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Book Review

The Academic Tournament over Executive Compensation

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE
OF EXECUTIVE COMPENSATION

By Lucian Bebchuk† and Jesse Fried††

Cambridge: Harvard University Press, 2004, Pp. xii, 278. \$24.95 cloth.

Reviewed by William W. Bratton†††

Executive pay brings out the worst in the corporate-governance system. No economic theory tells us the terms of an “optimal” pay arrangement that penalizes failure while rewarding effort and merit in just the right increments. Absent such a first-best template, we must rely on contracting practice and experience to teach us on a trial-and-error basis. But contracting practice provides an inadequate economic laboratory because firms herd to a small set of arrangements.¹ Critics charge that the practice also reflects a dysfunctional agency relationship. They complain that giveaways abound, despite an across-the-board shift towards incentive pay arrangements, despite the transparency mandates of a thick stack of regulations, despite the shaming strategies of institutional investors, and despite frequent exposés of excess in the vigilant business press. And even as management has its defenders, none of them claim it to be underpaid.

Many find this unsatisfactory situation puzzling. Why should a boondoggle persist in the teeth of the triumph of shareholder capitalism over the moribund managerialist model of the postwar period? Why, despite market controls, process protections, reporting requirements, and press reports, should compensation arrangements so clearly fail to measure up under the standard of arm’s-length contracting? In *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Lucian Bebchuk and Jesse

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1. See Iman Anabtawi, *Overlooked Alternatives in the Pay Without Performance Debate* 39-43 (Jan. 2005) (unpublished manuscript, on file with author) (suggesting that path dependence limits alternative pay arrangements).

Fried pose a cogent answer to these questions: managers possess and effectively wield power, ensuring that so-called incentive pay comes on easy terms (4-5, 61-117). Bebchuk and Fried also offer a simple prescription: given that the victims of the imbalanced arrangement are the shareholders and that management empowerment causes the injury, it follows that a plausible cure must include shareholder empowerment (10-12, 189-216). According to the authors, current executive compensation practice demonstrates that the separation of ownership and control identified by Berle and Means more than seven decades ago² still hobbles shareholder capitalism.

Bebchuk and Fried's intervention cuts against the grain of academic consensus on corporate governance. Berle and Means supposedly were long ago consigned to the dust bin of intellectual history. Their admonition against concentrated management power had its day as a corporate-governance paradigm during the mid-twentieth century, but the titans of contemporary financial economics have long since favored high-tech, market-oriented constructs over Berle and Means's description.³ In *Pay Without Performance*, Bebchuk and Fried confront these titans, dismissing their "official" view of executive compensation" (15-22).

And the titans have responded. Prime among them are Kevin Murphy, the leading academic analyst of executive compensation, and Michael Jensen, the progenitor of the "nexus of contracts" theory of the firm. Jensen and Murphy's combined work provided crucial academic impetus in the 1990s for the movement to equity-based executive compensation.⁴ Bengt Holmström, Steven Kaplan,⁵ and other economists⁶ now join Jensen and Murphy in the push back against *Pay Without Performance*.

This academic contest offers intriguing lessons for students of corporate governance. This is not a conventional debate pitting left against right or anti-management against pro-management factions. It is instead a

2. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* (rev. ed., Transaction Publishers 1991) (1932). Appropriately, Bebchuk and Fried invoke Berle and Means at the book's commencement. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004), at 15.

3. See William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 760-69 (2001).

4. See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990) [hereinafter Jensen & Murphy 1990]; Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV. May-June 138 (1990) [hereinafter Jensen & Murphy HBR].

5. See Bengt Holmström & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 10-14 (ECGI Finance Working Paper No. 20/2003), available at <http://ssrn.com/abstract=441100> (listing "several reasons" to be skeptical of executive compensation concerns).

