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Managerial Power and Executive Pay†

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1. *Introduction*

Bebchuk and Fried's *Pay without Performance* sets out to show that top executive compensation in the US is inefficient due to weak corporate governance. The issue of executive compensation has been the subject of much public debate for some years now and Bebchuk and Fried make (and have already made) an important contribution to this debate. As the authors state, their aim is to give a detailed account of compensation practice in the US with a view to revealing the large number of important shortcomings in those arrangements. Bebchuk and Fried also go some way towards describing the circumstances under which compensation contracts are determined, in order to support their main argument that compensation arrangements display significant inefficiencies. This then provides a starting point for thinking about regulatory implications of inadequate compensation practice. While Bebchuk and Fried do not attempt to provide a detailed proposal for corporate governance reform, they point in the direction of necessary regulatory change. This consists mainly of trying to shape the process by which compensation packages are determined in such a way that reduces inefficiencies.

The topic that Bebchuk and Fried deal with is clearly of great importance, as witnessed by the amount of attention the issue of CEO compensation has received over the last few years. This debate has naturally evolved in a piecemeal fashion, whereby practitioners, regulators and academics single out one particular aspect of compensation at a time and question its merits. As a result it has become hard to gain an overview of the many facets of executive compensation, let alone to keep track of all the regulation and underlying economics that may be able to account for the observed pay arrangements. *Pay without Performance* develops in a comprehensive way the arguments put forward by one camp in this debate, namely those advocating the view that current practice displays gross short comings from shareholders' perspective. The book is designed to be

† A review of Lucian Bebchuk and Jesse Fried's *Pay without Performance—The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, 2004) hereafter referred to as *Pay without Performance*. I wish to thank Silvia Rossetto for helpful comments on an earlier draft of this paper.

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of relevance to future compensation practice in two important ways. First, it can help shareholders evaluate proposals they come up against by improving their understanding of current pay practice and its deficiencies. Better understanding by decision makers can be important in mitigating the problem itself. Second, the analysis points in a particular direction as regards policy implications. This is effectively a corollary of the analysis of the system's deficiencies. According to Bebchuk and Fried the main course of action should be in the direction of increased board accountability to shareholders and improved shareholder rights.[1] This contrasts with, for example, a possible alternative of legislating more directly on CEO compensation.

The contribution that *Pay without Performance* makes is three-fold. First, it provides a detailed and concise summary of existing pay practice. Second, Bebchuk and Fried explore whether existing compensation arrangements are in shareholders' interest. Finally, the authors throw light on the process by which compensation packages are determined, which further emphasizes the inefficient nature of those arrangements and provides the basis for regulatory implications.

The overview of current pay practice utilizes a wealth of different sources, ranging from large scale empirical investigations to anecdotal practitioner evidence. It points out a large number of details of commonly used compensation arrangements that display inefficiencies according to Bebchuk and Fried. The main features of inefficiency can be summarized as follows. While managers do receive performance-sensitive pay in the form of stock option plans, many features of those plans are hard to reconcile with optimal contracting. In particular, stock options should reward relative instead of absolute performance, but rarely do so in practice.[2] Moreover, the almost uniform use of the current stock price as the exercise price is puzzling,[3] as is the common practice of allowing managers to unload their options once they vest.[4] Similarly, it is puzzling why poorly performing managers often get their stock option exercise prices re-set at a lower value, which appears to undermine the incentive effects those options are supposed to have.[5] In addition, Bebchuk and Fried argue that top executives commonly receive performance-insensitive compensation in a way that is largely hidden from shareholders' view, and that is inefficient from shareholders' perspective. Examples for this practice of camouflage include golden handshakes and parachutes as well as retirement perks and executive loans.[6]

In order to analyze whether these types of arrangements can be in shareholders' interest, Bebchuk and Fried scrutinize the legal constraints and regulatory requirements that shape pay practice. They then invoke a considerable amount of arguments from economic theory in order to determine what a compensation

[1] See *Pay without Performance*, discussion following p. 201.
[2] Ibid at 138.
[3] Ibid at 159.
[4] Ibid at 174.
[5] Ibid at 164.
[6] Ibid at 87 discusses so called 'gratuitous good-bye payments' and at 95 focuses on retirement benefits.

