

Pay Without Performance: Overview of the Issues

by Lucian A. Bebchuk, Harvard Law School, and Jesse M. Fried, University of California at Berkeley*

In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging.

—Warren Buffett, letter to shareholders of Berkshire Hathaway Inc. (February 2004)

In our recent book, *Pay Without Performance*,¹ and in several accompanying and subsequent papers,² we seek to provide a full account of how managerial power and influence have shaped executive compensation in publicly traded U.S. companies. Financial economists studying executive compensation have typically assumed that pay arrangements are produced by *arm's-length contracting*—contracting between executives attempting to get the best possible deal for themselves and boards trying to get the best deal for shareholders. This assumption has also been the basis for the corporate law rules governing the subject. We aim to show, however, that the pay-setting process in U.S. public companies has strayed far from the arm's-length model.

Our analysis indicates that managerial power has played a key role in shaping executive pay. The pervasive role of managerial power can explain much of the contemporary landscape of executive compensation, including practices and patterns that have long puzzled financial economists. We also show that managerial influence over the design of pay arrangements has produced considerable distortions in these arrangements, resulting in costs to investors and the economy. This influence has led to compensation schemes that weaken managers' incentives to increase firm value and even create incentives to take actions that *reduce* long-term firm value.

The dramatic rise in CEO pay during the last two decades has been the subject of much public criticism, which intensified following the corporate governance scandals that began erupting in late 2001. The wave of corporate scandals shook confidence in the performance of public company boards and drew attention to possible flaws in their executive compensation practices. As a result, there is now widespread recognition that many boards have employed compensation arrangements that do not serve shareholders' interests. But there is still substantial disagreement about the scope and source of such problems and, not surprisingly, about how to address them.

Many take the view that concerns about executive compensation have been exaggerated. Some maintain that flawed compensation arrangements have been limited to a relatively small number of firms, and that most boards have effectively carried out their role of setting executive pay. Others concede that flaws in compensation arrangements have been widespread, but maintain that these flaws have resulted from honest mistakes and misperceptions on the part of boards seeking to serve shareholders. According to this view, now that the problems have been recognized, corporate boards can be expected to fix them on their own. Still others argue that, even though regulatory intervention was necessary, recent reforms that strengthen director independence will fully address past problems; once these

* This paper is a revision of an article prepared for the summer 2005 issue of the *Journal of Corporation Law*. For financial support, we would like to thank the John M. Olin Center for Law, Economics, and Business and the Guggenheim, Lens, and Nathan Cummins Foundations (Bebchuk); and the Boalt Hall Fund and the U.C. Berkeley Committee on Research (Fried).

1. Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004). Earlier articles by us on which the book draws include Lucian A. Bebchuk, Jesse M. Fried, and David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review*, Vol. 69 (2002), pp. 751-846; and Lucian A. Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem,"

Journal of Economic Perspectives, Vol. 17 (2003), pp. 71-92.

2. These studies include Lucian A. Bebchuk and Jesse M. Fried, "Stealth Compensation via Retirement Benefits," *Berkeley Business Law Journal*, Vol. 2 (2004), pp. 291-325; Lucian A. Bebchuk and Jesse M. Fried, "Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage," forthcoming in *Journal of Corporation Law* (2005); Lucian A. Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Vol. 21 (2005), pp. 282-303; Lucian A. Bebchuk and Robert Jackson, Jr., "Putting Executive Pensions on the Radar Screen," Harvard Olin Paper No. 507, forthcoming in *Journal of Corporation Law* (2005); and Lucian A. Bebchuk and Yaniv Grinstein, "Firm Expansion and CEO Pay," Working Paper, Harvard Law School and NBER (2005).

reforms are implemented, boards can be expected to adopt shareholder-serving pay policies.

Our work seeks to persuade readers that such complacency is unwarranted. To begin with, flawed compensation arrangements have not been limited to a small number of “bad apples”; they have been widespread, persistent, and systemic. Furthermore, the problems have not resulted from temporary mistakes or lapses of judgment that boards can be expected to correct on their own; rather they have stemmed from structural defects in the underlying governance structure that enable executives to exert considerable influence over their boards. The absence of effective arm’s-length dealing under today’s system of corporate governance has been the primary source of problematic compensation arrangements. Finally, while recent reforms that seek to increase board independence will likely improve matters, they will not be sufficient to make boards adequately accountable; much more needs to be done.

Another, broader aim of our work has been to contribute to a better understanding of some basic problems with the U.S. corporate governance system. The study of executive compensation opens a window through which we can examine our current reliance on boards to act as guardians of shareholders’ interests. Our corporate governance system gives boards substantial power and counts on them to monitor and supervise company managers. As long as corporate directors are believed to carry out their tasks for the benefit of shareholders, current governance arrangements—which insulate boards from intervention by shareholders—appear acceptable. Our analysis of the executive pay landscape casts doubt on the validity of this belief and on the wisdom of insulating boards from shareholders.

A full understanding of the flaws in current compensation arrangements, and in the governance processes that have produced them, is necessary to address these problems. After providing a full account of the existing problems, our work also puts forward a set of proposals for improving both executive pay and corporate governance. We provide detailed suggestions for making both the amount of pay and its performance-sensitivity more transparent. Such transparency will provide a better check on managers’ power to influence their own pay. It will also eliminate existing incentives to choose compensation arrangements that are less efficient but more effective in camouflaging either the amount of pay or its insensitivity to managers’ own performance.

Furthermore, our analysis of the many ways in which pay schemes weaken or distort managerial incentives provides a basis for recommending how corporate boards could strengthen the link between pay and performance and thereby improve incentives. Finally, we propose a number of reforms that would make directors not only more independent of insiders but also more dependent on shareholders, thus improving board accountability to shareholders. Such reforms

may well offer the most promising route for improving executive compensation and corporate governance more generally.

In this paper, we outline some of the main elements of our critique of contemporary executive compensation and corporate governance arrangements, as well as our proposals and suggested reforms. We start by describing the limitations of the official arm’s-length model of executive compensation. We then turn to the managerial power perspective. We show that managerial influence can explain many features of the compensation landscape, and explain how this influence has led to opaque and distorted pay arrangements. We conclude with a discussion of our proposals for making pay more transparent, improving the design of pay arrangements, and increasing board accountability.

Before proceeding, we want to emphasize that our critique of existing pay arrangements and pay-setting processes does not imply that most directors and executives have acted less ethically than others would have in their place. Our problem is not with the moral caliber of directors and executives, but rather with *the system* of arrangements and incentives within which directors and executives operate. As currently structured, our corporate governance system unavoidably creates incentives and psychological and social forces that distort pay choices. Such incentives and forces can be expected to lead most people to go along with arrangements that favor their colleagues or individuals who can in turn favor them, as long as these arrangements are consistent with prevailing practices and conventions and thus not difficult to justify to themselves and to others. If we were to maintain the basic structure of the system and merely replace current directors and executives with a different set of individuals, the new directors and executives would be exposed to the same incentives and forces as their predecessors and, by and large, we would not expect them to act any differently. To address the flaws in the pay-setting process, we need to change the governance arrangements that produce these distortions.

The Stakes

What is at stake in the debate over executive pay? Some might question whether executive compensation has a significant economic impact on shareholders and the economy. The problems with executive compensation, it might be argued, do not much affect shareholders’ bottom line, but instead are mainly symbolic. However, the question of whether and to what extent pay arrangements are flawed is important for shareholders and policymakers because defects in these arrangements can impose substantial costs on shareholders.

Let’s start with the excess pay that managers receive as a result of their power—that is, the difference between what managers’ influence enables them to obtain and what they would get under arm’s-length contracting. As a recent study

Table 1 **Aggregate Top-Five Compensation, 1993-2003 (in billions of 2002 dollars)**

	Period	All ExecuComp Firms	Non-ExecuComp Firms	All Firms
Full period:	1993-2003	212	139	351
First five years:	1993-1997	68	55	123
Last five years:	1999-2003	122	70	192

Notes: The table shows aggregate compensation paid by a large set of public firms to their top five executives. The sample includes all ExecuComp firms and Compustat firms with market cap larger than \$50 million except for REITs, mutual funds, other investment funds (SIC codes 67xx), and firms with missing Compustat data. The compensation paid to executives of non-ExecuComp firms is estimated using the coefficients from annual regressions of compensation on firm characteristics in ExecuComp firms.

