REGULATION

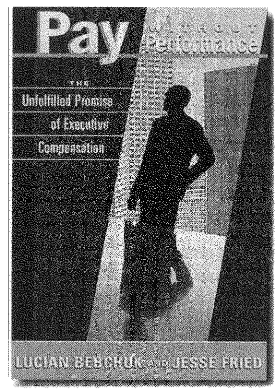
Misdiagnosing Manager Power

Reviewed by William A. Niskanen

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION

By Lucian Bebchuk and Jesse Fried

Cambridge, Mass.: Harvard University Press, 2004



LUCIAN BEBCHUCK AND Jesse Fried's book *Pay without Performance* is based on a simple premise:

> Managers use their power to secure rents.... Because managers and directors might have to bear market penalties and social costs if they adopt pay arrangements that are perceived as egregious, "outrage" costs and constraints place some limits on deviations from arms-length contracting. To avoid outrage, compensation designers attempt to hide, obscure, and justify . . . the amount and form of executive pay.

In other words, corporate managers, with the approval of compliant boards, effectively choose the amount and form of their own compensation, subject only to the limit that the compensation not provoke "outrage." As this book may become the standard reference for the law professors, sociologists, and journalists who share this managerial power perspective, it is important to evaluate the authors' reasoning and the empirical conditions that they claim as evidence for this perspective.

Bebchuk and Fried weave together a story with elements that are neither implausible nor new: CEOs who seek to increase their personal wealth even at the expense of the shareholders; directors who support the CEO out of loyalty, collegiality, and a desire for reappointment and who have neither the time, information, nor financial incentive to challenge him; and shareholders who have a very limited power to intervene. (The only internal error in this story is that the financial incentives of a director are a function of the total value of the shares that he owns, not his fraction of the total shares.)

The implications of this perspective for the level and form of executive compensation, however, cannot be directly tested, because there are no objective measures of the degree of board compliance and the limits on compensation that would not provoke outrage. But the authors claim that other types of evidence support their managerial power perspective. First, they make a prior personal judgment about the types of executive compensation that they believe are performance enhancing and those that are not. Second, they find that their favorite type of compensation is rare and that other types of compensation that they have judged to be ineffective are rather common.

But Bebchuk and Fried are wrong in their judgments about the types of compensation that are more or less performance enhancing. They assert, for example, that an option indexed to some broader industry or general stock index is much superior to an unindexed option because it does not reward or punish the executive for conditions common to the industry or the general stock market. But they apparently do not recognize that an executive would have to be offered many more indexed options or a higher salary to compensate him for the much lower expected return of an indexed option.

In contrast, Bebchuk and Fried judge that executive loans are not performance enhancing. A study by Lawrence Cunningham of the Boston College Law School, however, concludes,

> Loans are often tailored bonus schemes, forgiven or modified if executives achieve certain results. In that sense they resemble the incentive features of stock options, except that they are better. One reason loans are better than stock options is they have a downside if targets aren't met (the borrower must pay), whereas options expiring worthless pose no penalty.

In its infinite wisdom, of course, Congress has banned company loans to executives in the recent Sarbanes-Oxley Act.

Other types of evidence are also strongly inconsistent with the managerial power perspective on executive compensation. In contrast to Bebchuk and Fried's assertion that CEO compensation is only weakly related to firm performance, a 2000 paper by Brian Hall and

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Jeffery Liebman reported their estimate that a 10 percent increase in a firm's market value, which would add billions to the value of shareholders' wealth, would add $1.25 million to the value of a median CEO's accumulated stocks and options. In contrast to Bebchuk and Fried's assertion that corporations "camouflage" the amount and form of executive pay, a 2001 paper by Venky Nagar, Dhannanjay Nanda, and Peter Wysocki found that the level of disclosure "is positively related to the proportion of CEO compensation based on stock price." In a 2002 paper, Kevin Murphy reports that the average first-year compensation of CEOs hired from outside the firm (and thus who have little power over the existing board) is nearly twice that of CEOs promoted from within. In another 2002 paper, Michelle Hanlon, Shivaram Rajgopal, and Terry Shivlin report that "the future operating income associated with a dollar of Black-Scholes value of an ESO (executive stock option) grant is $3.82" and conclude that there is "little evidence in support of rent extraction" by top managers.

A 1994 summary of studies of executive compensation for the National Bureau of Economic Research by Nancy Rose concluded, "We find no evidence for the popular view that boards typically fail to penalize CEOs for poor financial performance or reward them disproportionately well for good performance." A similar 2003 survey for the Federal Reserve Bank of New York by John Core, Wayne Guay, and David Larcker concluded that, "in contrast to the allegation of many media pundits . . . who assert that incentive levels are random, arbitrary, or out of equilibrium, empirical evidence suggests that, on average, firms base their equity incentives on systematic and theoretically sensible factors."

Other evidence that Bebchuk and Fried offer in support of their managerial power perspective is that less than one percent of all CEOs resigned or were forced out each year because of poor performance in the years from 1993 through 1999; the authors do not mention that the stock market increased nearly 20 percent a year during that period. This situation, however, changed dramatically after the stock market peaked in early 2000. By 2002, Margarethe Miersema would observe, "The firings of CEOs when performance nosedives has become commonplace in U.S. business."

Executive compensation differs substantially among firms and has changed dramatically over time. Bebchuck and Fried provide no explanation of those differences or changes. They tell a plausible story that corporate executives have some managerial power, but they make no case that the differences in executive compensation are explained by the unmeasured differences in board compliance and the limits on compensation that would not provoke outrage, either among firms or over time. In summary, there is no reliable body of evidence that is consistent with substantial managerial power over their own compensation, and the managerial power perspective provides no explanation of the substantial differences in executive compensation among firms or over time.