contract should look like that is in shareholders' interest, given these constraints. In addition Bebchuk and Fried consult a lot of empirical academic work and use it to throw light on whether pay practice is consistent with the notion of shareholder wealth maximization. Beyond constructing their arguments carefully in this way, Bebchuk and Fried also provide a good example of the merits of joining up law and economics. It makes their analysis more comprehensive than most others and thereby highly relevant. In describing pay practice and analysing the merit of existing arrangements, the book also indirectly provides a comprehensive overview of what has become a large area of empirical and theoretical research. In this way *Pay without Performance* also will be of interest to academics working in this area.

Bebchuk and Fried's third main contribution is, as mentioned above, to investigate the circumstances under which compensation packages are determined. This serves to underscore their point that arrangements are not in shareholders' interest, and provides an important starting point for thinking about policy implications. In the process, Bebchuk and Fried propose the 'managerial power' framework which they believe better explains the observed pay practice than the constraint optimization framework that has commonly been put forward by economists. Constraint optimization here refers to the idea that compensation packages are determined as the result of shareholder maximization subject to a variety of constraints, such as behavioural constraints by the manager, legal constraints, bargaining power and so on. Bebchuk and Fried refer to this as the arm's-length bargaining or the arm's-length contracting approach. While Bebchuk and Fried subscribe to the arm's-length contracting approach as a valid normative framework, they argue that it provides a poor description of existing pay practice.

The main sources of governance failure that Bebchuk and Fried identify as the underlying reason for inefficient contracting over compensation arrangements can be summarized as follows. Bebchuk and Fried argue that there is a difference between disclosure and transparency of compensation arrangements. Current regulation largely ensures that disclosure is fairly complete. However, there is considerable lee-way regarding the actual reporting, which is often used by firms to disclose information without rendering it transparent: firms 'camouflage' actual pay arrangements.[7] Moreover, managers can get away with such behaviour because of the power they wield over the board. Board members are therefore often reluctant to take action against a CEO even when it would be in shareholders' interest to do so.[8] In addition, dispersed share ownership leads to a free rider problem of taking a disciplinary initiative among shareholders, which ultimately makes shareholders passive investors. Furthermore, even when shareholders, in particular institutional investors, do have large stakes they may suffer

[7] Ibid at 67.
[8] Ibid at 23.

from conflicts of interest over business relationships with the firm in which they hold the stake. A pension fund, for example, may hold a relatively large stake in a company whose employee pensions it hopes to (continue to) manage. Finally, litigation[9] or direct voting[10] provides limited means for shareholders to constrain management.

Once the weaknesses in corporate governance are identified, Bebchuk and Fried's policy recommendations follow naturally. They include a reduction in hurdles for proxy fights and hostile takeovers. Moreover, shareholder power over board decisions should be increased: proposals on executive compensation are currently 'precatory', which means that the board can simply reject them. Instead, shareholders should be able to make proposals that are binding on the board. Similarly, shareholders should be given more power in the appointment and re-appointment decisions of (independent) directors.[11] Moreover, boards should not have veto power over changing the governance arrangements in the company's charter. Finally, a tightening of the definition of what constitutes independent directors coupled with stronger positive incentives of those directors to act in shareholders' interest, would probably go some way in mitigating existing inefficiencies.

All three contributions made by Bebchuk and Fried are extremely valuable. Their book combines scholarly research with an exhaustive, yet concise, overview of what is now a well developed field of research. At the same time the authors' detailed knowledge of institutional arrangements and the regulatory and legal environment make the book highly instructive and an extremely relevant piece of research.

In addition to the above contributions, *Pay without Performance* also proposes a new descriptive framework for executive compensation, which is based around the notion of 'managerial power' and which will be discussed in more detail below. The merit of this framework is somewhat unclear for two main reasons. First, when Bebchuk and Fried try to prove the validity of their framework they are sometimes obliged to apply it in a rather ad hoc way, which fails to convince. Second, the framework itself appears to be somewhat ill-specified and it is hard to pin it down to something that would provide a testable alternative to the existing 'arms-length-bargaining' framework. While neither of these points reduces the strength of the book's main arguments, it seems unnecessary to put forward a framework that is neither compelling nor terribly helpful.