Source: Bebchuk and Grinstein, "The Growth of Executive Pay."

Table 2 **Compensation and Corporate Earnings**

	Period	Aggregate Top-Five Compensation to Aggregate Earnings
Three-year periods:	1993-1995	5.0%
	1994-1996	4.9%
	1995-1997	5.2%
	1996-1998	5.5%
	1997-1999	6.0%
	1998-2000	6.5%
	1999-2001	8.6%
	2000-2002	12.8%
	2001-2003	9.8%
Five-year periods:	1993-1997	5.2%
	1999-2003	8.1%
Full period:	1993-2003	6.6%

Notes: The table shows, for a large set of public firms, the ratio of the aggregate compensation of these firms' top-five executives to the aggregate earnings (net income) of these firms. The set of firms includes all ExecuComp firms and Compustat firms with market cap larger than \$50 million except for REITs, mutual funds, other investment funds, and firms with missing Compustat data. Income information is from Compustat, and the estimates of aggregate top-five compensation are calculated in the same way as in Table 1.

Source: Bebchuk and Grinstein, "The Growth of Executive Pay."

by Yaniv Grinstein and one of us documents in detail,³ the amounts involved are hardly pocket change for shareholders. Among other things, this study provides figures for the aggregate compensation of the top five executives of publicly traded U.S. firms. According to the study's estimates, which are shown in Table 1, these companies paid their top five executives a total of \$351 billion during the eleven-year period 1993-2003, with about \$192 billion paid during the five-year period 1999-2003. Note that the aggregate compensation figures reported by the study reflect only those amounts reported in each firm's annual summary compensation table. As will be discussed later, standard executive compensation datasets (like the ExecuComp dataset used in the study) omit many significant forms of compensation, such as the substantial amounts of retirement benefits received by executives. Thus, the aggregate compensation

figures may significantly understate the actual compensation received by top executives during this period.

Table 2 displays the ratio of aggregate top-five compensation to aggregate corporate earnings for publicly traded U.S. firms. Such aggregate compensation accounted for 6.6% of the aggregate earnings (net income) of publicly traded U.S. firms during the period 1993-2003. Moreover, during the most recent three-year period examined by the study (2001-2003), aggregate top-five compensation jumped to 9.8% of aggregate earnings, up from 5% during the period 1993-1995.

These figures indicate that if compensation levels could be cut without weakening managerial incentives, the gain to investors would not be merely symbolic; it would have a discernible effect on corporate earnings. But excess pay is unlikely to be the only or even the main cost of current

3. Bebchuk and Grinstein, "The Growth of Executive Pay," cited earlier.

compensation practices. Managers' influence over their compensation arrangements can result in the weakening and distortion of managerial incentives. In our view, the dilution and distortion of incentives could well impose a larger cost on shareholders than excessive compensation per se.

Existing pay arrangements have been producing two types of incentive problems. First, compensation arrangements have provided weaker incentives to increase shareholder value than would have been provided under arm's-length contracting. Both the non-equity and equity components of managerial compensation have been more sharply decoupled from managers' contribution to company performance than appearances might suggest. Making pay more sensitive to performance could therefore have substantial benefits for shareholders.

Second, prevailing practices not only fail to provide cost-effective incentives to increase value but also create perverse incentives. For example, managers' broad freedom to unload company options and stock can lead them to act in ways that reduce shareholder value. Executives who expect to unload shares have incentives to report misleading results, suppress bad news, and choose projects and strategies that are less transparent to the market. The efficiency costs of such distortions may well exceed—possibly by a large margin—whatever liquidity or risk-bearing benefits executives obtain from being able to unload their options and shares at will. Similarly, because existing pay practices often reward managers for increasing firm size, they provide executives with incentives to pursue expansion through acquisitions or other means, even when that strategy is value-reducing.

The Arm's-Length Contracting View

According to the "official" view of executive compensation, corporate boards setting pay arrangements are guided solely by shareholder interests and operate at arm's length from the executives whose pay they set. The premise that boards contract at arm's length with executives has long been and remains a central tenet in the corporate world and in most research on executive compensation by financial economists. In the corporate world, the official view serves as the practical basis for legal rules and public policy. It is used to justify directors' compensation decisions to shareholders, policymakers, and courts. These decisions are portrayed as being made largely with shareholders' interests at heart and therefore deserving of deference.

The premise of arm's-length contracting has also been shared by most of the research on executive compensation. Managers' influence over directors has been recognized by those writing on the subject from legal, organizational, and sociological perspectives, as well as by media commentary on executive pay. But the vast majority of research on executive pay has been done by financial economists, and most of their work assumes that corporate boards adopt pay arrangements that serve shareholders by providing managers with cost-effective incentives to maximize value. Because boards and executives operating at arm's length have incentives to avoid inefficient provisions, the arm's-length contracting view has led researchers to assume that executive compensation arrangements will tend to increase value.⁴ Some financial economists, whose studies we discuss at length in our book, have reported findings they viewed as inconsistent with the arm's-length model.⁵ However, most work in the field has started from the premise of arm's-length contracting between boards and executives.

Financial economists, both theorists and empiricists, have largely worked within the arm's-length model in attempting to explain common compensation arrangements as well as differences in compensation practices among companies.⁶ In fact, upon discovering practices that appear inconsistent with the cost-effective provision of incentives, financial economists have labored to come up with clever explanations for how such practices might be consistent with arm's-length contracting after all. Practices for which no explanation has been found have been described as "anomalies" or "puzzles" that will ultimately either be explained within the paradigm or disappear.

In our book, we identified many compensation practices that are difficult to understand under the arm's-length contracting view but can readily be explained by managerial influence over the pay-setting process. In response, critics suggested reasons why some of these practices could still have an explanation within an arm's-length contracting framework and argued that we have therefore not succeeded in ruling out completely the possibility of arm's-length dealing. For example, in response to our account of the significant extent to which pay is decoupled from performance, John Core, Wayne Guay, and Randall Thomas argue that there are circumstances in which large amounts of non-performance pay might be desirable.⁷ Similarly, in response to our criticism of the widespread failure of firms

4. The link between arm's-length contracting and efficient arrangements has led us to label arm's-length contracting as "efficient contracting" or "optimal contracting" in some of our earlier work. See Bebchuk, Fried, and Walker, (2002), cited earlier; Bebchuk and Fried (2003), cited earlier.

5. See, e.g., Olivier Jean Blanchard, Florencio Lopez-de-Silanes and Andrei Shleifer, "What Do Firms Do with Cash Windfalls?," *Journal of Financial Economics*, Vol. 36 (1994), pp. 337-360; David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance*, Vol. 52 (1997), pp. 449-476; and Marianne Bertrand and S. Mullainathan, "Are CEOs Rewarded for Luck? The Ones without Principals

Are," *Quarterly Journal of Economics*, Vol. 116 (2001), pp. 901-932.

6. For surveys from this perspective in the finance and economics literature, see, for example, John M. Abowd and David S. Kaplan, "Executive Compensation: Six Questions That Need Answering," *Journal of Economic Perspectives*, Vol. 13 (1999), pp. 145-168; and John E. Core, Wayne Guay, and David F. Larcker, "Executive Equity Compensation and Incentives: A Survey," *Economic Policy Review*, Vol. 9 (2003), pp. 27-50.

