significant, particularly when the practical application and pursuit of happiness has never really taken off as a serious area of research or application in professional disciplines, mainly because of the preconception that happiness cannot be defined. Now that empirical studies have highlighted that happiness is capable of being defined, the implications— in terms of influencing public policy and the development of the law— are potentially enormous.

In addition to the emergence of a scientific concept of happiness, happiness has recently become a legitimate topic for inquiry and discussion because of the "positive

[53] LAYARD, *supra* note 43, at 224 (emphasis added).
[54] MARTIN, *supra* note 44, at 3.

psychology" movement. Positive psychologists have sought to articulate with greater precision not only what happiness means, but also how to achieve greater happiness. According to the main architect of the positive psychology movement, Martin Seligman, in his book *Authentic Happiness* (2002):

> [Traditionally] the scientific evidence makes it seem unlikely that you can change your level of happiness in any sustainable way. It suggests that we each have a fixed range for happiness, just as we do for weight. … *New research into happiness, though, demonstrates that it can be lastingly increased. And a new movement, positive psychology, shows how you can come to live in the upper reaches of your set range of happiness.*[55]

In *Authentic Happiness*, Seligman sees happiness as being the pursuit of a meaningful life:

> The good life consists in deriving happiness by using your signature strengths every day in the main realms of living. The meaningful life adds one or more component: using these same strengths to forward knowledge, power or goodness. A life that does this is pregnant with meaning.[56]

Similarly, in *Making Happy People*, Martin articulates his understanding of what happiness involves. For Martin:

> … happiness is a mental state composed of three distinct elements:
> - Pleasure: the presence of pleasant, positive moods or emotions such as pleasure, contentment, joy, elation, ecstasy or affection.
> - Absence of Displeasure: the absence of unpleasant, negative moods or emotions, such as sadness, anxiety, fear, anger, gull, envy or shame.
> - Satisfaction: judging, on reflection, that you are satisfied with your life in general and with at least some specific aspects of your life (for example, your personal relationships, career or physical abilities).[57]

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[55] SELIGMAN, *supra* note 18, at 1-2 (emphasis added).
[56] *Id.* at 260.
[57] MARTIN, *supra* note 44, Ch 1.

Given that happiness is for various reasons our ultimate objective, we can now have an informed debate as to whether executive compensation arrangements (and indeed other aspects of corporate governance) truly are effective in appealing to the utility maximising needs of executives, or whether an alternative approach is warranted.

What is particularly interesting, and of special relevance to the study of executive compensation, are quite recent studies and commentary on the link between the accumulation of money and levels of personal happiness.

5.2 The Disassociation Between Money and Happiness

Contrary to the view of wealth maximisation relied upon by agency theorists, empirical studies that have been conducted on the link between levels of wealth and happiness have generally shown that there is only a weak correlation between wealth creation and happiness.[58] Indeed, based on comprehensive studies conducted by Ronald Inglehart, there is a much stronger connection between democracy and happiness than between wealth and happiness. From representative samples of around 170,000 people from a number of different countries, Inglehart concluded that there were rather significant national differences in the levels of happiness experienced by people.[59] For example, year after year, the Danes, Irish and Dutch were happier and more satisfied with life than the French, Greeks and Italians. From these studies, one point made by Inglehart was that a nation's well-being correlated only modestly with national affluence. In interpreting these results in his ground-breaking book *The Pursuit of Happiness*, David Myers stated that:

> Moreover, the surveyed nations differ in ways other than affluence, making it hard to disentangle cause and effect. For one thing, the most prosperous nations have enjoyed stable democratic governments, and there is a striking