The next section develops in more detail the traditional arm's-length bargaining framework and attempts to clarify how it differs from the 'managerial power' approach put forward by Bebchuk and Fried. Section 3 explores the usefulness of the managerial power approach in understanding compensation practice. This is done using two examples of compensation practice described by Bebchuk and

[9] Ibid at 45.
[10] Ibid at 48.
[11] Ibid at 208.

Fried as inefficient, namely the use of absolute performance based stock options, and the wide-spread use of 'gratuitous good-bye payments'. On the basis of these examples it is shown that the managerial power approach is not sufficiently well developed to provide a compelling descriptive theory of compensation practice.

2. *Arm's-length Bargaining or Managerial Power?*

Bebchuk and Fried's main argument is that the arm's-length bargaining approach inadequately accounts for CEO pay practice. Instead, pay practice can be understood once one accepts the managerial power model. This is important, because all central policy implications rest on the notion that managerial power should be reduced. How exactly does the managerial power approach differ from the arm's-length bargaining approach? According to the arm's-length bargaining approach, compensation packages are determined as follows. Since shareholders cannot be expected to negotiate individually with the CEO over the pay package, they delegate this task to the company's board. They thus treat CEO compensation in a similar way to any other business decision of the corporation, in which shareholders do not normally intervene. The board then negotiates a compensation package with the aim of maximizing shareholder wealth, subject to constraints. Those include: (i) the behaviour that the compensation package is likely to induce with the manager (managerial incentives to put effort into the company, or possible distortions regarding the choice of investment projects, e.g. short-term versus long-term projects), (ii) tax issues and regulatory requirements, and (iii) the bargaining power of the counter party.

In contrast to this, contracts are not negotiated by a board in the best interest of shareholders under the managerial power model. Instead, the board essentially agrees to pay packages that serve the CEO rather than shareholders. What puts any constraint on CEOs to expropriate shareholders in this model? Legal requirements might help to prevent outright fraud and market forces might put a bound on managerial rent extraction, but both would probably allow considerably more lee-way to CEOs than they actually do exert. The other important constraint is therefore the 'outrage' constraint by shareholders.[12] This constraint essentially states that when CEOs are perceived by shareholders to 'overdo' it, the latter will become 'outraged' and put a limit to CEOs' discretion.

Bebchuk and Fried take care to distinguish between rents that could be earned by a manager due to bargaining power in an arm's-length contracting framework, and those extra rents that are attributable to managerial power. Even under the arm's-length contracting model, managers can have considerable bargaining power vis-à-vis the firm, if they have unique skills.[13] In the most extreme case a (candidate) CEO might have all the bargaining power. That corresponds

[12] Ibid at 64.
[13] Ibid at 62.

to the case where a CEO can effectively make a take-it or leave-it offer over a compensation package to the firm. The board would then accept any package that leaves its shareholders no worse off than under the outside option that is available if the candidate CEO walked away from negotiations with the board. This outside option would be to hire another manager with a less appropriate set of skills. Effectively, the highly skilled manager can extract the entire surplus to firm value that he adds, over and above what the next best manager could generate.

Shareholders, however, are worse off according to the managerial power approach than they would be even if they had no bargaining power but contracted with a manager at arm's-length. What Bebchuk and Fried define as managerial rents now is effectively the amount of money a CEO can earn over and above that which would be available had the board bargained with the aim of maximizing shareholder wealth. Hence, the managerial power approach is defined by the fact that the board agrees to compensation packages that make the shareholders worse off than their outside option of hiring another manager. How is this possible? Two elements appear to be crucial to allow such extra rents to occur.

First, the board has a different objective function than shareholders. Bebchuk and Fried argue at length that the board indeed pursues a different objective than pure shareholder maximization (see discussion above). Mainly, the board has a certain amount of loyalty toward the manager.[14] The board can best be thought of as maximizing a combination of shareholder and CEO payoffs.