7. See, e.g., John E. Core, Wayne R. Guay, and Randall S. Thomas, "Is U.S. CEO Compensation Inefficient?," *Michigan Law Review*, Vol. 103 (2005), pp. 1142-1185.

to adopt option plans that filter out windfalls, both Jeff Gordon and Bengt Holmstrom argue that our analysis has not completely ruled out the possibility of explaining such failure within the arm's-length contracting model.⁸

These arguments reflect an implicit presumption in favor of arm's-length contracting: pay arrangements are assumed to be the product of arm's-length contracting unless one can prove otherwise. The presumption of arm's-length contracting, however, does not seem warranted. As we discuss below, an examination of the pay-setting process suggests that managerial influence seems likely to play a key role. Thus, given the *a priori* likelihood of managerial influence, the burden of proof should be on those arguing that executive pay arrangements are not significantly shaped by such influence. In any event, the fact that financial economists continue implicitly or explicitly to use arm's-length contracting as their baseline presumption indicates the dominance and power of this long-held view.

Limits of the Arm's-Length View

The official arm's-length story is neat, tractable, and reassuring. But it fails to account for the realities of executive compensation.

The arm's-length contracting view recognizes that managers are subject to an agency problem and do not automatically seek to maximize shareholder value. The potential divergence between managers' and shareholders' interests makes it important to provide managers with adequate incentives. Under the arm's-length view, the board attempts to provide such incentives cost-effectively through managers' compensation packages. But just as there is no reason to assume that managers automatically seek to maximize shareholder value, there is no reason to expect that directors will either. Indeed, an analysis of directors' incentives and circumstances suggests that director behavior is also subject to an agency problem.

Directors have had and continue to have various economic incentives to support, or at least go along with, arrangements that favor the company's top executives. A variety of social and psychological factors—collegiality, team spirit, a natural desire to avoid conflict within the board, friendship and loyalty, and cognitive dissonance—exert additional pull in that direction. Although many directors own some stock in their companies, their ownership positions are too small to give them a financial incentive to take the personally costly, or at the very least unpleasant, route of resisting compensation arrangements sought by executives. In addition, limitations on time and resources have made it difficult for even well-intentioned

directors to do their pay-setting job properly. Finally, the market constraints within which directors operate are far from tight and do not prevent deviations from arm's-length contracting outcomes in favor of executives. Below we briefly discuss each of these factors.

Incentives to be Re-Elected

Besides an attractive salary, a directorship is also likely to provide prestige and valuable business and social connections. The financial and nonfinancial benefits of holding a board seat naturally give directors an interest in keeping their positions.

In a world where shareholders select individual directors, board members might have an incentive to develop reputations as shareholder-serving. Typically, however, the director slate proposed by management is the only one offered. The key to retaining a board position is thus being placed on the company's slate. And because the CEO has had significant influence over the nomination process, displeasing the CEO has been likely to hurt one's chances of being put on the company slate. Directors have thus had an incentive to go along with the CEO's pay arrangement as long as the compensation package remains within the range of what can plausibly be defended and justified. In addition, developing a reputation as a director who blocks compensation arrangements sought by executives can only hurt a director's chances of being invited to join other boards.

The new stock exchange listing requirements, which attempt to give independent directors a greater role in director nominations, weaken but do not eliminate executives' influence over director nominations. The CEO's wishes can be expected to continue to influence the decisions of the nominating committee; after all, the directors appointed to the board are expected to work closely with the CEO. As a practical matter, director candidates who are opposed by the CEO are not expected to be offered board nomination and would likely decline the nomination if it were offered.⁹ Even if the CEO had no influence over nominations, members of the nominating committee would be unlikely to look favorably on an individual who has taken a tough position on the CEO's pay. They might wish to avoid the friction and unpleasantness accompanying disputes over the CEO's pay, or might simply side with the CEO for other reasons discussed below.

CEOs' Power to Benefit Directors

There are a variety of ways in which CEOs can benefit individual directors or board members as a group. For one thing, CEOs have influence over director compensation. As the company leader, usually as a board member, and often as

8. See Bengt Holmstrom, "Comments on Bebchuk and Fried's book 'Pay Without Performance: The Unfulfilled Promise of Executive Compensation'," forthcoming in *Journal of Corporation Law* (2005); Jeffrey Gordon, "Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'," *Journal of*

Applied Corporate Finance (this issue).

9. Daniel Nasaw, "Opening the Board: The Fight Is On to Determine Who Will Guide the Selection of Directors in the Future," *Wall Street Journal* (October 27, 2003), p. R8.

board chairman, the CEO can choose either to discourage or encourage increases in director pay. Independent directors who are generous toward the CEO might reasonably expect the CEO to use his or her bully pulpit to support higher director compensation. At a minimum, generous treatment of the CEO contributes to an atmosphere that is conducive to generous treatment of directors. And in fact, a study finds that companies with higher CEO compensation have higher director compensation as well—and that such high pay levels appear to reflect insider “cooperation” rather than superior corporate performance.¹⁰

CEOs also have often used their power over corporate resources to reward individual directors who were particularly cooperative. The new stock exchange listing standards place some limits on CEOs’ ability to reward independent directors, but they do leave CEOs with substantial power in this area. For example, these requirements allow the company to pay \$100,000 in additional compensation to an independent director. And there is no limit to how much the firm can pay an independent director’s immediate family members, as long as they are non-executive employees.

Similarly, the requirements limit but do not prohibit business dealings between a company and an independent director’s firm, and they place no limit on the company’s dealings with the director’s firm before or after the director qualifies for independent director status. The standards also permit unlimited contributions to charitable organizations that independent directors run, are affiliated with, or simply favor. In sum, executives’ control over corporate resources continues to enable them to provide many directors with rewards—rewards that generally outweigh the small direct personal cost to most directors of approving pay arrangements that fail to serve shareholder interests.

Friendship and Loyalty

Many independent directors have some prior social connection to the company’s CEO or other senior executives. Even directors who did not know the CEO before their appointment may well have begun their service with a sense of obligation and loyalty to the CEO. The CEO often will have been involved in recruiting the director to the board. As a result, directors often start serving with a reservoir of good will toward the CEO, which will contribute to a tendency to favor the CEO on compensation matters. This kind of reciprocity is expected and observed in many social and professional contexts. Not surprisingly, studies find that compensation committees whose chairs have been appointed after the CEO takes office have tended to award higher CEO compensation.¹¹

Collegiality and Authority

In addition to friendship and loyalty considerations, there are other social and psychological forces that make it difficult for directors to resist executive-serving compensation arrangements. The CEO is the directors’ colleague, and directors are generally expected to treat their fellow directors collegially. The CEO is also the company’s leader, the person whose decisions and visions have the most influence on the firm’s future direction. In most circumstances, directors treat the CEO with respect and substantial deference. Switching hats to contract at arm’s length with one’s colleague and leader is naturally difficult.

Cognitive Dissonance and Solidarity

Many members of compensation committees are current and former executives of other companies. Because individuals have a tendency to develop views that are consistent with their self-interest, executives and former executives are likely to have formed beliefs that support the type of pay arrangements from which they themselves have benefited. An executive who has benefited from a conventional option plan, for example, is more likely to resist the view that such plans provide executives with excessive windfalls.

Further reinforcing such cognitive dissonance, an executive who serves as a director in another firm might identify and feel some solidarity or sympathy with that firm’s executives and naturally would be inclined to treat these executives the same way he or she would like to be treated. Not surprisingly, there is evidence that CEO pay is correlated with the pay levels of the outside directors serving on the compensation committee.¹²

The Small Cost of Favoring Executives

Directors typically own only a small fraction of the firm’s shares. As a result, the direct personal cost to board members of approving compensation arrangements that are too favorable to executives—the reduction in the value of their shareholdings—is small. This cost is therefore unlikely to outweigh the economic incentives and social and psychological factors that induce directors to go along with pay schemes that favor executives.

Ratcheting

It is now widely recognized that the rise in executive compensation has in part been driven by many boards seeking to pay their CEO more than the industry average; this widespread practice has led to an ever-increasing average and a continuous escalation of executive pay.¹³ A review

10. Ivan E. Brick, Oded Palmon, and John K. Wald, “CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism,” forthcoming in *Journal of Corporate Finance* (2005).

11. Brian G. M. Main, Charles A. O’Reilly III, and James Wade, “The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives,”

Industrial and Corporate Change, Vol. 11 (1995), pp. 292-332.