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[58] It is important to note, however, that some recent economic studies of well-being (using so-called 'regression equations') have shown that one's level of income, and the nation's level of GDP (gross domestic product) were factors that contributed to the happiness levels of the individuals that were studied. *See*, for example, Rafael Di Tella, Robert J MacCulloch & Andrew J Oswald, *The Macroeconomics of Happiness*, 85 REVIEW OF ECONOMICS AND STATISTICS 809 (2003); Andrew J Oswald, *How Much Do External Factors Affect Well-Being? A Way to Use 'Happiness Economics' to Decide*, 16 THE PSYCHOLOGIST 140 (2003); Andrew E Clark & Andrew J Oswald, *A Simple Statistical Method for Measuring How Life Events Affect Happiness*, 31 INTERNATIONAL JOURNAL OF EPIDEMIOLOGY 1139 (2002). What these empirical studies do not show, however, is whether so-called 'psychological needs' of individuals contribute more or less to happiness than money and wealth. Indeed, the studies discussed by the author in this article suggest there is some positive correlation between money and happiness, albeit weak, in most instances. Further, similar to the findings discussed in this article by the author, what these economic studies generally show is that beyond satisfaction of basic needs, money contributes little to happiness. The results from happiness regression equations used in studies by economists show that higher income is associated with higher happiness for poorer countries, but the evidence is less strong within richer countries.

> link between a history of stable democracy and national well-being. The thirteen nations that have maintained democratic institutions continuously since 1920 all enjoy higher life satisfaction levels than do the nations whose democracies developed after World War II or have not yet fully emerged.[60]

Thus, across countries there is not a strong link between happiness and wealth. Similar results emerge within countries. It is not the case that within any country that people are happier simply because they are rich. Again in his book Myers, citing a University of Michigan survey, notes that what matters more than *absolute* wealth is *perceived/relative* wealth. This point is examined more closely below.

Myers also refers to a wide-ranging survey of the happiness levels of Americans from 1955 to 1990 during which time wealth (measured as purchasing power) doubled, the study noting that there was no increase in the happiness levels of respondents. This led Myers to conclude:

> So, whether we base our conclusions on self-reported happiness, rates of depression, or teen problems, our becoming better off over the past thirty years has not been accompanied by one iota of increased happiness or life satisfaction. ... Once beyond poverty, further economic growth does not appreciably improve human moral.[61]

It seems that `if not wracked by hunger or hurt, people at all income levels can enjoy one another and experience comparable joy'.[62]

5.2.1 The benefit of wealth continues to be overestimated

Further, people continue to overestimate the effect that having more money has on happiness levels. As Myers states:

> With each raise the extra money soon ceased to be extra, the new luxuries soon lost their luxurious feeling. So it goes as the treadmill elevates to

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[59] RONALD INGELHART, CULTURE SHIFT IN ADVANCED INDUSTRIAL SOCIETY (1990).
[60] DAVID MYERS, THE PURSUIT OF HAPPINESS 36 (1992).
[61] *Id*. at 43-44
[62] *Id*. at 39.

> incomes of over a hundred thousand dollars. At lower incomes people think that with more money they'd be happier and more generous. But seldom is this so. Indeed, a recent Gallup poll offered the astonishing result that people with incomes of under ten thousand dollars give 5.5 per cent to charity, and those earning fifty to sixty thousand give a stingier 1.7 per cent.[63]

Once the basic necessities of life are satisfied, further increases in income and material gains produce very little benefit in happiness terms. Indeed, as Paul Martin recently commented in *Making Happy People*:

> …[i]ncreases in personal wealth produce comparable increases in personal happiness only up to a point where basic human needs such as food, shelter, clean water and health care have been catered for. Beyond this basic level, further rises in wealth make proportionally smaller differences to happiness.[64]

Martin also provides a very useful summary of the reasons which psychologists and others who have studied the correlation between money and happiness give for why money doesn't buy happiness- once basic necessities are catered for

> [W]hy money brings relatively little happiness rests on three psychological processes, each of which dilutes the psychological benefits of rising wealth. These processes are habituation ('the shine wears off'), rising aspirations ('the more you have, the more you want'), and social comparison ('keeping up with the Joneses').[65]

That wealth does not improve one's level of happiness is a fact recognised by those who are extremely wealthy. As reported by Myers in his book, a survey of forty-one of the wealthiest Americans listed by *Forbes* Magazine, found them to be only slightly happier than average.