Second, shareholders are unable to reject the contract and to resort to the outside option of hiring a different manager. That is, shareholders do not become active even when they are expropriated, and in spite of being able in practice to vote on executive stock option plans. The latter should give them considerable power to reject compensation packages that leave them worse off than they would be if the (candidate) CEO walked away from the firm. Even though mandatory shareholder approval is new, Bebchuk and Fried point out that it has been widely used for many years. This is largely because only performance based pay is tax deductible, and in order for compensation to count as performance based, it requires shareholder approval.[15] Hence, the problem does not appear to be that shareholders lack the means to control compensation packages. The shortcomings identified by Bebchuk and Fried are that (i) shareholders vote on the general framework of the plan, but not a specific compensation package, and (ii) shareholder rejection, 'might well lead to a management crisis', or it might lead the board to award packages that are even more inefficient in order to design them so as not to require shareholder approval. Moreover, 'voting processes ... have built in biases toward management-sponsored proposals'.[16] Essentially, the management proposal can be promoted on firm expense, while a

[14] Ibid at 31.
[15] Ibid at 49.
[16] Ibid at 50.

shareholder has to pay for promotion himself, which generates an obvious free-rider problem. In addition there are problems of institutional shareholders voting against management, because they might hope to have business dealings with the company in which they hold a stake.

The issues that emerge from this discussion are that there are two constraints on shareholders enforcing arm's-length contracting. First, regulation is to some extent stacked against them. Second, shareholders face a free-rider problem, or, third, even a conflict of interest, and therefore do not vote against management.

It seems that this description provides a fairly precise framework for thinking about CEO compensation. The main difference to the arm's-length contracting model is that it takes into account explicitly a set of additional constraints under which contracting occurs. In particular it acknowledges that in reality, there are two agency problems, not just one. Under the standard model of delegation, the focus is on the agency problem between shareholders and the manager. In practice, however, we have an additional layer of agency problems: there is one agency problem between the shareholders and the board of directors and a further agency problem between the board and the CEO. This does not appear to be a controversial issue as it is widely acknowledged that in practice both agency problems are relevant.[17] Furthermore, Bebchuk and Fried point to a variety of reasons why shareholders in practice differ from the (single) shareholder underlying the simple agency model. In practice, a firm is not owned by a single individual, but by a multitude of shareholders, many of whom only hold a very small fraction of the company. This leads to well known free rider problems in monitoring the firm and makes shareholders potentially rather weak principals.[18] Furthermore, shareholders have limited power over board decisions due to regulatory constraints. Those mainly consist of ownership and holding requirements for shareholders that need to be met before they can nominate a new director.[19] Finally, institutional shareholders sometimes face conflicts of interest. For example a large institutional investor like a pension fund may also entertain a business relationship with the firm in the form of managing the employee pensions.[20]

Bebchuk and Fried make all of the above points, but they never make it quite so clear that their main hypothesis can be thought of as essentially an extension of traditional theory to allow for additional real world complications, as listed above. Instead, they present a 'new' managerial power model as a framework for understanding how compensation packages are determined. As mentioned above, two features characterize this approach. First, the board pursues a different

[17] Early examples of work that explore explicitly the agency problem inherent in the board of directors include J. Brickley and C. James 'The Takeover Market, Corporate Board Composition and Ownership Structure: The Case of Banking' (1987) *Journal of Law and Economics* 161–80 and M. Weisbach 'Outside Directors and CEO Turnover' (1988) *Journal of Financial Economics* 431–60.

[18] See for example A. Shleifer and R. Vishny 'Large Shareholders and Corporate Control' (1986) *Journal of Political Economy* 461–88.

[19] *Pay without Performance* at 207.

[20] Ibid at 50.

objective from maximization of shareholder wealth. Second, in order to put a boundary on how much worse off shareholders can be made by contracting with a CEO, Bebchuk and Fried appeal to shareholders' 'outrage constraint'. The main idea behind it is that once shareholders perceive CEOs as acting in an excessively self serving manner, they will be outraged and constrain the CEO's behaviour. The outrage constraint is thus an amalgamation of several issues with blurred boundaries. On the one hand it says something about shareholders' perceptions. On the other hand it only describes shareholders' perceptions in the event that they impose a constraint on CEOs. As a result, the outrage constraint is effectively defined by an empirical observation, namely that shareholders have acted to constrain CEO behaviour. This, however, makes the outrage constraint a concept with limited predictive power.