12. Main, O’Reilly III, and Wade (1995), cited earlier.

13. Kevin J. Murphy, “Executive Compensation,” in *Handbook of Labor Economics*, edited by Orley Ashenfelter and David Card (New York: Elsevier, 1999).

of reports of compensation committees in large companies indicates that a large majority of them used peer groups in determining pay and set compensation at or above the 50th percentile of the peer group.¹⁴ Such ratcheting is consistent with a picture of boards that do not seek to get the best deal for their shareholders, but are happy to go along with whatever can be justified as consistent with prevailing practices.

Limits of Market Forces

Some writers have argued that even if directors are under the considerable influence of corporate executives, market forces will force boards and executives to adopt the compensation arrangements that arm's-length contracting would produce. Our analysis, however, finds that market forces are neither sufficiently fine-tuned nor sufficiently powerful to compel such outcomes. The markets for capital, corporate control, and managerial labor do impose *some* constraints on executive compensation. But these constraints are by no means stringent and they permit substantial deviations from arm's-length contracting.

Consider, for example, the market for corporate control—the threat of a takeover. Most companies have substantial defenses against takeovers. For example, a majority of companies have a staggered board, which prevents a hostile acquirer from gaining control before two annual elections are held, and often enables incumbent managers to block hostile bids that are attractive to shareholders. To overcome incumbent opposition, a hostile bidder must be prepared to pay a substantial premium.¹⁵ The disciplinary force of the market for corporate control is further weakened by the prevalence of golden parachute provisions, as well as by payoffs made by acquirers to target managers to facilitate the acquisition. The market for corporate control thus exerts little disciplining force on managers and boards, leaving them with considerable slack and the ability to negotiate manager-favoring pay arrangements.

New CEOs

Some critics of our work have assumed that our analysis of managerial influence does not apply when boards negotiate pay with a CEO candidate from outside the firm.¹⁶ However, while such negotiations might be closer to the arm's-length model than negotiations with an incumbent CEO, they still fall quite short of this benchmark.

Among other things, directors negotiating with an outside CEO candidate know that, after the candidate becomes CEO, he or she will have influence over their re-nomination to the board and over their compensation and

perks. The directors will also wish to have good personal and working relationships with the individual who is expected to become the firm's leader and a fellow board member. And while agreeing to a pay package that favors the outside CEO imposes little financial cost on directors, a breakdown in the negotiations, which might embarrass the directors and force them to re-open the CEO selection process, would be personally costly to them. Finally, directors' limited time forces them to rely on information shaped and presented by the company's human resources staff and compensation consultants, all of whom have incentives to please the incoming CEO.

Firing of Executives

Some have suggested that the increased willingness of directors to force out CEOs over the past decade, especially in recent years, provides evidence that boards do in fact deal with CEOs at arm's length.¹⁷ However, firings or resignations under fire are still limited to unusual situations in which the CEO is accused of legal or ethical violations (such as Fannie Mae, AIG, Boeing, and Marsh) or is viewed by revolting shareholders as having a record of terrible performance (such as Morgan Stanley and HP). Without strong outside pressure to fire the CEO, mere mediocrity is far from enough to get a CEO pushed out. Furthermore, in the rare cases in which boards fire executives, boards often provide the departing executives with benefits beyond those required by the contract to sweeten the CEO's departure and alleviate the directors' guilt and discomfort. All in all, boards' record of dealing with failed executives does not support the view that boards treat CEOs at arm's length.

In sum, a realistic picture of the incentives and circumstances of board members reveals many incentives and tendencies that lead directors to behave very differently than boards contracting at arm's length with their executives over pay. Recent reforms, such as the new stock exchange listing requirements, may weaken some of these factors but will not eliminate them. Without additional reforms, the pay-setting process will continue to deviate substantially from arm's-length contracting.

Power and Pay

The same factors that limit the usefulness of the arm's-length model in explaining executive compensation suggest that executives have had substantial influence over their own pay. Compensation arrangements have often deviated from arm's-length contracting because directors have been influenced by management, insufficiently motivated

14. John M. Bizjak, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?," Working paper (2003).

15. Lucian Bebchuk, John Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review*, Vol. 54 (2002).

16. Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," *University of Chicago Law Review*, Vol. 69 (2002), pp. 847-869.

17. See, e.g., Holman W. Jenkins, "Outrageous CEO Pay Revisited," *Wall Street Journal* (October 2, 2002), p. A17.

to insist on shareholder-serving compensation, or simply ineffectual. Executives' influence over directors has enabled them to obtain "rents"—benefits greater than those obtainable under true arm's-length contracting.

In our work, we find that the role of managerial power can explain many aspects of the executive compensation landscape. It is worth emphasizing that our conclusion is not based on the amount of compensation received by executives. In our view, high absolute levels of pay do not by themselves imply that compensation arrangements deviate from arm's-length contracting. Our finding that such deviations have been common is based primarily on an analysis of the process by which pay is set and an examination of the inefficient, distorted, and nontransparent structure of pay arrangements that emerge from this process. For us, the "smoking gun" of managerial influence over pay is not high levels of pay, but rather such things as the correlation between power and pay, the systematic use of compensation practices that obscure the amount and performance insensitivity of pay, and the showering of gratuitous benefits on departing executives.

Power-Pay Relationships

Although top executives generally have some degree of influence over their boards, the extent of their influence depends on various features of the company's governance structure. The managerial power approach predicts that executives who have more power should receive higher pay—or pay that is less sensitive to performance—than their less powerful counterparts. A substantial body of evidence does indeed indicate that pay is higher, and less sensitive to performance, when executives have more power.

First, there is evidence that executive compensation is higher *when the board is relatively weak or ineffectual* vis-à-vis the CEO. In particular, CEO compensation is higher when the board is large, which makes it more difficult for directors to organize in opposition to the CEO; when more of the outside directors have been appointed by the CEO, which could cause them to feel gratitude or obligation to the CEO; and when outside directors serve on three or more boards, and thus are more likely to be distracted.¹⁸ Also, CEO pay is 20% to 40% higher if the CEO is the chairman of the board, and it is negatively correlated with the stock ownership of compensation committee members.¹⁹

Second, studies find a negative correlation between the *presence of a large outside shareholder* and pay arrangements

that favor executives. A large outside shareholder might engage in closer monitoring and thereby reduce managers' influence over their compensation. One study finds a negative correlation between the equity ownership of the largest shareholder and the amount of CEO compensation; more specifically, doubling the percentage ownership of a large outside shareholder is associated with a 12% to 14% reduction in a CEO's non-salary compensation.²⁰ Another study finds that CEOs in companies without a 5% (or larger) outside shareholder tend to receive more "luck-based" pay—that is, pay associated with profit increases that are generated entirely by external factors (such as changes in oil prices and exchange rates) rather than by managers' own efforts.²¹ This study also finds that, in companies lacking large outside shareholders, boards make smaller reductions in cash compensation when they increase CEOs' option-based compensation.

Third, there is evidence linking executive pay to the *concentration of institutional shareholders*, which are more likely to monitor the CEO and the board. One study finds that more concentrated institutional ownership leads to lower and more performance-sensitive compensation.²² Another study finds that the effect of institutional shareholders on CEO pay depends on the nature of their relationships with the firm.²³ This study reports that CEO pay is negatively correlated with the presence of "pressure-resistant" institutions—institutions that have no other business relationship with the firm and thus presumably are concerned only with the firm's share value. But CEO pay is positively correlated with the presence of "pressure sensitive" institutions—those having business relationships with the firm (such as managing its pension funds) and thus more vulnerable to management pressure.

Finally, studies find a connection between pay and *anti-takeover provisions*, arrangements that make CEOs and their boards less vulnerable to a hostile takeover. One study finds that CEOs of companies adopting anti-takeover provisions enjoy above-market compensation before adoption of the provisions and that adoption is followed by further significant increases in pay.²⁴ This pattern is not readily explainable by arm's-length contracting; indeed, if risk-averse managers' jobs are more secure, shareholders should be able to pay the managers less. Another study finds that CEOs of companies that became protected by state anti-takeover legislation enacted during the period of 1984-1991 reduced their holdings of shares (which became less impor-

18. John Core, Robert Holthausen, and David Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics*, Vol. 51 (1999), pp. 371-406.

