International Company and Commercial Law Review

2005

Publication Review

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION

Lucian Bebchuk.

Jesse Fried.

Reviewed by James A. Fanto.

If one has time to read only a single book about corporate governance in US publicly traded companies, this is the book to read. This book is particularly recommended to a reader who is not a US citizen, who is unfamiliar with the governance of US public companies and/or who is concerned about the spread of US executive pay practices into other countries. The book's title is deceiving; it does so much more than address the technical issue of executive compensation. Its real point is to call attention to the continued existence of the well-known problem in US corporate governance: that senior executives, particularly the chief executive officer ("CEO"), operate firms for their own benefit, not for the interests of shareholders and other firm claimants. They discuss how this problem has starkly surfaced again in the awarding of almost obscene amounts of pay and other benefits to top executives. This has occurred despite US corporate governance (held up as a model for other countries), which is built on supervision by directors, and despite the extensive company disclosure mandated by the US Securities and Exchange Commission (the "SEC") (again, the model of company disclosure), which is designed to prevent companies and their executives from engaging in improper practices.

The story of US executive compensation is well known, but the authors tell it well in Part I of their book. Looking for ways to motivate executives to act on behalf of shareholders, rather than on behalf of themselves and company employees, economists and others came up with the idea that the best way to align executive and shareholder interests was through performance-based executive compensation. A good example is the executive stock option. As the process should work, a CEO would receive stock options over several years (i.e. they would "vest"), and the options would be valuable only if the company's stock price rose. Thus, in this best of all possible worlds, the executive would have an incentive to work hard for the company because he or she would directly benefit as the company's stock price reflected this hard work. It mattered little if the executive received enormous compensation from this arrangement because all shareholders would be rewarded from the CEO's single-minded pursuit of his or her self-interest.

Unfortunately, as the authors explain, the new performance-based executive compensation is a complete sham for it permits CEOs to take more from companies than they ever had in the past, all with little relation to their performance. The authors point to two reasons for this failure. First, they observe that, as mandated by US corporate law, a company's board of directors (usually a board compensation committee) institutes the compensation arrangements. They would be performance-based only if the board or board committee negotiates at arm's length with the CEO so as to design a compensation system that rewards good performance and punishes the bad. However, as has been known for some time, the real power in a US public corporation lies with the CEO (this the authors call the "managerial power" perspective), and board members are generally passive (despite years of reforms to US boards!). Thus, motivated to maximise their compensation, CEOs, with their compensation consultants, lawyers and tax advisers, dominate pay negotiations with board compensation committees, for directors are motivated by self-interest (they want to be renominated to boards) and for social reasons (executives themselves, they want to get along with fellow CEOs) to accede to the CEO demands. As a longstanding, and justifiable, critic of US corporate law, the SEC sought to reduce managerial power by enhancing a company's disclosure of its executive compensation arrangements and their relation to a company's performance. But the resulting disclosure does not serve its purpose of restricting compensation, because it is often dense and indecipherable and because executives found loopholes in the disclosure rules to hide or "camouflage" compensation. Moreover, US corporate law places all kinds of obstacles before shareholders who, reacting to this disclosure, want to discipline directors for failing to limit executive compensation.

In a readable and revealing manner, the authors then describe the numerous methods whereby CEOs and other senior executives take outsized compensation that has little or no relationship to their performance. A real contribution is their discussion, in Part II, of undisclosed or poorly disclosed "stealth" compensation that executives receive, which can even dwarf their visible compensation: consulting arrangements with the firm following departure, retirement benefits and executive loans. In Part III, the authors discuss at length the way in which an executive's visible compensation--the salary, the bonuses and the infamous stock options--has been removed from performance. Here they usefully explain how the recent strategy of companies to pay executives in restricted stock, rather than stock options, has actually increased, rather than reduced, executive compensation, which remains unconnected with performance.

The authors thus paint a depressing picture of governance in US public companies where, unchecked, CEOs all but steal from their shareholders. It is surprising, then, that they remain optimistic and are not even disturbed by the size of executive compensation. They simply want managerial power restricted so that an arm's length bargaining can truly function between the CEO and the board. They offer their own prescriptions for reform in Part IV, discussing compensation systems that are tied to performance and methods of ensuring actual compensation negotiation (e.g. allowing shareholders concerned about compensation excesses to use a company's proxy statement to replace passive directors with others committed to negotiating on a company's behalf). The latter is a subject of a current SEC rule proposal, although, as the authors point out, the SEC reform does not go far enough and may not even proceed at all because of fierce opposition by CEOs who want to maintain a system under which they can only win.

The book includes approximately 50 pages of notes and references, and an index.

James A. Fanto
Professor Brooklyn Law School