> Wealth, after all, brings prestige, more choice of activities such as travel, and opportunities to satisfy one's desire to help others and change the world. Still,

[63] *Id*. at 53.
[64] MARTIN, *supra* note 44, at 147.

> four in five of these people, all with net worths well over $100 million, agreed that 'money can increase or decrease happiness, depending on how it is used'.[66]

In *Happiness: Lessons from a New Science*, Layard also disputes the traditional association between money and happiness, with this powerful statement:

> I am an economist. I love the subject and it has served me well. But economics equates changes in the happiness of a society with changes in purchasing power- or roughly so. I have never accepted that view, and the history of the last fifty years has disproved it. Instead, the new science of happiness makes it possible to construct an alternative view, based on evidence rather than assertion.[67]

As reported by Layard, statistics show a very weak correlation in developed countries in the last 50 years between income and happiness. 'In America, the richest quarter have roughly doubled their living standards but they have become no happier. The poor have also become richer, but no happier. In other countries, the story is similar.'[68]

Indeed, in a US *Time* magazine poll conducted in December 2004, money was not one of the top eight answers to the question 'What are your major sources of happiness?'. In fact, money ranked fourteenth. Nor was money or high material status one of the four top answers to the question 'what one thing in your life has brought you the greatest happiness?' From the surveys, it was found that Americans are overwhelmingly happy and optimistic people, regardless of income. According to the *Time* poll, happiness tended to increase as income rose to $50,000 a year (with the mean annual household income in the US being around $43,000). But after that money did not have any dramatic effect on one's level of happiness.[69]

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[65] *Id.* at 149.
[66] MYERS, *supra* note 60, 40.
[67] LAYARD, *supra* note 43, at ix.
[68] *Id.* at 29-31.
[69] *See* Claudia Wallis, *The New Science of Happiness*, TIME, 17 January 2005.

In the same issue of *Time* magazine, which contained a special feature on the new science of happiness, Gregg Easterbrook, editor of *The New Republic*, wrote an article focusing on the impact of money on happiness. Easterbrook reports that the accumulation of money has a very weak (and in some cases), negative correlation with one's level of happiness.

> If you made a graph of American life since the end of World War II, every line concerning money and the things that money can buy would soar upward, a statistical monument to materialism. Inflation-adjusted income per American has almost tripled. The size of the typical new house has more than doubled. A two-car garage was once a goal; now we're nearly a three-car nation. …
>
> Yet if you charted the incidence of depression since 1950, the lines suggest a growing epidemic. Depending on what assumptions are used, clinical depression is 3 to 10 times as common today than two generations ago. …
>
> To be sure, there is ample evidence that being poor causes unhappiness. Studies by Ruut Veenhoven, a sociologist at Erasmus University in Rotterdam, show that the poor- those in Europe earning less than about $10,000 a year- are rendered unhappy by the relentless frustration and stress of poverty. But you knew that. The surprise is that after a person's annual income exceeds $10,000 or so, Veenhoven found, money and happiness decouple and cease to have much to do with each other.
>
> …
>
> Because those with wealth often continue to feel jealously about the possessions or prestige of other wealthy people, even large sums of money may fail to confer well-being. That seems true because of a phenomenon that sociologists call reference anxiety- or, more popularly, keeping up with the Joneses. According to that thinking, most people judge their possessions in comparison with others'. People tend not to ask themselves, Does my house meet my needs? Instead they ask, Is my house nicer than my neighbour's? If you own a two-bedroom house and everyone around you owns a two-bedroom house, your reference anxiety will be low, and your two-bedroom house may seem fine. …