19. Core, Holthausen, and Larcker (1999), cited earlier; Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence," *Management Science*, Vol. 48 (2002), pp. 453-469.

20. Cyert, Kang, and Kumar (2002), cited earlier.

21. Marianne Bertrand and Sendhil Mullainathan, "Agents With and Without Principals,"

American Economic Review, Vol. 90 (2000), pp. 203-208.

22. Jay C. Hartzell and Laura T. Starks, "Institutional Investors and Executive Compensation," *Journal of Finance*, Vol. 58 (2003), pp. 2351-2374.

23. David Parthiban, Rahul Kochar, and Edward Levitas, "The Effect of Institutional Investors on the Level and Mix of CEO Compensation," *Academy of Management Journal*, Vol. 41 (1998), pp. 200-208.

24. Kenneth A. Borokhovich, Kelly R. Brunarski, and Robert Parrino, "CEO Contracting and Anti-Takeover Amendments," *Journal of Finance*, Vol. 52 (1997), pp. 1503-1513.

tant for the purpose of maintaining control) by an average of 15%.²⁵ Arm's-length contracting, by contrast, might predict that CEOs protected by anti-takeover legislation would be *required by their boards* to increase their shareholdings to restore their incentive to generate shareholder value.

Limits of Managerial Influence

There are, of course, limits to the arrangements that directors will approve and executives will seek. Although market forces are not sufficiently powerful to prevent significant deviations from arm's-length outcomes, they do impose *some* constraints on executive compensation. If a board were to approve a pay arrangement viewed as egregious, for example, shareholders would be less willing to support incumbents in a hostile takeover or a proxy fight.

In addition, directors and executives adopting such an arrangement might bear social costs. Directors approving a clearly inflated and distorted pay package might be subject to ridicule or scorn in the media or in their social and business circles. Most directors would wish to avoid such treatment, even if their board positions were not at risk, and these potential social costs reinforce the constraints imposed by market forces. Like market forces, these potential costs cannot preclude significant deviations from shareholder-serving arrangements, but they may discourage the adoption of arrangements that are patently abusive and indefensible.

One important building block of the managerial power approach is therefore "outrage" costs. When a board approves a compensation arrangement favorable to managers, the extent to which directors and executives bear economic costs (such as heightened risk of takeover) and social costs (such as embarrassment) will depend on how the arrangement is perceived by outsiders whose views matter to the directors and executives. The more outrage a compensation arrangement is expected to generate, the larger will be the potential economic and social costs, and thus the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place.

There is evidence that the design of compensation arrangements is indeed influenced by how outsiders perceive them. One study finds that, during the 1990s, CEOs who were the target of shareholder resolutions criticizing executive pay had their annual (industry-adjusted) compensation reduced over the following two years.²⁶

Camouflage and Stealth Compensation

The critical role of outsiders' perception of executives' compensation and the significance of outrage costs explain the importance of yet another component of the manage-

rial power approach: "camouflage." The desire to minimize outrage gives designers of compensation arrangements a strong incentive to try to legitimize, justify, or obscure—or, more generally, to camouflage—the amount and performance-insensitivity of executive compensation.

The desire to camouflage has an important effect on pay structures. We show that compensation designers' attempts to obscure the amount and performance-insensitivity of compensation have led to arrangements that undermine and distort managerial incentives, thereby weakening firm performance. Overall, the camouflage motive turns out to be quite useful in explaining many otherwise puzzling features of the executive compensation landscape.

Among the arrangements that disguise or downplay the amount and performance-insensitivity of compensation are executive pension plans, deferred compensation arrangements, and post-retirement perks. Most executive pensions and deferred compensation arrangements do not enjoy the large tax subsidy granted to the standard retirement arrangements provided to other employees. In the case of executives, such arrangements merely shift tax liability from the executive to the firm. The efficiency grounds for providing compensation through in-kind retirement perks are also far from clear.

All of these arrangements, however, make executives' compensation less visible to investors, regulators, and the general public. Among other things, existing disclosure rules do not require companies to place a dollar value on—or include in their publicly filed summary compensation tables—the amounts provided to executives after they retire. Although the existence and terms of executives' retirement arrangements must be disclosed in various places throughout the firm's public filings, this disclosure is less visible because outsiders, including compensation researchers and the media, focus on the dollar amounts reported in the compensation tables.

In a recent empirical study, Robert Jackson and one of us used information provided in proxy statements to estimate the value of the executive pension plans of S&P 500 CEOs.²⁷ About two-thirds of CEOs have such plans, and the study estimated the value of these plans for all the CEOs who recently left their firms or are close to retirement age. For the median CEO in the study's sample, the actuarial value of the CEO's pension was \$15 million, which made up about one-third of the total compensation (both equity-based and non-equity) they had received during their service as CEOs.

Furthermore, the study indicates that, when pension value is included in calculating executive pay, compensa-

25. Shijun Cheng, Venky Nagar, and Madhar V. Rajan, "Identifying Control Motives in Managerial Ownership: Evidence from Antitakeover Legislation," *Review of Financial Studies*, Vol. 8 (2005), pp. 637-672.

26. Randall S. Thomas and Kenneth J. Martin, "The Effect of Shareholder Proposals

on Executive Compensation," *University of Cincinnati Law Review*, Vol. 67 (1999), pp. 1021-1065.

27. See Bebchuk and Jackson (2005), cited earlier.

tion is much less linked to performance than commonly perceived. After pension value is included, the percentage of a CEO's total compensation that is "salary-like" (i.e., the portion that consists of fixed annual payments, such as basic salary during the CEO's service and pension payments afterwards), increases from 16% to 39%. The study documents that the current omission of retirement benefits from standard compensation datasets has distorted investors' picture of pay arrangements. In particular, this omission has led to: 1) significant underestimations of the total amount of pay; 2) considerable distortions in comparisons among executive pay packages; and 3) substantial overestimations of the extent to which executive pay is linked to performance.

While companies do not make the value of executive pensions transparent, they are required to disclose enough information to enable diligent researchers to estimate the value of these pensions. In contrast, the information provided about deferred compensation arrangements does not allow even the most careful analyst to estimate with any precision the value conferred on executives through these arrangements. Thus, this form of compensation is especially effective in camouflaging potentially large amounts of non-performance pay.

Gratuitous Goodbye Payments

In many cases, boards give departing CEOs payments and benefits that are not required under the terms of a CEO's compensation contract. Such gratuitous "goodbye payments" are common even when CEOs perform so poorly that their boards feel compelled to replace them. For example, when Mattel CEO Jill Barad resigned under fire, the board forgave a \$4.2 million loan, gave her an additional \$3.3 million in cash to cover the taxes for forgiveness of another loan, and allowed her unvested options to vest prematurely. These gratuitous benefits were offered in addition to the considerable benefits that she received under her employment agreement, which included a termination payment of \$26.4 million and a stream of retirement benefits exceeding \$700,000 per year.

It is not easy to reconcile such gratuitous payments with the arm's-length contracting model. The board has the authority to fire the CEO and pay no more than the CEO's contractual severance benefits. There should be no need to "bribe" a poorly performing CEO to step down. In addition, the signal sent by the gratuitous goodbye payment will, if anything, only weaken the incentive of the next CEO to perform.

The making of such gratuitous payments, however, is quite consistent with the existence of managerial influence

over the board. Because of their relationship with the CEO, some directors might be unwilling to replace the existing CEO unless he or she is very generously treated. Other directors might be willing to replace the CEO even without a gratuitous goodbye payment but prefer to give it either to reduce their personal discomfort in forcing out the CEO or to make the separation process less personally unpleasant. In all of these cases, directors' willingness to make such payments stems from their relationships with the CEO.

