MANAGERIAL AND DECISION ECONOMICS
Manage. Decis. Econ. **26:** 407–409 (2005)

BOOK REVIEW

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, by Bebchuk, L. and Fried, J. Harvard University Press: Cambridge and London, 2004, 304 pp. USD 24.95 (cloth)

Many books that are written on financial or economic topics suffer either from a lack of academic rigor or so much focus on scholarly esoterica as to make the book inaccessible to the public at large. Fortunately, this work by Bebchuk and Fried is successful at including many headline-making examples intertwined with academic support to make an interesting book for upper managers, directors, academics, and the populace at large.

The basic premise of the book is that the current status of corporate governance, including recent reforms of the Sarbanes–Oxley Act and other regulatory rule changes, falls short of the executive compensation packages that arm's-length bargaining would produce. Executives have power and influence over boards and the compensation committee even when directors are independent. The authors note that the current reforms are a step in the right direction for executive compensation, but due to the nature of appointment to the board and other realities of board and executive interaction, the process is far from complete.

In addition to compensation, the authors discuss other agency problems between managers and shareholders, such as empire building, retaining too much cash, foregoing profitable investment opportunities, blocking value-increasing takeovers, perquisite consumption, managerial slack, and others. The authors explain 'the threat of board intervention is expected to curb managers' tendency toward self-serving behavior, thereby reducing agency problems' (p. 17). Most economists have assumed that boards are serving shareholder interests and therefore are motivated to create contracts, including compensation, that maximize shareholder value, known as the efficient contracting hypothesis. Alternatively, many of the outcomes observed in practice that economists find puzzling are consistent with the hypothesis of managerial power.

The focus of the book is executive compensation. Compensation should not only meet the executive's reservation price, but also tie pay to performance and thereby improve shareholder value. The authors rebut the oft-repeated argument that CEOs are like star athletes and illustrate that executives are different due to their desire to 'camouflage' pay and receive large gratuitous payments and exit pay (p. 21).

The authors explain that directors cannot be expected to serve shareholder interests any more than executives. Recent regulatory changes require the compensation committee to be independent, but the desire to be reelected, collegial, and a team-player in addition to interlocked directorates, as well as the compensation and prestige associated with being a director create an unlikely arm's-length negotiation over compensation. The authors note the egregious compensation packages in several well-known scandals where executives received large bonuses and salary when their companies were close to bankruptcy. Other problems that exist for directors include the small cost to directors who hold few shares, the lack of feedback and reputation effects, and the lack of time and effort spent on directing the firm. The problems do not disappear with compensation consultants (termed 'prostitutes' in a quote on p. 38), or with newly hired CEOs as directors attempt to garner favor with their new colleague, and problems are exacerbated by the lack of firings for poorly performing managers.

Shareholders have little power to intervene into compensation. The courts generally have deferred to the board, which has the incentive to please the CEO, particularly if the stockholders do not protest too loudly. Given current US law, litigation is unlikely to be fruitful since courts routinely grant wide discretion to boards and only in extreme breeches of fiduciary duty allow intervention. Shareholders can vote on option plans for executive compensation, but only about 1% of them get rejected and shareholders often suffer worse value-reducing pay packages when they are. Additionally, shareholders can offer resolutions to boards, but these are non-binding.

Many financial economists believe in the ability of market forces to govern corporate behavior. For one, managerial labor markets would dictate what the market will pay for a successful CEO. The authors show that about 70% of CEOs are promoted from within, hence the inability to capture market wages. The market for corporate control through a takeover or proxy contest is likewise very rarely used, and particularly so with staggered boards and other protection mechanisms inconsistent with arm's-length bargaining. Capital and product markets also are not very effective in limiting executive pay since executive pay does not typically raise product or capital costs significantly.

Managers prefer their pay decoupled from performance. If they receive large salaries and bonuses, especially when employees are downsized or the stock is performing poorly, there is an 'outrage cost' (p. 64). So, managers prefer to receive payments that appear to be based on performance and are really camouflaged rent extraction. The most common way to do this is to use stock options, usually at-the-money, and benefit when prices rise. While in principle options tie executive pay to shareholder wealth, most of the gains in prices come from market or industry effects. And, if the stock price is falling, compensation is often changed to reflect the executive's pay as compared to the labor market, or the options are repriced to reflect the lower stock price. The authors suggest a better way to tie pay to performance is to award options basing either vesting or strike prices on relative performance to a peer group.

Managerial power is expected to be related to higher pay that is less sensitive to performance. Power is stronger when the board is large and members sit on many boards, shareholders are more dispersed, and there is anti-takeover protection. Perhaps one of the strongest statements of managerial power is when executives leave the firm either by dismissal, takeover, or retirement, and then the departing executive receives gratuitous pay. This pay for poor performance (likely in two of the cases) is not consistent with arm's-length bargaining. The fired CEO may receive payments as a 'bribe' to board members resisting removal. An acquisition, which often signals poor performance, is likewise accompanied with either a severance package or consulting arrangement for the ousted CEO, but since target shareholders get large premiums, the outrage is minimal.

When CEOs retire, it may be that they are being rewarded for a job well done, but the unnecessary payments are often disguised from public view since they are not reported on accounting statements. Retirement also allows ample opportunity to provide camouflage for benefits that are difficult to value such as private jets, tax-deferred supplemental retirement plans (SERPs), defined benefit plans not tied to performance, deferred compensation, above-market interest investments, and other 'stealth compensation.' Another example is consulting contracts, such as the retired AOL CEO's $1 million per year for up to 'five days per month' (p. 109). These arrangements are not what would be expected if shareholder interests were the main goal.

