Pay Without Performance: The Unfulfilled Promise of Executive Compensation. By LUCIAN BEBCHUK and JESSE M. FRIED. [Cambridge, Massachusetts and London: Harvard University Press. 2004. 304 pp. Hardback £16.95. ISBN 0–674–01665–3.]

MANY CORPORATE SHAREHOLDERS have the distinct feeling that something is picking their pockets—and that something is not Adam Smith's "invisible hand". Such shareholders should invest in a copy of *Pay Without Performance*. Executive compensation is the black hole of corporate governance and Professors Bebchuk and Fried contribute significantly to understanding the agency problems that compensation practices reveal. Their book reviews and builds upon previous academic work, masterfully combining scholarly rigour with general audience appeal.

The nub of their argument is this: the "official view" (as they call it) of executive compensation is bunk. That "official view" claims executive compensation is set by arm's length negotiation: senior managers on one side, company directors on the other. Non-executive external directors can be trusted to safeguard shareholders' interests, and will draw upon the advice of independent professionals including compensation experts. Although executive compensation may seem high (as do the pay cheques of elite athletes and Hollywood stars), shareholders can rest assured that it is the fiercely competitive market for scarce top managerial talent that has pushed salary levels skyward.

The reality, write Bebchuk and Fried, is poles removed from this "official view". Executive compensation is settled not by arm's length negotiation but through a rigged process where powerful managers dominate pliant boards and extract economic "rents" at the expense of the corporation's shareholders. Executive pay-setting is not a triumph of healthy capitalism, but a sad story of cronyism, camouflage and captive consultants. Nor is this managerial power story confined to corporations with widely-dispersed share ownership. "Rent extraction", the authors warn, "may well take place, even if to a reduced extent, in companies where the presence of blockholders or institutional investors makes managers relatively less powerful" (p. 86).

Bebchuk and Fried do not suggest that managerial power is the sole determinant of managerial pay. Thus, they are able to answer critics who find examples of high pay in contexts where managerial power seems equivocal. But if managerial power is not the entire story, it surely accounts for the greater part of the plot. Evidence abounds that managerial power, not arm's length negotiation, explains executive compensation. High pay itself is suspect. But the clincher they find in the artful detachment of executive compensation from meaningful performance standards, even in the case of equity-based compensation such as stock option plans. Such schemes typically do not correct for the effects of positive general market movements. A rising tide lifts all boats, and the cagey captain of industry is rewarded for riding the crest of every convenient wave, even if his firm's performance relative to its competitors is actually sub-par. And if markets tumble? Not to worry. Executives are rarely blamed for falling markets. Their out-of-the-money options have routinely been re-priced (lowering the performance bar), a practice not wholly ended despite Financial Accounting Standards Board rules requiring re-priced options to be expensed.

The curious use of options concerns Bebchuk and Fried especially.

They well understand the theoretical justification for executive stock options, which provide an antidote to the excessive risk aversion that might otherwise hobble managers whose human capital is ineluctably linked to the survival of their corporate employer. But that rationale cannot explain corporate America's actual option-granting practices. Why, for example, do we not observe considerable differences between the structure of companies' compensation packages—differences reflecting the unique risk characteristics of each firm? Why, instead, do we observe remarkable uniformity across a range of firms of different sizes and profiles? And, why, if creating proper "incentives" is the goal of equity-based compensation, are executives typically permitted to unwind their equity "incentives" early and easily—again with little variation between radically different firms?

"Outrage constraint" was the term Bebchuk and Fried had earlier coined to describe one potential brake on runaway executive compensation: a constraint based on fears of outraging shareholders, or perhaps the public generally. The authors review that work, but note that outrage constraint is, at best, an imprecise tool, and may well motivate directors to direct their ingenuity toward hiding the true level of their pay (by stuffing cash into post-retirement benefits, say) rather than towards improving the financial performance of their corporate employers.

It is a sceptical picture of contemporary corporate culture, and one which, they argue, recent US corporate governance reforms are not likely to ameliorate, since many key reforms reflect practices already in place at the very companies plagued by compensation excesses. Yet the book is not merely a lament. The authors tackle the issue of more closely aligning directors' incentives with those of shareholders. Their wish is to improve directors' accountability by making directors genuinely "dependent" upon shareholders. They would, for example, endorse the Securities and Exchange Commission's controversial proposed rule to permit shareholders in certain circumstances to place directorial nominees directly on the "ballot". Indeed, they consider the director nomination proposal too small a step, and argue further for corporate law rules that would end the obstacle to shareholder democracy posed by staggered boards by requiring directors to be re-elected annually *en bloc*.

They would favour, too, a legislated end to US managers' power to reincorporate in another US state and amend the corporate charter. Here the book joins a lengthy "race to the bottom"/"race to the top" academic literature spurred by Delaware's unique position in America's corporate law competitive federalism. Bebchuk and Fried are sceptical of "race to the top" claims (dare I dub them "Dela-wary"?) and accordingly doubt that preserving managers' unfettered discretion to reincorporate is likely to result in anything but manager-friendly decisions. Their prescription is to increase shareholder voice by improving transparency, and rid executives of their unchallenged power positions. As for concerns critics have voiced about possible dangers of increased shareholder democracy, Bebchuk and Fried dismiss these as incoherent, irrelevant, or more than outweighed by the prospect of increased shareholder-value creation.

Impressive in scholarship, impeccable in timing, and accessible in style, this book deserves the attention of academics, policy makers and long-suffering investors.

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