Of course, taking managerial power *as given*, providing gratuitous payments to fired CEOs could be beneficial to shareholders in some instances. If many directors are loyal to the CEO, such payments might be necessary to assemble a board majority in favor of replacing the executive. In this case, the practice helps shareholders when the CEO's departure yields a benefit larger than the cost of the goodbye payment. For our purposes, however, what is important is that these gratuitous payments, whether or not they are beneficial to shareholders (given managers' power), reflect the existence and significance of managerial influence.

The Decoupling of Pay from Performance

In the early 1990s, prominent financial economists such as Michael Jensen and Kevin Murphy urged shareholders to be more accepting of large pay packages that would provide high-powered incentives.²⁸ Shareholders, it was argued, should care much more about providing managers with sufficiently strong incentives than about the amounts spent on executive pay. Defenders of current pay arrangements view the rise in pay over the past 15 years as the necessary price—and one well worth paying—for improving executives' incentives.

The problem, however, is that executives' large compensation packages have been much less sensitive to their own performance than has been commonly recognized. Shareholders have not received the most bang for their buck. Companies could have generated the same increase in incentives at a much lower cost to their shareholders, or they could have used the amount spent to obtain more powerful incentives.

Non-Equity Compensation

Although the equity-based fraction of managers' compensation has increased considerably during the past decade and has therefore received more attention, non-equity compensation continues to be substantial. In 2003, non-equity compensation represented on average about half the total compensation of both the CEO and the top five executives of S&P 1500 companies not classified as new economy firms.²⁹

Although significant non-equity compensation comes in the form of base salary and sign-up "golden hello"

28. Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives," *Journal of Political Economy*, Vol. 98 (1990), pp. 225-264; and Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay, but How," *Har-*

vard Business Review, Vol. 68 (1990), pp. 138-153.

29. Bebchuk and Grinstein, "The Growth of Executive Pay," cited earlier.

payments that do not purport to be performance-related, much non-equity compensation comes in the form of bonus compensation that does purport to be performance-based. Nonetheless, empirical studies have failed to find any significant correlation between non-equity compensation and managers' own performance during the 1990s.³⁰

A close examination of compensation practices suggests why non-equity compensation is not tightly connected to managers' own performance. First of all, many companies use subjective criteria for at least some of their bonus payments. Such criteria could play a useful role in the hands of boards guided solely by shareholder interests. However, boards favoring their top executives can use the discretion provided by these plans to ensure that executives are well paid even when their performance is substandard.

Furthermore, when companies do use objective criteria, these criteria and their implementation are usually not designed to reward managers for *their own contribution* to the firm's performance. Bonuses are typically based not on how the firm's operating performance or earnings increased relative to its peers but rather on other metrics. And when companies fail to meet the established targets, the board can reset the target (as happened at Coca-Cola in 2001 and at AT&T Wireless in 2002) or compensate the executives by setting even lower figures going forward.

Finally, many boards award bonuses to managers simply for buying other companies. In about 40% of large acquisitions during the period 1993-1999, the acquiring-firm CEO received a multi-million dollar bonus for completing the deal.³¹ But making acquisitions hardly appears to be something for which managers should receive a special reward—that is, a payment above and beyond whatever benefit they get from the effect of the acquisition on the value of the managers' options, shares, and earnings-based bonuses. Executives do not lack incentives to make value-increasing acquisitions. If anything, investors' concern is that executives may engage in empire-building and make too many acquisitions. Thus, although the making of a large acquisition might provide a convenient excuse for a large bonus, acquisition bonuses are not called for by incentive considerations.

Windfalls in Equity-Based Compensation

In light of the historically weak link between non-equity compensation and managerial performance, shareholders and regulators wishing to make pay more sensitive to performance have increasingly encouraged the use of equity-based compensation, often in the form of stock options. We strongly support equity-based compensation, which in

principle can provide managers with desirable incentives. In practice, however, the design of executives' stock options has enabled executives to reap substantial rewards even when their own performance was merely passable or even poor.

Rewards for Market-Wide and Industry-Wide Movements. Conventional stock options enable executives to gain from any increase in the nominal stock price above the grant-date market value. This in turn means that executives can profit even when their companies' performance significantly lags that of their peers, as long as market-wide and industry-wide movements provide sufficient lift for the stock price. A substantial fraction of stock price increases is due to such movements, rather than to firm-specific factors that might reflect the manager's own performance.

Although there is a variety of ways in which market- and industry-driven windfalls could be filtered out, very few companies have adopted equity-based plans that even attempt to filter out such windfalls. Unfortunately, most of the boards now changing their equity-based compensation plans in response to outside pressure are still choosing to avoid plans that would effectively eliminate such windfalls. Instead, they are moving to plans based on restricted stock that fail to eliminate, and sometimes even increase, these windfalls.

Rewards for Short-Term Spikes. Option plans have been designed, and largely continue to be designed, in ways that enable executives to make considerable gains from temporary spikes in the company's stock price, even when long-term stock performance is poor. Companies have given executives broad freedom to unwind equity incentives, a practice that has been beneficial to executives but costly to shareholders. In addition to being granted the freedom to exercise their options as soon as they vest and sell the underlying stock, executives often have considerable control over the timing of sales, enabling them to benefit from their inside information. Compounding the problem, many firms have adopted reload plans that make it easier for executives to lock in profits from short-term spikes. The features of option plans that reward managers for short-term spikes not only decouple pay from managers' own performance, but also provide incentives to manipulate earnings. There is in fact significant evidence linking executives' freedom to unload options with earnings manipulation and financial misreporting.³²

Compensation At and After Departure

As already noted, the dollar value of a substantial portion of executive compensation is not reported in firms' publicly filed summary compensation tables and is therefore not included in standard compensation datasets. This "stealth compen-

30. See Murphy (1999), cited earlier.

31. Yaniv Grinstein and Paul Hribar, "CEO Compensation and Incentives: Evidence from M&A Bonuses," *Journal of Financial Economics*, Vol. 71 (2004), pp. 119-143.

32. Daniel Bergstresser and Thomas Philippon, "CEO Incentives and Earnings Manage-

ment: Evidence from the 1990s," forthcoming in *Journal of Financial Economics* (2005); Scott L. Summers and John T. Sweeney, "Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis," *Accounting Review*, Vol. 73 (1998), pp. 131-146.

sation” includes executive pensions, deferred compensation arrangements, and post-retirement consulting contracts and perks. These less visible forms of compensation have tended to be insensitive to managerial performance, thus further contributing to a decoupling of pay from performance.

Take, for example, Franklin Raines, who was forced to retire as Fannie Mae’s CEO in late 2004. Upon departure, Fannie owed him (and his surviving spouse after his death) an annual pension of approximately \$1.4 million, an amount specified without any connection to the firm’s stock performance under Raines. In a case study of his compensation, we estimated the value of this non-performance element of pay at about \$25 million.³³

Further decoupling pay from performance are severance payments given to departing executives. Executives pushed out by their boards are typically paid a severance amounting to two or three years’ worth of annual compensation. These payments are not reduced even when the executive’s performance has been clearly and objectively dismal. Furthermore, standard severance provisions do not reduce the severance payment even if the executive quickly finds other employment.

It is doubtful that these severance arrangements reflect efficient, arm’s-length contracting. Non-executive employees are both more likely to be terminated than executives and less financially capable of bearing this risk. But they are not protected from having to bear a substantial monetary loss in the event of termination. If executive severance provisions were driven by risk-bearing considerations, one would expect non-executive employees to have such provisions as well.

More importantly, if executives’ high pay is justified by the importance of providing them with incentives, one would expect their compensation arrangements to be *more* sensitive to performance than non-executive pay and to provide *less* protection in the event of dismal failure. Current corporate severance practices not only fail to strengthen the link between pay and performance, they undermine it by diminishing the difference between payoffs for good and bad performance.

Improving Transparency

We now turn to our proposals for improving pay arrangements and the governance processes that produce those arrangements. We start with a reform that we view as a “no-brainer,” one for which we see no reasonable basis for opposition. In particular, the SEC should require public companies to make the amount and structure of their executive pay packages more transparent.