> Our soaring reference anxiety is a product of the widening gap in income distribution. In other words, the rich are getting richer faster, and the rest of us are none too happy about it. … [I]n the past few decades … [r]apid growth in income for the top 5% of households has brought about a substantial cohort of people who live notably better than the middle class does, amplifying our reference anxiety. That wealthier minority is occupying ever larger homes and spending more on each change of clothes than others spend on a month's rent.
>
> …
>
> Paradoxically, it is the very increase in money- which creates the wealth so visible in today's society- that triggers dissatisfaction. As material expectations keep rising, more money may engender only more desires. … As men and women move up the economic ladder, most almost immediately stop feeling grateful for their elevated circumstances and focus on what they still don't have.[70]

In *The Progress Paradox: How Life Gets Better While People Feel Worse* (2003), Gregg Easterbrook discusses in depth the contemporary overlap of sanguine circumstances and personal unhappiness. According to Easterbrook, there is a progressive shift away from a strict focus on materialism because it is now recognised that this is not conducive to happiness.

> …[S]ociety is undergoing a fundamental shift from "material want" to "meaning want", with ever larger numbers of people reasonably secure in terms of living standards, but feeling they lack significance in their lives. A transition from "material want" to "meaning want" is not a prediction that men and women will cease being materialistic; no social indicator points to such a possibility. It is a prediction that ever more millions will expect both pleasant living and a broad sense that their lives possess purpose.[71]
>
> …
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> Average Americans and Europeans not only live better than more than 99 per cent of the human beings who have ever existed, they live better than most of

[70] *See* Gregg Easterbrook, *The Real Truth About Money: Why We Remain Keen For Green Even Though It Often Gives Us More Social Anxiety Than Satisfaction*, TIME, 17 January 2005, A32.

> the royalty of history, if owing only to antibiotics. … But we don't seem particularly pleased about our lot. In 1997, 66 per cent of Americans told pollsters they believed "the lot of the average person is getting worse". People once had it better, back in the good old days. That's what many would now protest.[72]

5.2.2 Relative wealth impacts on happiness

As noted above, another interesting finding recorded by Myers in *The Pursuit of Happiness* is that happiness is largely determined according to the attainment of others: we feel good or bad depending on whom we compare ourselves to (so-called 'relative wealth').[73]

> Happiness shrivels with the gap between what we have and what we want, what we have and what we expected to have by now, what we have and what our neighbours have.[74]
>
> …
>
> This explains the reason that happiness increases when a person escapes poverty, but societies do not become happier as they progress from relative poverty to affluence.[75]

The significance of relative wealth to one's level of happiness was discussed in detail by Professor Layard in *Happiness: Lessons from a New Science*. According to Layard, money per se is not the cause of unhappiness, but rather happiness comes from consistently comparing our income/wealth with others. Layard states:

> We are heavily driven by the desire to keep up with other people. This leads to a status race, which is self-defeating since if I do better, someone else must do worse.[76]

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[71] GREGG EASTERBROOK, THE PROGRESS PARADOX: HOW LIFE GETS BETTER WHILE PEOPLE FEEL WORSE xix (2003).
[72] *Id.* at 50-51.
[73] MYERS, *supra* note 60, at 56.
[74] *Id.* at 57.
[75] MYERS, *supra* note 60 at 56.
[76] LAYARD, *supra* note 43, at 7.

Layard explains that the pursuit of relative wealth, and status which comes from wealth, has some unfavourable consequences in happiness terms as a 'zero-sum game':

> …the desire for status is utterly natural. But it creates a massive problem if we want to make people happier, for the total amount of status available is fixed. Putting it crudely, status is like the outcome of a race. There is number 1, number 2, number 3 and so on. If my score improves, someone else's deteriorates. My gain is his loss. In the jargon, we are engaged in a zero-sum gain.[77]

Layard also suggests that the phenomenon of 'social comparison' (ie, comparing ourselves to our neighbours or colleagues), which makes relative wealth is so important, explains why happiness has dropped while incomes have increased.