The introduction of a fuzzy concept like the outrage constraint as an alternative framework obscures the underlying governance failures, which Bebchuk and Fried rightly point to in some parts of the book. Simply alluding to an outrage constraint seems unsatisfactory, because it leaves many of the important questions unanswered: once shareholders are outraged, how do they impose constraints on CEO behaviour? This is an important question, because it lies at the heart of shareholders' failure to limit CEO power to begin with. Moreover, if shareholders can constrain CEO behaviour by being outraged, why can they not impose constraints without being outraged? Is there anything substantive we can say about when shareholders become outraged? For example, why should they not become outraged as soon as the board proposes a compensation package that leaves them worse off than their outside option of not hiring that CEO?

A further problem of focusing on a descriptive approach of 'managerial power' subject to an outrage constraint, is that it makes it hard to assess to what extent regulators should be concerned about the existing arrangements. Given that the managerial power approach is designed to be descriptive, it cannot directly help guide policy, because it makes no normative statements. To illustrate this point consider the following issue. Bebchuk and Fried argue that the contracts and issues that the boards deal with 'are hardly complex'[21] and therefore it is implausible to explain the observed inefficiencies coming about from honest mistakes made by the board of directors and remuneration committees. But if the problems are so simple why did remuneration practice not meet the outrage constraint earlier? Arguably, outsiders had a harder time understanding what was going on, because of the lack of transparency.[22] Bebchuk and Fried thus distinguish between disclosure and transparency. However, sophisticated institutional investors with

[21] Ibid at 77.

[22] Examples of pay practice that display elements of 'camouflage' are retirement benefits, deferred compensation and executive loans. Some aspects of compensation have to be included in compensation tables provided for a company's annual public filing. The numbers included there are very visible and in as far as compensation arrangements actually have to be included in these tables, they are transparent. However, some forms of payment have to be disclosed in the SEC filings, but do not have to be included in the compensation tables. An example is pension payments after a CEO retired (compensation tables need not include payments to former executives). Ibid at 100.

large stakes in firms could arguably be expected to understand this (disclosed!) material. The point here is that if shareholders remained more passive than warranted by their outrage constraint, should we really be that concerned about their welfare? The only way to answer that question is to be specific about why shareholders do not act as soon as they are expropriated. And this cannot be summarized with reference to an outrage constraint.

Similarly, Bebchuk and Fried argue that 'investors and other outsiders are generally less bothered by excessive and distorted pay arrangements when markets are rising rapidly. The bull market of the 1990s ... weakened the outrage constraint, giving managers and boards more latitude to boost executive pay'.[23] As a descriptive piece of theory this argument seems to be rather ad hoc. And as the basis for a normative statement it is not very helpful. It is not clear how one could derive policy implications from this kind of statement. Are we to think of shareholders as greedy fools? If so, are not shareholders themselves to blame for the expropriation they have experienced? On the other hand, if shareholders are rational agents, albeit with limited capacity to scrutinize all aspects of company policy, then why should they allow themselves to be expropriated more when markets rise compared to when they fall? Maybe there is a plausible answer to this question, but Bebchuk and Fried do not give it.

Thus the introduction of a purely descriptive framework based on managerial power makes it hard to derive the normative statements necessary for policy recommendations. After the arm's-length bargaining model has been discarded as inadequate, it can also no longer serve to guide policy, precisely because it does not take into account some of the constraints under which policy must operate. The best way forward must be to extend the existing framework to allow for further constraints that the simple arm's-length bargaining framework does not take into account. This can provide a basis for a descriptive and normative theory by allowing the model either to reflect all of the currently existing constraints, or to study how changing the constraints can improve the welfare objective.

3. *Examples of Inefficient Compensation*

Pay without Performance identifies a multitude of compensation features that the authors find impossible to reconcile with the notion of arm's-length contracting. Their main concern is not with the level of pay per se that CEOs receive, even though this has been subject to much public controversy. Instead, they acknowledge that high levels of pay may be justifiable if a CEO adds a lot of value to a firm, which may well be the case. Bebchuk and Fried focus on the way in which CEOs are paid and argue that shareholders do not get the best possible return for the amount of money they spend on CEO compensation.