6. Two leading economic experts on pay, John E. Core and Wayne Guay, have joined a legal academic, Randall Thomas, in commenting on Bebchuk and Fried. See John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay without Performance?*, 103 MICH. L. REV. 1142 (2005).

contest for shareholder capitalism's high ground. Bebchuk and Fried and their interlocutors make their cases in a tightly delimited framework.⁷ All parties disassociate themselves from complaints about the level of management compensation (8-9). Bebchuk and Fried's overpayment case thus does not turn on the fact that the average S&P 500 chief executive officer (CEO) made thirty times more than the average production worker in 1970 but 210 times more in 1996.⁸ It is not the amount of pay that bothers them but rather the failure to make big payoffs to managers contingent on their creating shareholder value (6, 9). The debate over *Pay Without Performance*, then, amounts to an intra-familial quarrel within the group that posits shareholder value maximization as the firm's objective. Those who view firms' core objectives differently, favoring stakeholder capitalism or the harmonization of the firm's financial reward system with that prevailing in outside society, will find no allies on either side.⁹

Bebchuk and Fried come to the table with impeccable credentials as proponents of shareholder value maximization, but neither hesitates to criticize prevailing institutional arrangements. Nor does either display the reflexive aversion to regulatory solutions so common among corporate institutions' contemporary observers. Thus positioned, Bebchuk and Fried throw down the gauntlet, demanding that the economists either defend the prevailing compensation practice, explaining how it demonstrates a free-market success story, or join them in condemnation. The opposition has risen to the challenge, countering Bebchuk and Fried's management-power description and offering theories to justify prevailing pay practices.

This review looks at the state of play in this academic tournament. Three defenses of the prevailing compensation practice have been mooted. First, much of what Bebchuk and Fried explain as results of executive power also can be explained in terms of the economic relationship between risk and return. In this view, higher risks attending equity-based pay must

7. Bebchuk and Fried reject the hypothesis that self-esteem alone motives managers; in their account, money matters more. See BEBCHUK & FRIED, *supra* note 2, at 8. They also do not confront alternative explanations of performance pay. For an example of a contrasting theoretical approach, see Edward P. Lazear, *Output-Based Pay: Incentives, Retention or Sorting?* (IZA Discussion Paper No. 761, 2003), available at <http://ssrn.com/abstract=403900>. Lazear rejects the notion that performance incentives have anything to do with observed executive pay practices, citing the absence of downside penalties. He proposes that equity-based pay ameliorates information asymmetries. The executive, an informational insider, trades less risky cash compensation for riskier equity compensation so as to reassure outsiders. This leads to the prediction that equity-based compensation is more likely to appear when the firm's production function is little understood and information is hard to glean. *Id.* at 2-3. Lazear's proposition makes sense but does not undercut Bebchuk and Fried, who suggest that the insider gets more stock than is needed to rectify the information asymmetry. See BEBCHUK & FRIED, *supra* note 2, at 7.

8. Kevin J. Murphy, *Executive Compensation* 51 (Apr. 1998) (unpublished manuscript), available at <http://ssrn.com/abstract=163914> [hereinafter Murphy 1998].

9. Cf. Anabtawi, *supra* note 1, at 36-39 (suggesting a description of pay practice following a team production model).

be compensated with higher upside payouts, and the practice embodies an arm's-length trade-off. Bebchuk and Fried respond that the risks can be addressed without sacrificing performance sensitivity. Since they accept the economists' base point that the amount paid to executives matters less than the mode of payment, it follows that enhanced performance sensitivity can be compensated with higher upside payouts. The problem, they contend, is the firms' failure to draw on a long existing menu of performance-sensitive techniques in the first place. Second, the defenders posit an informational shortcoming: boards incorrectly believe that stock options are a bargain mode of compensation, underestimating their costs in comparison to cash payments. Bebchuk and Fried find this implausible in a world where chief executive officers fill a majority of board seats. Third, the defenders note that managers on the whole have done well for shareholders since the early 1990s' shift to performance pay. As to this, Bebchuk and Fried respond with the shareholder-value norm itself: one takes it seriously or one does not; if one does, apologies fail as justifications.

Both sides score points in this back-and-forth. But significant concessions have been accreting on the defensive side. There results a clear victory for Bebchuk and Fried. They win the match when the defense acknowledges that management power matters. This seemingly meager concession changes the terms of discourse in a field that expunged the concept of power from its positive account more than two decades ago. The erasure accompanied the transition from social theory to economics as the primary language of description.¹⁰ The reappearance of "power" in the description¹¹ causes the burden of persuasion to shift from the critics to the defenders of prevailing practices. The question then turns to whether material improvements to pay practice are feasible. When the answer turns out to be yes, the debate ends in favor of Bebchuk and Fried.

