Book reviews

The executive pay–performance dilemma: An unfulfilled promise or no promise at all?

Lucian Bebchuk and Jesse Fried. 2004.
Pay without performance: The unfilled promise of executive compensation
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James McConvill. 2005.
The false promise of pay for performance: Embracing a positive model of the company executive
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Two recent texts present opposing views about the fundamental assumptions underlying the executive pay-performance relationship. In their book, *Pay without performance: The unfilled promise of executive compensation*, Harvard University law professors Lucian Bebchuk and Jesse Fried challenge the view that executive remuneration arrangements are designed to enhance shareholder value. The authors contend that managerial power, exercised primarily by corporate CEOs, has resulted in remuneration being structured to benefit the financial interests of executives rather than shareholders, and that boards are 'captive' to the influence of executives in this respect. Deakin University law lecturer James McConvill has responded to Bebchuk and Fried in a monograph titled *The false promise of pay for performance: Embracing a positive model of the company executive*. McConvill argues that the assumptions underlying Bebchuk and Fried's 'managerial power' thesis derive from a false understanding of human motivation and behaviour.

Pay without performance: The unfilled promise of executive compensation

Bebchuk and Fried's book is firmly situated within an agency theory perspective and its assumption of the inherent potential for an adversarial manager–shareholder relationship. The authors acknowledge that an effective process for determining executive compensation is not the sole solution to the agency relationship, but flawed remuneration arrangements are clearly a major part of the problem.

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The 'agency problem' arises from the fundamental assumptions of Berle and Means (1932) and Jensen and Meckling (1976) regarding the divergence of interests between the owners and their agents; in turn this rests on the economic perspective of actors being primarily concerned with maximising their own personal outcomes. Bebchuk and Fried adopt these assumptions and proceed on the basis that '[w]hen 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' (Bebchuk and Fried 2004, 63). The notion that 'executives do not instinctively seek to maximize shareholder value' (2004, 23) is therefore taken as a logical consequence once it is accepted that managers wish to have as much 'slack' as possible.

But what determines whether executives can 'get away with it'? Clearly, if the directors are maximising shareholder benefits they will be exercising independent board oversight by seeking to minimise agency costs and relate incentives to shareholder value. This focus on shareholder interests requires that the board bargains 'at arm's length' with executives to best ensure outcomes favourable to shareholders. According to Bebchuk and Fried, defects in the underlying governance structures, particularly the insulation of directors from shareholders, enables the CEO to exert undue influence over the board. This influence has led to directors being unable to conduct arm's length bargaining over executive compensation; and it is the absence of director independence, not mistakes or poor judgment, that the authors see as the causal issue allowing executives undue influence over their own pay. Bebchuk and Fried argue that the phenomenon of CEO influence is so entrenched that ultimately it affects the executive labour market itself: 'when the market as a whole is distorted by an absence of arm's-length bargaining, general conformity to market terms cannot allay concerns about the amount and structure of executive compensation' (Bebchuk and Fried 2004, 22).

The lack of effective oversight of executive compensation leads to a series of related outcomes. First it enables executives to obtain 'rents' or financial benefits in excess of those obtainable from an independent board engaged in arm's length bargaining. Rents are limited only by 'outrage costs' being the potential economic and social impact of shareholder and community reaction to compensation arrangements seen as outrageous. Economic costs include the possibility of board members losing their seats and social impact refers to reputational damage, and either or both of these follow from remuneration decisions perceived as providing egregious benefits to executives. Directors may therefore engage in 'camouflage' to minimise the potential for outrage by obscuring excessive – and by definition, economically inefficient – remuneration arrangements. Such arrangements are aimed at reducing the transparency of remuneration by providing financial benefits through vehicles such as loans to executives and post-retirement perquisites, including consultancy arrangements.

The issue of managerial power and its negative impact on board independence is the underlying theme throughout the book. Major aspects of this power are the potential for the CEO to exercise significant influence over direct and indirect economic benefits to directors, the sense of obligation and loyalty of directors to a CEO who has supported their nomination and appointment, and the general sense of authority derived from being what is arguably the figurehead of the corporation. Bebchuk and Fried conclude with recommendations to counter the current adverse impact of managerial power on director independence. Their recommendations are divided into two areas: improvement in the design and structure of executive remuneration arrangements and improvements in corporate governance processes. With regard to compensation arrangements, they focus on developing cost-effective incentives related to the generation of shareholder value, improved transparency of all aspects of remuneration and a requirement for shareholder approval of certain aspects of compensation arrangements. Improvements related to governance processes aim to reverse the current insulation of directors from shareholders by deliberately increasing director dependence on – and accountability to – shareholders, particularly with regard to board appointments, reappointments and director remuneration.

Despite the comprehensive and compelling presentation of Bebchuk and Fried's argument, their managerial power thesis remains open to challenge on the basis of alternative explanations and competing evidence. For example, Bebchuk and Fried rely on the managerial power thesis to explain the growth in CEO remuneration levels over the past three decades; however, there is a growing stream of evidence demonstrating a significant increase in the proportion of externally appointed CEOs – that is, CEOs not in a position to hold managerial power over board members – at premiums well above internal appointments and that CEOs capable of managing large complex organisations are in short supply, thus bidding up CEO remuneration levels (Hermalin 2005; Himmelberg and Hubbard 2000; Murphy 2002; Murphy and Zabojnik 2003, 2004).