[23] Ibid at 74.

Bebchuk and Fried argue their point regarding the inefficiency of existing pay practice in a very systematic way. They describe, one by one, stylized features of compensation contracts that they view as inefficient. This could be, for example, the way in which the exercise price of executive stock options is set. They then illustrate that each particular feature is indeed inefficient in the sense that an alternative exists which would be more desirable for shareholders, but not in the interest of CEOs. For example, it would be better for shareholders to link the exercise price to a stock market or industry index rather than being based purely on the firm's own stock price. In a sense Bebchuk and Fried identify a puzzle, namely why do we see certain arrangements when they do not serve the best interest of shareholders? Bebchuk and Fried then invoke the 'managerial power' approach and argue that the observed pay practice can be explained under this approach.

Much of the time this method works well. However, in some instances one is left wondering whether the 'puzzle' has really been resolved by the managerial power approach. At times it seems like the managerial power approach does not really provide a terribly compelling alternative. In order to make the observations consistent with the new explanation, Bebchuk and Fried sometimes need to resort to rather ad hoc ways of applying their theory. This weakens their case rather than strengthen it. Arguably, a theory has more credibility if it admits that it cannot explain every single observation than when it tries to do just that. We know that there is no theory in the social sciences that can explain every observation within the realm of its applicability. Bebchuk and Fried therefore apply a hurdle to their own theory that is unnecessarily high. And the only way for them to clear their own hurdle is to come up with a theory that is sufficiently vague to permit explaining all observations. The following two examples of inefficient compensation arrangements illustrate this point.

A. *Executive Stock Options and Absolute Performance Compensation*

CEOs receive stock options, which are intended to provide incentives to increase the firm's share price: if the CEO manages the firm well, he will be rewarded for it, because the firm's stock price will increase and this increases the value of his stock options. It is known from economic theory, however, that there may be a cheaper way of providing the same incentives. This would be to reward a manager on the basis of his performance relative to other firms instead of purely on the basis of the manager's absolute performance.[24] Bebchuk and Fried therefore conclude that the types of stock option schemes that are commonly used are sub-optimal.[25] They argue that these types of options are nevertheless used because they are preferred by managers. According to Bebchuk and Fried this is

[24] See D. Mookherjee, 'Optimal Incentive Schemes with Many Agents' (1984) *Review of Economic Studies*, 51, 433–46.
[25] Ibid at 138.

so because index linked options can provide the same incentives at lower cost to shareholders, essentially because they reduce the windfalls that managers receive when they happen to be lucky. As Bebchuk and Fried put it, 'for the same reason that shareholders should favour reduced-windfall [relative performance benchmarked] options, managers prefer conventional options' (p. 144).

This conclusion is not obvious, which becomes clear when we consider more carefully the reasons why relative is said to be superior to absolute performance compensation. Broadly speaking there are two sets of circumstances which can justify the use of relative performance based compensation. One is limited liability of the manager, the other managerial risk aversion.

In case of limited liability, the manager's agency rent could be reduced by introducing relative performance based pay. In that case, shareholders would be better off and the manager would be worse off, just as argued by Bebchuk and Fried. However, given the evidence provided by them regarding high *levels* of pay for top CEOs, it seems unlikely that binding limited liability constraints are the main reasons for using relative performance based pay. Clearly, if the main point of relative performance based pay were the reduction of expected pay levels there would be more direct ways to achieve the same goal. To put it differently, given the high levels of pay observed in practice, there is no reason to believe that relative performance based compensation has to play a major role in adjusting pay levels.

Consider managerial risk aversion instead. It is well known that absolute performance based pay exposes a manager to considerable risk over which he has no control. If the overall economy, for example, goes into recession, the manager would be punished even though he may have managed the firm extremely effectively. A more efficient incentive contract would therefore make the CEO's pay contingent on the firm's relative rather than absolute performance. That way the CEO's incentives to manage the firm well would be preserved without exposing him to unnecessary risk. And because a risk averse CEO values the reduction in risk exposure, he would be willing to accept a relative performance based contract that yields lower expected compensation than the cheapest absolute performance package that provided the same incentives. Essentially, CEOs should demand higher expected payments when they are more exposed to risk and therefore such index linked options could reduce average compensation without making the CEO worse off. Shareholders should therefore prefer to award stock options that are linked to a stock market or industry index.