Part I of this review sets out Bebchuk and Fried's power-based description of the framework in which firms set the terms of executive employment contracts. Part II assays the descriptive alternatives the defense puts forward and Bebchuk and Fried's responses thereto. Given a positive account that focuses on a single element (power) in a complex institution (corporate governance), one would expect the defense to highlight other factors motivating existing compensation practice, as it has done. But the critics do not succeed in invalidating Bebchuk and Fried's diagnosis. Indeed, as Part III shows, the distance between Bebchuk and Fried and their critics has so narrowed as to change the tenor of the debate, which

10. I can recall only one paper by a legal theorist published during the last twenty years that placed power at the center of its description of the large corporation. See Lynn L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19 (1988).

11. In recent years others have used "influence costs" as a more neutral, less threatening phrase for what Bebchuk and Fried call "power." See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION, AND MANAGEMENT* 269-78 (1992).

now devolves into a disagreement over subtle differences of perspective respecting generally acknowledged shortcomings in compensation practice. Part III also takes up Bebchuk and Fried's prescriptions. Here they confront political realities. The significant law reform needed to effect shareholder empowerment will not occur anytime soon. This leaves Bebchuk and Fried playing a hortatory role in a self-regulatory dialogue. That task retains importance, for boardroom practice will never change absent robust criticism like that advanced in *Pay Without Performance*.

I THE CHARGE

Bebchuk and Fried charge that governance structures empower top managers, who, subject only to loose normative constraints, use their power to extract rents disguised as incentive pay. First, Bebchuk and Fried acknowledge the obvious: CEO compensation has ballooned (9-10), with total remuneration increasing by more than eleven times in the past thirty years. Next, the authors fix arm's-length bargaining as their normative base point¹² and assert that pay would be tied to performance at arm's length. More particularly, an arm's-length compensation scheme would (1) pay enough to retain executives; (2) encourage executives to increase the value of the firm; and (3) avoid terms that reduce firm value ("inefficient terms"). Finally, the authors describe impediments to arm's-length bargaining, including the structure of the board (which promotes cozy relationships with CEOs), the lack of substantial outside shareholders, and anti-takeover arrangements. These prevent the market from influencing compensation policy. Top managers emerge with power over directors. They use their power to extract "rents," defined as more favorable benefits than those available under an arm's-length bargain (4-5). In theory, "outrage costs"—influential outsiders' expressions of disapproval—should limit these rents (5, 65). In practice, however, firms resort to "camouflage" to minimize outrage costs, reducing transparency by disguising or hiding inefficient payment terms (5, 70).

Bebchuk and Fried's case requires a two-part proof. First, they must show that managers do exercise power over directors. Next, they must demonstrate that the resulting pay structure is not keyed to shareholder value creation.

12. BEBCHUK & FRIED, *supra* note 2, at 18-19. Jensen and Murphy describe a similar base point, noting that the firm faces the relationship between the amount of pay conceded and the ability to attract better employees. Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 20-21 (Harv. NOM Working Paper No. 04-28, 2004), available at <http://ssrn.com/abstract=561305> [hereafter Jensen & Murphy].

A. Power

Power is hard to prove, which helps explain why it disappeared from economically informed descriptions of corporate institutions.¹³ In contrast, one can easily verify money payments. Overall CEO compensation increased sixfold over the last two decades.¹⁴ Average total remuneration of executives of S&P 500 companies (adjusted for inflation) grew from \$850,000 in 1970 to \$14 million in 2000, falling with the stock market to \$9.4 million in 2002.¹⁵ Average base salaries, on the other hand, increased only from \$850,000 to \$2.2 million during the same period.¹⁶ The bulk of these compensation increases, therefore, resulted from “incentive” pay.

To demonstrate a causal connection between management power, which is not observable, and the payoffs, which are, Bebchuk and Fried draw on the arm’s-length bargain model, crucially but reasonably assuming that an arm’s-length deal would tightly tie pay to performance. They then draw inferences from real-world institutions, showing that governance arrangements are ill suited to foster arm’s-length bargaining between top managers and their corporate employers. Four factors, all well known to students of corporate governance, contribute to this debility. First, the board itself is weak because process infirmities bind outside directors to the CEO, by virtue of either fear or unflagging loyalty. Large board sizes, CEO chairmanship, interlocks,¹⁷ and financial dependence on CEOs all decrease directors’ abilities to bargain effectively (80-82). Second, most firms lack a substantial outside shareholder, whose financial interest would otherwise influence bargaining over pay (82-83). Third, oversight by large institutional shareholders tends to lead to more sensitive pay arrangements, and some firms have fewer large institutional shareholders than do others (83). Fourth, even for firms with large institutional shareholders, anti-takeover arrangements insulate most managers from the discipline the market for corporate control otherwise would impose (83-85).