A further approach takes issue with the notion of 'outrage costs', an essential element of Bebchuk and Fried's argument: 'When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favour' (Bebchuk and Fried 2004, 65). However, as Murphy (2002) notes, following the introduction of US legislation limiting the tax deductibility of CEO pay in 1992, together with the introduction of extensive Securities and Exchange Commission disclosure rules, median salaries in the period 1992 to 2000 for S&P 500 CEOs increased 17 percent after allowing for inflation and cash bonuses. This suggests not only that public outrage had little influence on CEO pay, but also that the notion of outrage costs itself is irrefutable in that it assumes that any unobserved practice is avoided because it could be considered outrageous (Murphy 2002). There also appears no way to meaningfully value the utility to the firm, a director or CEO resulting from incurring or avoiding the reputational damage forming part of outrage costs (Bainbridge 2005).

The fact that there are alternative explanations and competing evidence with regard to the determination of CEO pay remains an important issue, particularly with regard to governance implications. Changes required under Bebchuk and Fried's managerial power explanation propose regulatory changes to further strengthen the independence of directors and their dependence on the shareholder body. However, there are two concerns with adopting Bebchuk and Fried's 'shareholder primacy' governance recommendations. First, it would be premature given that their managerial power argument remains strongly contested and, despite Bebchuk and Fried's forceful presentation of their case, alternative explanations are equally credible. Second, there is no evidence to suggest that such changes would necessarily lead to improved corporate governance or more effective remuneration decisions (Bainbridge 2005; Gordon forthcoming; Murphy 2002).

The second area in which Bebchuk and Fried's managerial thesis is questioned relates to methodological issues, particularly with regard to the overwhelming reliance on agency theory and traditional positivist research approaches. Leading scholars from within economics have warned of the dangers of spurious correlations making acceptance of causal interpretation questionable (Hermalin and Weisbach 2003). Others, outside the economics discipline, draw attention to the 'great inferential leaps' made from proxy variables (such as board composition) to output variables (board performance) with no direct evidence on the intermediary processes that link the inputs to the outputs (Forbes and Milliken 1999; Pettigrew 1992). Daily, Dalton and Cannella (2003) are more pointed in their criticism when they refer to 'empirical dogmatism' as being a major barrier to advancing research in the field of corporate governance.

These methodological criticisms are not just issues of experimental design and the need for interdisciplinary approaches: at heart there are significant ontological and epistemological issues at stake. In his extensive review of Bebchuk and Fried's book, Bainbridge (2005, 16) questions the explanatory power of their model thus:

> Physicists have long sought a unified field theory, which would provide a single set of simple laws that explain the four interactions or forces that affect matter – i.e., the strong, electromagnetic, weak and gravitational forces. To date, they have failed, which provides a strong cautionary tale for anyone seeking a unified field theory of social interactions among fallible humans, whose behaviour is far harder to predict than is that of, say, an electron.

Notwithstanding the persuasive force of their argument, Bebchuk and Fried's 'managerial power' thesis remains a strongly contested explanation of the determination of CEO pay. Clearly the jury is still out!

The false promise of pay for performance: Embracing a positive model of the company executive

McConvill states at the outset that he does not dispute Bebchuk and Fried's argument that managerial power is a factor that has led to the decoupling of executive pay from performance – an issue which he nonetheless spends an entire chapter discrediting. His major aim is to contest two underlying assumptions of agency theory on which Bebchuk and Fried's approach is founded. First, agency theory is premised on an essentially adversarial relationship in which executives are seen as being naturally inclined to maximise their personal interests at the expense of the shareholders. Second, the solution to this adversarial situation is to provide financial incentives to align the interests of executives and shareholders.

McConvill's objective is to counter the negative view of management inherent in agency theory by developing the alternative approach of 'positive corporate governance'. This opposing view sees the behaviour and motivations of executives in a positive light: 'to recognise their personal strengths and virtues, and to promote the tangible implications that this positive perspective has for corporate governance' (McConvill 2005, 72). The thrust of McConvill's approach is his attempt to bring together three broad streams of thought: writings on *intrinsic work motivation* to demonstrate the inherent satisfaction and positive meaning and identity in work; '*happiness studies*' to show the ultimate disassociation between money and happiness; and *stewardship theory* to present an alternative and positive model of the executive based on psychological and sociological research.

Despite my personal sympathy for McConvill's overall direction, I think he fails to make his case convincing for several reasons. He appears to totally reject agency theory and its approach to corporate governance based on external regulation. This is in direct contrast to the paper by Davis, Schoorman and Donaldson (1997), which he quotes selectively, who make the clear point that their aim is 'to reconcile the differences between stewardship and agency by describing the conditions under which each is necessary' (21).