Executives also receive loans from their firms and this practice has created some of the most sensational scandals. For example, Bernard Ebbers received up to 20% of WorldCom's cash in loans to help him pay off debt in his personal brokerage account and he left the bankrupt firm owing $408 million (p. 113). The argument is that managerial interests will be more aligned with shareholders if they own more stock, but one study found that loans enabling managers to buy 100 shares of stock result in an actual increase of 8 shares on average as many other shares are sold. Additionally, about half the loans made have no interest and almost all are at below-market rates, and even worse, departing executives often have the loan forgiven when unpaid.

The authors discuss non-equity based compensation and suggest that it is most often disconnected from performance. CEO compensation is shown to be correlated with market-wide stock price increases, firm size, and other one-time events such as interest rate or oil price shocks. Bonuses are likewise tied to non-performance, or when tied to performance the bar is so low to almost guarantee large payments. General Electric and Verizon are shown as examples where managers were paid hefty bonuses when earnings were inflated due to accounting for pension income (p. 125). Similarly, firms that have managers who fail to meet performance goals often move the goal posts, such as redefining bonus triggers by lowering earnings or growth targets. Executives may also receive signing bonuses, pay for completing acquisitions (often the detriment of shareholders), split-life insurance policies that build large cash value, and other arrangements that are at odds with arm's length bargaining.

One of the most interesting, and likely controversial issues in the book is the discussion of conventional options as executive pay-for-performance. While it is widely believed that managerial interests are aligned with shareholders through stock options, the authors show that even below-average performers experience huge gains. Again, the point is that the link between pay and performance should not be due to market or sector increases that are beyond manager control. There are many ways to reduce the windfall gains on options that arise due to non-managerial factors including indexing the strike price to the market or sector, rewards for outperforming peers, or vesting when certain peer-related goals are met. In my view, the authors do not spend enough time here on the perverse incentives this could provide, such as manipulating accounting numbers to exceed the peer group, but they do illustrate the need for peer comparisons.

Conventional options have many reasons for their use including the limit of $1 million on tax deductibility of executive compensation, and the favorable feature of not expensing options add to their camouflage as pay. In the case of Cisco, expensing options would have wiped out all of the company's profit (p. 151). Other reasons to use conventional options are to reduce volatility increasing projects, retain CEOs during boom times, reducing risk-bearing for the CEO, and diversification arguments. In most cases, indexed options will provide the same benefit at lower cost and reflect true performance.

Options, when granted, are most often at-the-money. The quarrel with this practice is that managers are rewarded for normal market moves. For example, Steven Jobs of Apple Computer was granted 20 million options and if Apple's stock price increased by only 5% per year, they would be worth almost $550 million upon expiration. Managers often time positive announcements after their receipt of options and then make large gains when prices increase. Even worse, firms often either reprice the options or replace them with lower strike price options when the firm does poorly—even if it is the manager's decisions that cause the poor performance. Indexing solves the declining market problem, and if the firm beats the market in such periods, rewards still accrue.

Executives often unwind options by selling many of those currently owned when receiving a new allotment. Some of this is necessary due to the need of the executive to diversify risk, but only managerial power can explain the ability to unwind almost all positions prior to leaving the firm, including trading on inside information and delaying the disclosure until after selling as allowed under current rules. The authors do note the perverse incentives for executives that are created under these conditions.

Up to this point in the book, the authors have indicated the importance of managerial power and the lack of arm's-length bargaining for the board. It is clear that director's incentives are to favor executives over the shareholders unless there are extreme problems. They now offer some suggestions for improving the process. Boards should seek to reduce windfall option plans by controlling for market or sector performance. Bonuses should be given for carefully defined good performance. There should be separation of unwinding and vesting of option plans. When managers fail, there should be no more compensation than that contractually required. Accounting transparency should be increased, including expensing of options and a monetary value reported for all forms of compensation. Shareholders should have the ability to pass binding rules on compensation.

Directors that are focused on shareholder value are the best remedy for executive compensation problems, as well as all agency problems. Independence alone will not align shareholders with directors if the executives set the reelection slate. Director compensation and appointment should be separated from executives as much as possible. However, simply providing more director compensation or shares only shifts the agency problem up a level and we are no better off. To better align boards and shareholders, an active role is encouraged from large shareholders and particularly so for institutional investors. Additionally, proxy contests, or at least the viable threat of a proxy contest, could allow shareholders influence over the board. Allowing shareholders to present a 'short slate' of directors would also be a positive move. Removing staggered boards would also allow more influence, and the argument that managers would spend all their time fighting shareholders is shown to be largely a myth.

In my opinion, this book is well worth the time to read if you are interested in corporate governance and executive compensation. The book presents a relatively balanced view of the issues with good documentation of empirical evidence, including work that disagrees with the authors' viewpoint. It is informative and strikes an interesting balance with stories from the headlines and academic research and will benefit the reader by presenting the alternative explanation of managerial power over boards in compensation negotiations.

KEN B. CYREE
Department of Finance,
University of Mississippi,
227 Holman Hall University,
MS 38677, USA

DOI: 10.1002/mde: 1250