In Bebchuk and Fried’s view, the system’s built-in checks do not suffice to correct this imbalance and ensure that shareholder interests dominate. Consider, for example, the shareholder vote. Reelection to the board remains a practical certainty for most independent directors, at least so long as they remain on the CEO’s good side (25-26). The annual election

13. The other reason is political. Progressive critics of corporations assert that power implies responsibility; corporate power, once identified, justifies regulatory constraints. See William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* 23-24 (Geo. Law & Econ. Research Paper No. 606481, 2004), available at <http://ssrn.com/abstract=606481>.

14. Holmström & Kaplan, *supra* note 5, at 10.

15. Jensen & Murphy, *supra* note 12, at 24.

16. *Id.*

17. For example, where an outside director of Firm 1 is the CEO of Firm 2, and the CEO of Firm 1 is outside director at Firm 2, concerns of reciprocity will prevent either from objecting to the other’s pay.

accordingly does not amount to a significant threat. Nor do other shareholder votes much matter. Up-down votes on incentive compensation are a blunt instrument that shareholders rarely wield and are no substitute for real back-and-forth negotiation (49-51).

Meanwhile, the rewards and norms of the system encourage boardroom collegiality (27-28, 31-33). Back scratching prevails—there is a reason why 67% of outside directors are active or former CEOs (33).¹⁸ Other outside directors may be free of this structural bias towards CEOs, but they suffer no reputation loss when they go along with a lax pay deal. To avoid losing face, the board needs only to stay in the range of acceptable compensation.¹⁹ And even if an independent director had an inclination to get tough and find her way onto a compensation committee, time and information constraints would limit her effectiveness. Captured compensation consultants²⁰ continue to take the lead in pay-setting (36-39). Thus camouflaged through comparisons to pay increases in like firms, on the surface compensation appears legitimate (70-71).

Market constraints do not impress Bebchuk and Fried, who perceive that the stock market checks only bigger, higher-profile wealth transfers (53-58). The executive employment market similarly falls short. Contrary to casual appearances, the rate of executive firing increased only slightly in the 1990s (41-42). Furthermore, the holder of the top job has no incentive for further promotion within the firm. The possibility of moving on to another, bigger firm only strengthens the CEO's resolve to get a good package, for under prevailing custom a hiring firm compensates a new CEO for the value of any unvested equity compensation at the CEO's old firm (54). In sum, current institutional structures do not foster arm's-length bargaining and instead allow CEOs to exert power.

B. Rents

Having established that the governance framework invites slack, Bebchuk and Fried then show in detail that pay practices fall short of the arm's-length standard. This presentation takes up most of the book. Much of it addresses stock-option programs. More shocking to the reader is a long list of lucrative bells and whistles: retirement pensions, deferred compensation, post-retirement perquisites, and consulting fees, all of which are performance-insensitive and easily hidden in supplemental retirement plan disclosures rather than broadcast in the compensation table included in the annual proxy statement (95-99).

18. Bebchuk and Fried note that 41% of directors are active executives while 27% are retired. Half are CEOs.

19. *Id.* at 34-36.

20. Historically, management engages the compensation consultant, assuring a favorable report. For the classic account of the consultation process, see GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 43-50 (1991).

Bebchuk and Fried contend that stock-option plans fail to motivate performance, singling out exercise prices, numbers of options granted, and vesting rules. Their main complaint goes to price. Companies almost universally fix the option's exercise price at the stock price at the time they grant the option. A low-powered incentive results because the executive will be in the money so long as the stock price does not go down and stay down during the grant's ten-year life. A stronger incentive would follow if companies priced options out of the money, that is, above the stock's market price; but only 5% do so (160). The common practice of leaving the price fixed for the life of the option also reduces the incentive effect. A fixed price rewards the executive for market-wide and sector-wide upward price movement in addition to upward movement due to the company's own performance (said to account for only 30% of stock growth on average). Because the market tends to rise over time, a payoff is virtually guaranteed.