To successfully present an 'either-or' approach McConvill needs to synthesise the three streams of thought underlying his argument to present a cogent basis for an alternative explanation to agency theory. Ultimately, this alternative approach needs to acknowledge the personal and situational factors found in an organisational context and how the positive corporate governance model addresses these issues, as did Davis, Schoorman and Donaldson (1997) with their explanation of stewardship theory. But McConvill fails to bridge this gap: each of the seven chapters contains extensive quotes from diverse sources, but at the end of each chapter, as with the end of the book itself, there remains an impression of three parallel streams that intersect at various stages, rather than coming together to form a clearly articulated basis for his end thesis.

McConvill's apparent positioning of positive corporate governance as the preferred – if not 'right' – approach suffers from his lack of a clearly integrated foundation to present and defend this position. In turn, this makes two of his proposed consequences following adoption of this governance model look naïve and simplistic. First, and on the basis that the 'agency problem' is the underlying justification for external regulation of corporate governance, he predicts that there will be no further need for external regulation: 'If we can be confident that executives are naturally inclined to pursue what is best for the company, and doing so is an incentive in itself, external regulation can be dispensed with' (McConvill, 2005, 75). No suggestions are given as to what is included in the term 'external regulation', and whether it includes changes to existing corporations law, stock exchange listing regulations and guidelines and the roles of various regulatory bodies. Nor is there any discussion of what might replace these formal requirements and roles and how it might operate. This is definitely a radical if not revolutionary suggestion, but is it feasible? It is highly unlikely that the legislature, regulatory bodies and the general community would depart from externally imposed safeguards irrespective of the degree of confidence we may collectively develop in the trustworthiness of executives safeguarding our financial investments and superannuation funds.

Second, McConvill proposes that the benefits flowing from the positive corporate governance model may be reflected in the introduction of alternative models of executive pay. In this respect he suggests 'a "best practice" position tying the level of executive compensation with average weekly earnings in the economy

– with a multiple – (perhaps 15 to 20 times average weekly earnings) as the ceiling rate' (McConvill 2005, 88).

The introduction of a multiple of 15 to 20 times average weekly earnings will have a mixed reception. Based on FY2003 annual report data from the *Australian Financial Review* (Executive salaries 2004), the median total remuneration (including benefits, bonuses and equity-based rewards) of the top 100 CEOs was $2 143 249 and, according to the Australian Bureau of Statistics (accessible at www.abs.gov.au/Ausstats/abs@.nsf), the average weekly ordinary time earnings (AWOTE) in May 2004 was $949.63 or $49 381 per annum. Even allowing 20 times AWOTE, an amount of $987 620, it is going to require significant powers of persuasion to negotiate with CEOs to trade-off more than 50% of their remuneration for the intrinsic worth and personal satisfaction they receive for performing their role. However, given that there are in excess of 1500 companies listed on the Australian Stock Exchange, those CEOs languishing on a mere 3 to 4 times AWOTE (and yes, they do exist!) may well see the proposal as providing significant opportunity for a pay hike. McConvill provides no explanation of why a remuneration model based on a multiple of average weekly earnings merits the term 'best practice'; nor is there any explanation of how to implement such a scheme in a way that would win the support of CEOs or their boards.

McConvill's case is not helped by what appears to be at best a passing familiarity with research into the CEO pay–performance relationship. He acknowledges an 'immense number' of empirical studies showing a very weak link between executive pay and company performance but illustrates his point with reference to a little-known 1994 Australian study based on data from 1989–90. One of the more substantive, and relatively recent, meta-analyses (e.g. Tosi, Werner, Katz and Gomez-Mejia 2000) would provide a more comprehensive source of support. Further, in chapter 4 ('Critique of the Bebchuk-Fried thesis') McConvill suggests that 'recent areas of scholarship' such as tournament theory offer 'promising alternatives' to the managerial power thesis. Tournament theory is neither recent nor particularly promising: there was no support for the theory when it was originally tested by O'Reilly, Main and Crystal (1988) and, with the exception of a paper by Conyon, Peck and Sadler (2001) finding some supporting evidence, it has not played a significant role in the literature over the last fifteen years. Finally, and remaining with tournament theory, in endnote 65 (p. 93) McConvill cites a study by Malmendier and Tate (2005) titled 'Superstar CEOs' as a further study of tournament theory. While the term 'tournament' appears in the abstract and the text, the paper is not about tournament theory, instead it follows the impact that winning high-profile CEO awards has on the subsequent performance and pay of those CEOs.

Overall, this is a laborious and repetitive text. A simple yet crucial issue for the author's argument is an initial and succinct statement of agency theory: explanations of agency theory from different writers crop up on page 6, again on pages 12, 13 and 14, before the original explanation from Jensen and Meckling (1976) appears on page 17; then follow further descriptions on pages 19 and 20 before I lost interest in counting. Insufficient attention has been paid to editing such that the same quote is duplicated on page 23 and there are several typographical errors scattered throughout. The paper by Anabtawi is not available from SSRN as referenced (nor is it available on Google Scholar!). Small issues perhaps, but nonetheless they do not help McConvill present his case convincingly. And the fact that the case is not presented as a persuasive alternative by default further enhances the dominance of agency theory, and its assumptions of economic efficiency, as the major explanation in this area of research.

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