> When people become richer compared with other people, they become happier. But when whole societies have become richer, they have not become happier- at least in the West.[78]

In his book, Layard refers to a study of Harvard University School of Public Health students to demonstrate his point that what makes people happy is their relative income (having more than others), rather than their absolute income.

The group of students were asked to choose between living in two imaginary worlds (in which prices were the same):

- In the first world, you get \$50 thousand a year, while other people get \$25 thousand (average).
- In the second world, you get \$100 thousand per year, while other people get \$250 thousand (average).

[77] *Id.* at 150.
[78] *Id.* at 31.

A majority of the Harvard students who were surveyed preferred the first imaginary world.

This quest for greater relative income, because it catches so many in its trap, results in an overall deterioration in happiness in our society. Layard explains:

> … the struggle for relative income is totally self-defeating at the level of society as a whole. If my income rises relative to yours, your income falls relative to mine by exactly the same amount. The whole process produces no net social gain, but may involve a massive sacrifice of private life and time with family and friends. It should be discouraged.[79]

In *Making Happy People*, Paul Martin also contends that, in happiness terms, relative wealth rather than absolute wealth is the key influence.

> In an affluent nation like the UK, personal wealth is more of a relative quantity than an absolute one. What matters is not so much feeling better off than you were before as feeling better off than other people.[80]
>
> …
>
> Wealth and celebrity do not produce enduring happiness, but chasing after them can cause unhappiness.[81]

Indeed, the force of relative wealth is an important factor explaining the otherwise irrational practices and trends in executive compensation. If we accept that society places itself on a continuing treadmill of social comparison, then it becomes easier to accept that the pay for performance pay-setting methodology is fundamentally flawed. Executives are never going to be completely satisfied with their lot, even if they are earning several dozen times more than the average worker in the company: there will nearly always be someone else in a similar position somewhere who is earning more. Pay for performance is flawed in the sense that it accentuates, and to a large extent depends upon, the continuation of the social comparison treadmill- with executives always keeping their eyes and ears alert to who is earning more than them (for the

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[79] *Id.* at 151.
[80] MARTIN, *supra* note 44, at 150.

purpose of working towards getting paid a higher amount, and ostensibly achieving greater status), rather than using their energies to pursue what is in the company's best interests. Receiving 50 times rather than 40 times average pay is most unlikely to be a life changing experience for an executive who already would have all their material needs satisfied.

In this section, I have referred to just a small amount of the mountains of material in the emerging science of happiness to demonstrate that the other key assumption, that wealth maximisation equates with 'utility' maximisation (that is, maximising happiness) is also flawed. The best way to make executives happy is not to appeal to their hip pocket, but rather to recognise and foster those factors that make executives genuinely motivated to do best by the corporation. That is, we need to construct and focus our energy on a positive model of the executive.

6. Conclusion

The literature drawn upon in this article suggests that the overwhelming majority of top executives are focused on company performance, both for the personal benefits (most importantly enhanced personal happiness from being seen to be trustworthy, but also job satisfaction, ego, status) and benefits for the company and its stakeholders that flow from this. And this is without remuneration- once the basic necessities of life are satisfied- being part of the equation. If the motivation and utility (that is "happiness") of executives is not dependent upon their level of pay, why go to such great efforts to link pay with performance?

Consulting literature on human motivation and behaviour outside of the narrow confines of agency theory (and related works in economic analysis) provides a fresh and illuminating perspective on the problem of pay for performance. The decoupling of pay from performance that we have witnessed in recent times, principally in the US but also in other developed economies, represents more than just a wrong turn on the yellow brick road to reach the Wizard of Optimal Company Performance. Rather, the

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[81] *Id.* at 231.

pay for performance bandwagon has well and truly crashed and burned. The wicked witch is surely dead.