When Bebchuk and Fried argue that managers' prefer absolute performance based pay for the same reason that shareholders prefer relative performance based pay, they compare apples and oranges. They compare the average payoff of two different compensation schemes but do not make an allowance for the fact that poorly diversified managers may value the same average payoff differently, depending on how risky it is. Given that risk aversion, however, is the very reason why relative is superior to absolute performance based compensation, any comparison between the two types of schemes must take a risk adjustment into account explicitly.

Effectively, Bebchuk and Fried's discussion confounds two issues at this point, which should be distinguished more clearly. First, how does the compensation arrangement affect the overall surplus, including the efficiency of risk sharing? Second, how is the overall surplus split between shareholders and the manager? Relative performance is said to be desirable for *both* parties, because it increases the overall surplus, including the benefits from efficient risk sharing. The issue of how the surplus is then split can be separated from how the surplus is generated, because it can be regulated entirely through the fixed component of benefits. The argument for the prevalent use of standard stock option schemes that Bebchuk and Fried provide is therefore not a sufficient explanation. If the managerial power approach is to explain this phenomenon, it must be because somehow managers can design an absolute performance contract such that they receive a higher (risk adjusted) rent, than under the relative performance contract that they can design. Given that they are supposed to have power over the board it is not clear why they do not get the best of both worlds by designing a relative performance contract that reduces their risk exposure, but design it in such a way that they continue to expropriate shareholders to the same degree as under conventional options. Why should a manager's ability to expropriate shareholders be reduced when they try to do so via index linked stock options as compared to non-index linked stock options? There may be good reasons for this, but Bebchuk and Fried do not make that case.

One way in which Bebchuk and Fried could make their case more compelling in this regard might be to put less emphasis on what economists claim to be optimal contractual arrangements from a theoretical perspective. That kind of argument will invariably be subject to criticism on the grounds that economists' theory-based recommendations are never unequivocal.[26] Instead it might be instructive to look more directly to empirical evidence in order to try to establish whether the conventional stock option schemes widely used in the US are indeed sub-optimal. One way of doing so might be to consider pay practice in other countries that suffer less from the types of governance failures described in Bebchuk and Fried. Admittedly, such international comparisons always face the difficulty of entailing a change in several 'parameters', not just corporate governance. Most obviously the regulatory environment changes, which may also affect optimal compensation arrangements (most notably taxation). Nevertheless, it might be interesting to compare, for example, UK and US pay practice with a view to establishing whether the degree of relative performance evaluation changes. Arguably, the UK does not exhibit some of the governance failures that

[26] There is a host of research pointing to problems with relative performance based compensation. For example, it is clear that relative performance based compensation may affect competition between firms in a way that may not be desirable for shareholders (see R. Aggarval and A. Samwick, 'Executive compensation, strategic competition, and relative performance evaluation' (1999) *Journal of Finance* 54, 1999–2043).

plague the US according to Bebchuk and Fried. For example, the UK takeover code makes defences against hostile takeovers much harder compared to the US. Similarly, board accountability to shareholders is arguably stronger in the UK. One might therefore expect to see more use of relative performance-based stock option schemes compared to the US. This, of course, has to be weighed against some of the potential tax disadvantages that relative performance-based schemes face in the US.[27]

B. *Incentives are Undermined by Gratuitous Good-bye Payments*

Bebchuk and Fried point out that substantial severance payments for CEOs are not uncommon. Such payments are often not contracted upon *ex ante*, but instead arise at the discretion of the board at the time a CEO is fired, or when he agrees to have the company acquired by another firm.[28] It is true that such payments are hard to reconcile with an arm's-length contracting approach to compensation. Bebchuk and Fried therefore conclude that the managerial power approach can resolve the puzzle. This is how it works. We already know that the board, or at least some of its members, is reluctant to fire the CEO even after poor performance. The outrage constraint, however, becomes binding at some stage when performance has been too dismal. At this point the board may accept that it needs to replace the CEO. But in order for the board not to be excessively hard on the CEO, it agrees to award generous gratuitous payments. According to Bebchuk and Fried, the board members 'may wish to alleviate the general discomfort or even guilt they feel for pushing out their colleague and leader'.[29]

