Other Reviews

Pay without Performance: The Unfulfilled Promise of Executive Compensation.

Lucian Bebchuk and Jesse Fried. Boston: Harvard University Press, 2004. 304 pp. $24.95.

I am in complete agreement with comments from the dust jacket of *Pay without Performance*, having made the same arguments (see Tosi et al., 1999): the book is a "crystal clear and dispassionate, but ultimately devastating, analysis of how our deeply flawed system of corporate governance has led to grossly excessive executive compensation" (John Bogle, Founder, the Vanguard Group). The authors persuasively argue that "executives of large companies have immense power and they use this power to pay themselves large amounts that are insufficiently related to performance" (Oliver Hart, Professor of Economics, Harvard University) and present "a powerful challenge to financial economics' view that compensation arrangements are designed by boards to increase shareholder value. . . . Their work will shape debates on executive compensation for years to come" (Joseph Stiglitz, Professor of Economics, Columbia University and Nobel Laureate).

The authors' fundamental argument, based on a convincing body of empirical evidence, is that top executives (*read* chief executive officers) have been able to influence the compensation setting process, leading to pay structures that do not create adequate incentives for them to work in the best interests of equity holders. They also point the finger at financial economists for ignoring this large body of empirical evidence: when "discovering practices" or finding empirical results that are not consistent with the standard economic explanation from agency theory, these financial economists "have often labored to come up with clever explanations for how such practices [and results] may be consistent with [the theory] after all. When no explanation could be found, these "have been considered 'anomalies' or 'puzzles' that will ultimately either be explained or disappear" (p. 3).

Bebchuk and Fried systematically show in their book, which contains four parts, that these "anomalies" and "puzzles" can be explained simply by the role of managerial power in the pay setting process. There are four chapters in part 1, "The Official View and Its Limits," that outline the "official view" of chief executive officer (CEO) pay levels and practices and address, as well, some of the issues that arise from it. Chapter 1 sets forth the tenets of the canon of financial economics, i.e., the agency theory perspective and how it has dominated the philosophy and practice of CEO pay, as well as a substantial portion of the research on compensation that has been done by the financial economists who, to an important degree, created these tenets (e.g., Holstrom, Mirlees, Murphy, Jensen, Meckling, Fama, and others). Their key point is that the official story based on the premise of an arm's-length bargaining model between CEOs and boards is "neat, tractable, and reassuring" (p. 3). Chapter 2 analyzes this arm's-length model relative to a body of studies, the results of which seriously question the premise. Here

Bebchuk and Fried trot out some of the heretical literature and the heretics (e.g., Khurana, O'Reilly, Main, Crystal, Wade, and Boeker, among them). In chapter 3, the authors show why shareholders are relatively defenseless to do much—an unimportant point in the canon because, we must remember, these stockholders are supposedly risk-neutral, which means in common language that they are indifferent to compensation matters in that they can simply sell their stock if they don't like it and invest in a firm more to their liking. In chapter 4, the authors raise doubts about the Holy Grail of the canon—that markets will solve the compensation issues that they raise.

The profaning of the canon continues in part 2, "Power and Pay," in which the sacrilegious notion of managerial power is set forth. The authors' premise here is simple and clean: that CEOs have a very significant influence over their own pay and, operating in their own self-interest (a central tenet of the canon and one with which the authors agree), they are able to extract rents, the "extra returns that . . . individuals obtain due to their positional advantage" (p. 62). Chapter 6 is a review of relevant literature demonstrating that powerful managers are paid more than less powerful ones, market effects notwithstanding, and that it is the "outrage" constraint (Can you really believe that they are paid so much!!) that prevents them from taking even more. The remaining chapters in this section describe how managerial power results in better departure packages (chap. 7), better retirement benefits (chap. 8), and attractive executive loan arrangements (chap. 9) for CEOs.

The authors are likewise irreverent in part 3, "Decoupling Pay from Performance," attacking one of the two key control mechanisms in agency theory, the alignment of managerial incentives with those of equity holders. The chapters provide detailed descriptions of virtually every form of CEO compensation, ranging from the ordinary (base salary) to the esoteric (options of all sorts) and how different elements of the CEO compensation package—bonuses for acquisitions, bonus "hellos," and soft landings (chap. 10), options, and option pricing (chaps. 11, 12, 13, and 14)—are used to weaken and camouflage links between firm performance and CEO compensation.

They indict consultants and compensation committees, who are very clever and sophisticated in using these various devices to decouple CEO pay from performance (and the interests of equity holders) and have set pay at the high levels that it has reached. This is not surprising, they contend, because it is the price that the consultants and board members must pay to serve their own best self-interest, both economic (i.e., high fees) and social (the status that travels with board membership). The authors' arguments are not casual assertions but are carefully supported by empirical studies that have demonstrated that this happens and how it occurs.