Financial economists have paid little attention to transparency. They tend to focus on stock price behavior

and assume that any publicly available information, even if understood by only a small number of professionals, becomes incorporated into stock prices. Thus, economists are typically interested in *whether* certain information is publicly available, not *how* it is disclosed. As we have discussed, SEC regulations already require detailed disclosure of the compensation of a company’s CEO and its four other most highly paid executives. Thus, from economists’ stock-pricing perspective, there is already a significant amount of information available about executive compensation.

In our view, however, it is critical to recognize the importance of making such disclosures transparent. The purpose of executive compensation disclosure is not merely to enable accurate pricing of corporate securities, but to provide some check on arrangements that are too favorable to executives. This goal is not well served by disseminating information in a way that makes the information understandable to a small number of market professionals but opaque to others.

Public officials, governance reformers, and investors should work to ensure that compensation arrangements are and remain transparent. Transparency would provide shareholders with a more accurate picture of total pay and its relationship to performance and thereby provide some check on departures from arrangements that serve shareholder interests. Furthermore, transparency would eliminate the distortions that currently arise when pay designers choose particular forms of compensation for their camouflage value rather than for their efficiency. Finally, transparency would impose little cost on companies because it would simply require them to disclose clearly information they have or can obtain at negligible cost.

Although we support improved mandatory disclosure requirements, nothing prevents companies in the meantime from voluntarily making pay more transparent. Investors should demand more openness, and companies should not continue to follow a “lawyerly” approach of not disclosing more than is legally required. The measures described below could substantially increase the transparency of pay arrangements:

Recommendation 1: Place a Dollar Value on All Forms of Compensation

Companies should be required to place a dollar value on all forms of compensation and to include these amounts in the summary compensation tables contained in company SEC filings. Executives routinely receive substantial “stealth compensation” in the form of pensions, deferred compensation, and post-retirement perks and consulting contracts. Although certain details of these benefits appear in various SEC filings, companies have not been required to place a dollar value on any of these forms of benefits and to include

33. Bebchuk and Fried (2005), cited earlier.

this value in the summary tables that receive the most attention from investors and the media. These benefits have not even been included in the standard database used by financial economists to study executive compensation.

In our view, companies should be required to place a monetary value on each benefit provided or promised to an executive, and to include this value in the summary compensation table in the year the executive becomes entitled to it. Thus, for example, the compensation tables should include the amount by which the expected value of an executive's promised pension payments increases during the year. In addition, it might be desirable to require companies to place a dollar value on and report any tax benefit that accrues to the executive at the company's expense (for example, under deferred compensation).

Recommendation 2: Disclose All Non-Deductible Compensation

The tax code permits companies to deduct certain payments to executives but not others. Companies routinely include in their disclosure boilerplate language notifying shareholders that some of the arrangements may result in the firm being unable to deduct a portion of an executive's compensation. But they do not provide details about what particular amounts end up not being deductible. Companies should provide full details about the components of pay that are not deductible, place a monetary value on the costs of this non-deductibility to the firm, and disclose this dollar cost to investors.

Recommendation 3: Expense Options

Options should be expensed. From an accountant's perspective, expensing is desirable because it leads to a more accurate reflection of the company's financial situation. In our view, expensing is beneficial because it makes the costs imposed by option-based compensation more visible to investors on an ongoing basis.

Rationalizing the accounting treatment of option plans would also level the playing field among different types of options. It would eliminate a major excuse used to avoid indexed and other reduced-windfall options. The fact that such options must be expensed while conventional options need not has long been a convenient excuse for using conventional options that reward managers for general market or sector rises.

Recommendation 4: Report the Relationship between Pay and Performance

Companies should report to their shareholders how much of their executives' profits from equity and non-equity compensation is attributable to general market and industry movements. This could be done by requiring firms to calculate and report the gains made by managers from the

exercise of options (or the vesting of restricted shares, in the case of restricted share grants) and to report what fraction, if any, reflects the company's success in outperforming its industry peers. Such disclosure would help clarify the extent to which the company's equity-based plans reward the managers for good relative performance.

Recommendation 5: Disclose Option and Share Unloading

Companies should be required to make transparent to shareholders on a regular basis the extent to which their top five executives have unloaded any equity instruments received as part of their compensation. Although a diligent and dedicated researcher can obtain this information by sifting through stacks of executive trading reports filed with the SEC, requiring the firm to compile and report such information would highlight for all investors the extent to which managers have used their freedom to unwind incentives.

Improving Pay Arrangements

Well-designed executive compensation can provide executives with cost-effective incentives to generate shareholder value. We have argued, however, that the promise of such arrangements has not yet been realized. Below we note various changes that companies should consider, and investors should urge companies to adopt, in order to strengthen the link between pay and performance and thereby improve executives' incentives.

Recommendation 1: Reduce Windfalls in Equity-Based Compensation

Investors should encourage firms to adopt equity compensation plans that filter out at least some of the gains in the stock price that are due to general market or industry movements. With such filtering, the same amount of incentives can be provided at a lower cost, or stronger incentives can be provided at the same cost. This can be done not only by indexing the exercise price of stock options, but in other ways as well. For example, by linking the exercise price of options to changes in the stock price of the worst-performing firms in the industry, market-wide movement can be filtered out without imposing excessive risk on executives. It is also important to note that moving to restricted stock is not a good way to address the windfalls problem. In fact, grants of restricted stock provide even larger windfalls than conventional options.

Recommendation 2: Reduce Windfalls in Bonus Plans

For similar reasons, companies should design bonus plans that filter out improvements in financial performance due to economy- or industry-wide movements. Even assuming that it is desirable to focus on accounting rather than stock price performance, as most bonus plans seek to do, reward-

ing executives for improvements in accounting measures enjoyed by all companies in the industry is not a cost-effective way to provide incentives. Thus, bonus plans should not be based on absolute increases in earnings, sales, revenues, and so forth, but rather on such increases relative to peer companies.

Recommendation 3: Limit the Unwinding of Equity Incentives

Investors should also seek to curtail executives' broad freedom to unwind the equity-based incentives provided by their compensation plans. It may be desirable to separate the vesting of options and managers' ability to unwind them. By requiring that executives hold vested options (or the shares resulting from the exercise of such options) for a given period after vesting, boards would ensure that options already belonging to executives will remain in their hands for some time, continuing to provide incentives to increase shareholder value. Furthermore, such restrictions would eliminate the significant distortions that can result from rewarding executives for short-term spikes in the stock price that do not subsequently hold. To prevent circumvention, such restrictions should be backed by contractual prohibitions on executives' hedging or using any other scheme that effectively eliminates some of their exposure to declines in the firm's stock price.

In addition, it might be desirable, as one of us proposed some time ago, to require executives to disclose *in advance* their intention to sell shares, providing detailed information about the intended trade, including the number of shares to be sold.³⁴ Providing executives with opportunities to sell their shares when their inside information indicates the stock price is about to decline can dilute and distort their incentives.

Recommendation 4: Tie Bonuses to Long-Term Performance

Even assuming it were desirable to reward managers for improvements in accounting results, such rewards should not be given for short-term results but only for improvements that are sustained over a considerable period of time. Rewarding executives for short-term improvements is not an effective way to provide beneficial incentives and indeed might create incentives to manipulate short-term accounting results.

Compensation contracts should also generally include "clawback" provisions that require managers to return payments based on accounting numbers that are subsequently restated. Such return of payments is warranted,

regardless of whether the executive was in any way responsible for the misreporting. When the board believes it is desirable to tie executive payoffs to a formula involving a metric whose value turns out to have been inflated, correctly applying the formula requires reversing payments that were based on erroneous values. The governing principle should be: "What wasn't earned must be returned."

Recommendation 5: Be Wary of Paying for Expansion

Because running a larger company increases managers' power, prestige, and perquisites, executives might have an incentive to expand the company at the expense of shareholder value. Executive compensation arrangements should seek to counter rather than reinforce this incentive.