It is not obvious that this is a convincing explanation. The situation described here is one where the shareholders' outrage constraint has kicked in, or at least is a sufficiently serious threat for board members to adjust their behaviour in a way that is less favourable toward the CEO. Given that shareholders' outrage constraint is reached, how does the board get away with gratuitous payments at this point? Golden handshakes receive a great deal of public attention and given that the board agrees to fire the CEO, because shareholders are scrutinizing the board's actions at this point, why do shareholders not become outraged by those gratuitous good-bye payments?

Bebchuk and Fried do not address this question head on. If they were to do so, the answer would probably have to lie in the way in which the shareholders' outrage constraint is triggered. This, however, renders the whole concept of an outrage constraint increasingly empty. We are moving towards a point where the outrage constraint is defined by what makes it consistent with the evidence. It thus ceases to be a falsifiable element of a theory.

[27] see D. Schizer 'Tax Constraints on Indexed Options' (2001) *University of Pennsylvania Law Review* 149, 1941–54.

[28] *Pay without Performance* at 87.

[29] Ibid at 89.

Precisely this point becomes even more evident when Bebchuk and Fried discuss the common practice of golden parachutes, or more generally payments made to the CEO of a target company, when that CEO agrees to have their company acquired by another firm. Bebchuk and Fried argue that boards can get away with golden goodbye payments to the CEO of a company that is about to be acquired, because 'when companies are acquired, the outrage constraint is likely to be relatively loose'.[30] Why should the outrage constraint be less binding at this juncture? According to Bebchuk and Fried this is because target shareholders typically receive a premium when they tender their shares. Their resulting monetary gain makes target shareholders more complacent and less likely to become outraged. Moreover, the target firm's board will step down after the acquisition, which reduces the cost to the board of potential shareholder outrage. This may of course be right, but one is left feeling that one could equally well argue that the outrage constraint is more binding when a company is subject to a takeover attempt. It would be perfectly plausible to argue that the takeover event itself alerts shareholders to the fact that their CEO had not performed up to potential (why else would the acquiring firm be willing to pay a premium?). This should trigger outrage. Moreover, arguably the board should be less inclined to act in concert with the CEO, because the relationship between CEO and the board is going to terminate anyway after the takeover. It therefore seems that a plausible story can be told about *any* observation on the basis of an outrage constraint.

The point here is not so much that Bebchuk and Fried provide an explanation that is unlikely to be correct. The problem is that they introduce a concept as the underlying explanation that is rather ill defined and therefore provides little grip in attempting to explain the empirical observations.

4. *Conclusion*

Bebchuk and Fried's detailed account of current compensation practice in the US provides a compelling case for the hypothesis that inefficiencies in corporate governance are a serious concern. The book derives its strength from its thorough foundation on detailed institutional and regulatory knowledge which is then combined with a deep understanding of the relevant theoretical and empirical research in financial economics. In this way Bebchuk and Fried put together a detailed and comprehensive account of how certain governance failures give rise to inefficient executive compensation arrangements. Bebchuk and Fried are at their strongest when they describe the details of current arrangements and the institutional process leading up to those arrangements. *Pay without Performance* also argues persuasively that governance problems in the US lead to compensation arrangements that are less than optimal for shareholders. However, the

[30] Ibid at 90.

alternative descriptive framework provided in the book based on managerial power is less compelling. This is largely because one of its central elements, the 'outrage constraint' remains relatively poorly specified and therefore lends limited predictive power to this descriptive framework. At the same time this does not diminish the interesting insights the book provides, nor does it pose a major obstacle to carrying forward the work Bebchuk and Fried have done. *Pay without Performance* contains a wealth of indications as to where the roots of the governance problems lie and as such it fulfils its promise of providing a thorough description as well as the foundations of a normative framework of the problem of top executive compensation.