Bebchuk and Fried propose two potential ways to increase options' incentives. First, indexing would reset the exercise price upward and downward over time to filter out changes attributable to the market or sector. Alternatively, companies could condition vesting on meeting a fixed performance target (139-42). Neither palliative is current practice, despite the obvious incentive benefits.

Bebchuk and Fried further argue that fewer stock options would be better. According to the empirical evidence they cite, the positive marginal effect of stock options on a manager's incentives declines as the number of stock options granted increases, and the benefits of the last option granted may be less than the cost (138). "Reloading," or the automatic grant of a new option each time the holder exercises an existing option, is also a problem for the authors, because it enables the executive to lock in protection against a subsequent decline in the stock price, perversely turning stock price volatility into a source of personal profit (169-70).²¹

Finally, Bebchuk and Fried believe that managers should not be allowed to sell their incentive stock. Under the prevailing practice, once the option vests, the exercising executive is free to sell the underlying stock. Currently, executives do sell 90% of the stock purchased upon exercise (176). No nefarious intentions need be read in. They sell in order to diversify their portfolios, acting no differently from other rational investors. But Bebchuk and Fried object to the concession of free transfer, arguing that restraints on alienation and on hedging would tie the executive's interest

21. Bebchuk and Fried also disapprove of the practice of substituting new grants at a lower exercise price for grants that expire out of the money. See BEBCHUK & FRIED, *supra* note 2, at 165-67. Formerly that result also was accomplished by amending the plan to lower the price, a practice that ceased when the Financial Accounting Standards Board changed the accounting treatment in 1998.

closer to long-term value creation within the firm (174-77).²² And, although bad motives need not be read in, nefarious deeds do occur. Some executives use inside information to time their sales. Here too, correction would be easy—executives should be forced to disclose their sales in advance (178-83, 191).²³

Bebchuk and Fried also target cash bonus structures, depicting them as even worse than stock-option plans. Stock-option plans, however lax their construction, have the great merit of conditioning rewards on the stock price, which in turn is determined by free-market actors. Cash bonuses can be structured the same way, but tend not to be. Bonus rewards frequently depend on meeting targets within the payees' control that have no necessary connection with bottom-line performance improvement—targets such as spending all the funds in an annual budget or, worse, closing an acquisition. When payees fail to meet their performance targets, the targets are often lowered *ex post* (124-27). There also are bonuses on entry and exit. Bonuses for signing are unsurprising, assuming a competitive market for the best managers. Bonuses for leaving, whether by firing, retirement, or acquisition, are a little more disturbing, competitive market or not (89). Bebchuk and Fried report that the average severance package equals three or more years of compensation, with only 2% of firms reducing it in the event the CEO finds new work (134). Firing, argue Bebchuk and Fried, should not be a cash bonanza for executives (132-35). This is of course just what happened when Disney threw out Michael Ovitz, a golden goodbye that led to a derivative action that challenged the Disney board's good faith; the action miraculously survived the defense's motion to dismiss.²⁴ Ironically, Disney's defense counsel might very well have cited to Bebchuk and Fried in support of the argument that the corporation did nothing unusual.

Bebchuk and Fried also take a parting shot at restricted stock, viewed by many pay consultants and commentators as a healthy alternative to stock options. The case for restricted stock builds on the dynamics of option valuation: options gain in value as the firm's stock becomes more volatile, perversely tying the wealth of an executive option holder to stock

22. The extent of the limitations would be subject to negotiation. Bebchuk and Fried note that the practice is changing, with firms adopting target ownership plans. They complain that the targets are low, however. See BEBCHUK & FRIED, *supra* note 2, at 176-77.

23. Also disturbing are loans made to finance purchases of company stock, now prohibited by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402(a), 116 Stat. 787 (2002). These were often forgiven, with forgiveness implicating an additional payment of 25% gross up to cover the income tax payable on loan forgiveness. BEBCHUK & FRIED, *supra* note 2, at 116. Alternatively, the executive would borrow money from the firm to exercise stock options and later sell the stock back to the firm to repay the loan, taking advantage of a pre-Sarbanes-Oxley loophole that permitted the executive's report of the stock sale to be delayed until forty-five days after the end of the fiscal year. BEBCHUK & FRIED, *supra* note 2, at 117.