A recent study by Yaniv Grinstein and one of us finds that executives' decisions to expand company size—by issuing new equity to finance acquisitions or investments or by avoiding distributions—are associated with increases in subsequent executive pay.³⁵ Controlling for past performance, the compensation of continuing CEOs is positively and substantially correlated with firm expansion during their service. While a larger firm size might lead the board to raise executive pay, boards should keep in mind that an expectation that expansion will result in higher pay can provide executives with incentives to expand even when doing so would not be value-maximizing.

Recommendation 6: Restore Dividend-Neutrality

Under current option plans, terms are not updated to reflect the payment of dividends and, as a result, executives' payoffs are reduced when they decide to pay a dividend. There is evidence that companies run by executives whose pay has a large option component tend to pay lower dividends and instead distribute cash through share repurchases,³⁶ which have a less adverse effect on the value of managers' options but may not be the most efficient form of payout.³⁷ To reduce distortions in managers' payout decisions, all equity-based compensation should be designed in such a way that it neither encourages nor discourages the payment of dividends. In particular, in the case of option plans, the exercise price of options should be adjusted downward to reflect a dividend payment.

Recommendation 7: Rethink Executive Pensions

There are reasons to doubt the efficiency of the widespread practice of using Supplemental Executive Retirement Plans (SERPs) to provide executives with a major component of their career compensation. Unlike pension plans used

34. See Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure," *Southern California Law Review*, Vol. 71 (1998), pp. 303-392.

35. Lucian A. Bebchuk and Yaniv Grinstein, "Firm Expansion and CEO Pay," cited earlier.

36. Christine Jolls, "Stock Repurchases and Incentive Compensation," NBER Working

Paper No. 6467 (1998). Jolls' findings were subsequently confirmed by George Fenn and Nellie Liang, "Corporate Payout Policy and Managerial Stock Incentives," *Journal of Financial Economics*, Vol. 60 (2001), pp. 45-72.

37. See Jesse M. Fried, "Informed Trading and False Signaling with Open Market Repurchases," forthcoming in *California Law Review* (2005).

for non-executive employees, SERPs do not enjoy a tax subsidy. And given that companies have been moving away from defined benefit plans to defined contribution plans for non-executive employees, it is far from clear that providing executives with defined benefit plans is required by risk-bearing considerations. Unlike defined contribution plans, which force the employee to bear the risk of poor investment performance, defined benefit plans shift the risk of investment performance to the firm. However, executives do not seem less able to bear such risk than other employees. While the efficiency benefits of SERPs are far from clear, SERPs impose incentive costs. They provide executives with pay that is largely independent of performance, thereby weakening the overall link between total pay and performance. Boards would thus do well to reconsider their heavy use of SERPs.

Recommendation 8: Avoid Soft-Landing Arrangements

Soft-landing arrangements, which provide managers with a generous exit package when they are pushed out due to failure, dilute executives' incentives. While companies spend large amounts on producing a payoff gap between good and poor performance, the money spent on soft-landing arrangements works in the opposite direction, narrowing the payoff gap between good and poor performance.

At present, executives are commonly promised generous severance arrangements in the event of termination, unless the termination is triggered by an extremely narrow set of circumstances (such as criminal indictment or "malfeasance"). Boards should consider provisions that make the termination payoff depend on the reasons for the executive's termination and the terminated executive's record. Even if companies stick to the existing, broad definition of termination without cause, the payoff in such a termination should depend in part on the firm's performance relative to its peers during the executive's service. An executive who is terminated against a background of extremely poor stock performance should get less than an executive who is terminated when the company's performance is reasonable.

Improving Board Accountability

Past and current flaws in executive pay arrangements have resulted from underlying problems within the corporate governance system: specifically, directors' lack of sufficient incentives to focus solely on shareholder interests when setting pay. If directors could be relied on to focus on shareholder interests, the pay-setting process, and board oversight

of executives more generally, would be greatly improved. The most promising route to improving pay arrangements is thus to make boards more accountable to shareholders and more focused on shareholder interests. Such increased accountability would transform the arm's-length contracting model into a reality. It would improve both pay arrangements and board performance more generally.

Recent reforms require most companies listed on the major stock exchanges (the New York Stock Exchange, NASDAQ, and the American Stock Exchange) to have a majority of independent directors—directors who are not otherwise employed by the firm or in a business relationship with it. These companies must also staff compensation and nominating committees entirely with independent directors. Although such reforms are likely to reduce managers' power over the board and improve directors' incentives somewhat, they fall far short of what is necessary.

Our analysis shows that the new listing requirements weaken executives' influence over directors but do not eliminate it. More importantly, there are limits to what independence can do by itself. Independence does not ensure that directors have incentives to focus on shareholder interests or that the best directors will be chosen. In addition to becoming more independent of insiders, directors also must become more *dependent on shareholders*. To this end, we should eliminate the arrangements that currently entrench directors and insulate them from shareholders.

To begin with, shareholders' power to replace directors should be turned from myth into reality. Even in the wake of poor performance and shareholder dissatisfaction, directors now face very little risk of being ousted. Shareholders' ability to replace directors is extremely limited. A recent study by one of us provides evidence that, outside the hostile takeover context, the incidence of electoral challenges to directors has been practically negligible in the past decade.³⁸ This state of affairs should not continue.

To improve the performance of corporate boards, impediments to director removal should be reduced.³⁹ As a first step, shareholders should be given the power to place director candidates on the corporate ballot. In addition, proxy contest challengers that attract sufficient support should receive reimbursement of their expenses from the company. Furthermore, it would be desirable to limit the use of staggered boards, a feature of most public companies, to impede director removal. Staggered boards provide powerful protection from removal in either a proxy fight or a hostile takeover. And a recent study by Alma Cohen and one of us finds that staggered boards are associated with economically significant reductions in firm value. Share-

38. Lucian Bebchuk, "The Case for Shareholder Access to the Ballot," *The Business Lawyer*, Vol. 59 (2003), pp. 43-66.

39. For a fuller analysis of the ways in which shareholder power to remove directors

could be made viable, see Lucian Bebchuk, "The Myth of the Shareholder Franchise," Working paper, Harvard Law School (2005).

holders should be able to replace all the directors each year or at least every other year.⁴⁰

In addition to making shareholder power to remove directors viable, boards should not have veto power—which current corporate law grants them—over proposed changes to governance arrangements in the company’s charter. Shareholders should have the power, which they now lack, to initiate and adopt changes in the corporate charter. Under current rules, shareholders can pass only nonbinding resolutions. And, as documented in a recent empirical study by one of us, boards often choose not to follow resolutions that receive majority support from shareholders, even if these resolutions have passed two or three times.⁴¹ This state of affairs should change.

Allowing shareholders to amend the corporate charter would over time improve the entire range of corporate governance arrangements without outside regulatory intervention. If there is concern that shareholders are influenced by short-term considerations, shareholder-initiated changes could require approval by majority vote in two successive annual shareholder meetings. But we should not continue denying shareholders the power to change the corporate charter, no matter how widespread and long-lasting the

shareholder support for such a change. Allowing shareholders to set governance arrangements would help make boards more accountable to shareholders.

To fully address the existing problems in executive compensation and corporate governance, structural reforms in the allocation of power between boards and shareholders are necessary. Given political realities, such reforms will not be easy to pass. But the corporate governance flaws that we have discussed—and have shown to be pervasive, systemic, and costly—call for such reforms.

LUCIAN BEBCHUK is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, as well as Director of the Program on Corporate Governance, at the Harvard Law School. He is also a Research Associate of the National Bureau of Economic Research and Fellow of the European Corporate Governance Institute.

JESSE FRIED is Professor of Law and Co-Director of the Berkeley Center for Law, Business, and the Economy at the Boalt Hall School of Law, University of California at Berkeley.

40. Lucian Bebchuk and Alma Cohen, “The Costs of Entrenched Boards,” *Journal of Financial Economics*, Vol. 78 (2005), pp. 409-433.

41. Lucian Bebchuk, “The Case for Increasing Shareholder Power,” *Harvard Law Review*, Vol. 18 (2005), pp. 833-914.