In part 4, the authors make their recommendations. Chapter 15 sets forth their ideas about how to strengthen incentive alignments by using more equity-based approaches that minimize windfalls, are more transparent, and increase the role of outside monitoring. Chapter 16 describes changes to the corporate governance system that might have the effect of increasing the links between CEO compensation and firm performance. These include, for example, making directors more dependent on shareholders, modifying the compensation structure of directors to create greater incentives for them to act in the interests of equity holders, and restructuring the election process of board members to allow for greater participation by equity holders.

Throughout the book, the authors demonstrate an awareness of conventional explanations of CEO compensation in the theories of financial economics, but they present very balanced and reasoned, but respectful, arguments that demonstrate why and how the managerial power perspective is a better explanation for CEO pay. These arguments are a nice mixture of anecdotal incidents and empirical literature. For example, one anecdote describes how executives like Steve Jobs of Apple can benefit from stock options even when the real returns to shareholders may be very low (p. 161), and another illustrates how executives can benefit from insider information, as in Gary Winnick's disposal of Global Crossing stock before the company filed for bankruptcy (p. 181). Their solid bedrock, however, is the extensive range of what I believe is indisputable empirical evidence, evidence that may have been a puzzle and an anomaly for the financial economists who work in the area, but evidence that comes as no news to many readers and contributors (e.g., O'Reilly, Porac, Westphal, Gomez-Mejia, Zajac, Hambrick, Finkelstein, and Wade) to the *Administrative Science Quarterly* and the *Academy of Management Journal*, myself among them. For nearly twenty years, there has been a stream of empirical studies, most of which have been ignored in much of the theoretical and empirical work in financial economics, of how managerial power dominates the nature of CEO compensation and the process of setting CEO pay. And there is further evidence for their skeptics, which they could have called upon to support the power perspective, such as work by Baumol (1959), Marris (1964), McEachern (1975), and Salancik and Pfeffer (1980). I read this empirical support to be so strong and so extensive, in fact, that if it was a "puzzle" and it was "anomalous," the puzzle was too large and the anomalies too great to be dismissed, almost out of hand, by hoping that they could be resolved by future research that would make them consistent with the canon—there should have been more serious reconsideration of reformulating the canon.

Despite the evidence that Bebchuk and Fried bring to their case, there are, and will continue to be, defenders of the canon. One reviewer of the book categorically asserted that

> Bebchuk and Fried . . . make the very plausible point that managerial influence over the board of directors taints the process by which executive compensation is set. In other words, the system by which agency costs are to be checked is itself tainted by an agency-cost problem. . . . [But] in order to fix perceived problems with executive compensation, [they] advocate dramatic changes in that system that would have the effect of considerably strengthening the power of shareholders vis-à-vis directors. Yet, they have not made an adequate case for proceeding with sweeping reforms until we

know more about the impact of the substantial changes enacted by Sarbanes-Oxley and the SRO listing standards. . . . Unfortunately, they have not persuasively made the case that the stakes justify the dramatic reforms they propose. Bebchuk and Fried want to replace the time-tested corporate governance system of director primacy with an untested new system based on shareholder primacy. The case for doing so was not made in this work, however. . . . Before blowing up a system of corporate law that has worked well for generations, it would be appropriate to adopt a wait-and-see approach to give the new changes time to work their way through the system. To the extent additional change or reform is thought desirable at this point, surely it should be in the nature of minor modifications to the newly adopted rules designed to enhance their performance, rather than radical and unprecedented shifts in the system of corporate governance that has existed for decades. (Bainbridge, 2005: 1662)

Another review that pointed out the error of the authors' ways is based on some empirical evidence and standard theoretical explanations. Core, Guay, and Thomas (2005) declared that there is ". . . no convincing evidence that pay contracts are systematically suboptimal" (p. 1182) and that "[considering] stock options, which are the primary source of their incentives . . . corporate executives have very large pay-performance incentives" (p. 1181). They maintain that Bebchuk and Fried's policy recommendations are incorrect

. . . because we believe that pay practices are [not failing]. . . . [Further,] . . . their recommendations that pay be made more sensitive to performance stems from a general misunderstanding about the primary source of U.S. CEOs' incentives. U.S. CEOs do in fact have very strong pay-for-performance equity incentives (more than in any other country in the world) through their stock and option portfolios. (pp. 1183–1184)

So, there you have it. Just as when others have attacked strong beliefs and a well-developed canon in the past with new and strong evidence (e.g., the earth rotates around the sun, not the other way around; the earth is round, not flat), the guardians remain convinced otherwise. But the strong evidence eventually prevails, and to me, the evidence that Bebchuk and Fried are right is more than convincing: managerial power plays a very dominant role in the determination of CEO compensation, and the corporate governance system in the United States needs to be fixed.

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