24. See *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

volatility. Awarding the stock outright avoids that problem. Bebchuk and Fried agree that stock ownership can prevent executives from benefiting from volatility, subject to the caveat that the executive be prohibited from selling the stock. But they note that an option plan can just as easily restrain alienation. They also raise a loud objection: restricted stock is an option with an exercise price of zero, and there is no reason to believe zero is an optimal exercise price (170-71). To see their point, compare the award of an option to buy 100 shares at \$100 and an outright grant of 100 shares, both awarded with the stock trading for \$100. Assume that the stock price declines to \$80 on the day after the grant and stays at \$80 forever because the firm is badly managed. The holder of the option is wiped out; the holder of the stock emerges with eighty cents on the dollar despite poor performance. Current movement to restricted stock rather than indexed options thus confirms Bebchuk and Fried's rent-collection charge.

C. Summary

Bebchuk and Fried do not prove beyond doubt that their inventory of devices for greater performance sensitivity would work exactly as they project. Prevailing practice has had perverse effects;²⁵ more could be in the offing under a revised practice. But Bebchuk and Fried do not have to prove this counterfactual negative. They acknowledge the predictable problems and suggest plausible means of countering them. The most important problem concerns time horizons. Stock-option plans have tended to bias managers towards short-term results, in some cases with disastrous consequences. But as Bebchuk and Fried show, the problem can be solved by restraints on alienation that lock executives into long-term positions in their firms' equity. What is needed is carefully monitored experimentation, which has been lacking for the reasons Bebchuk and Fried identify.

Bebchuk and Fried thus succeed with their *prima facie* case. It suffices for them to show that corporate pay practice represents a windfall, which in turn implies CEO influence at work. Significantly, Bebchuk and Fried make no claim to originality for these basic points. They build on a body of existing discussions.²⁶ The purpose of the book is to gather existing learning so as to place the onus in academic and policy discussions on

25. See, e.g., Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1930 (2001) (suggesting that indexed options could adversely affect investment policy).

26. Professor Elson has been describing pay practice as a function of board capture in the legal literature for years. See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651 (1995); Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 156-64 (1996). A management-influence hypothesis also has appeared in the economic literature. See Marianne Bertrand & Sendhil Mullainathan, *Agents With and Without Principals*, 90 AMER. ECON. REV. 203 (2000); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901 (2001).

management's defenders. To evaluate the book's success, we accordingly must see whether the defense rebuts the prima facie case.

II THE DEFENSE

Bebchuk and Fried's economist interlocutors offer three responses: (1) executive pay arrangements amount to rational employment contracts in which the employer concedes high returns to compensate for the risks of equity-based compensation; (2) any departure between actual compensation arrangements and those predicted by an arm's-length-bargaining model can be traced to the perverse effects of regulation and informational shortcomings of corporate decision makers; and (3) the quantum of overcompensation is modest and the system will self-correct without regulation. All three points have meritorious aspects, requiring modification of Bebchuk and Fried's description. The interlocutors, however, succeed neither in displacing power from the positive account nor in recasting the windfall as an acceptable arm's-length deal.

The following discussion takes up the three responses in turn, noting Bebchuk and Fried's responses to each. The principal interlocutor is Kevin Murphy, often writing in collaboration with Brian Hall or Michael Jensen.

A. *Risk, Return, and Optimal Contracting*

Murphy and Hall's view of executive compensation contrasts sharply to that of Bebchuk and Fried. Rather than linking compensation practice to executive power, they tie it instead to the economic relationship between risk and return.²⁷ Instead of linking compensation practice to executive power, they tie it instead to the economic relationship between risk and return. From the firm's point of view, the cost of an executive stock option is the same as the cash consideration the firm would receive from a third-party investor in the same option. However, third-party investors and firm employees view the options in critically different ways. Third-party investors are fully diversified and positioned to hedge the risk of the option; accordingly, they are risk neutral.²⁸ Employees, on the other hand, are underdiversified and risk-averse, so it follows that they value the option less than third parties.²⁹ It further follows that an option is an inferior form of compensation compared to cash: to constitute \$1 of pay in the eyes of the employee, option compensation must be increased to make up for the

27. See generally Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives* (Harv. NOM Working Paper No. 00-05, 2002), available at <http://ssrn.com/abstract=304960> [hereinafter Hall & Murphy 2002].

28. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 859-60 (2002).

29. Jensen & Murphy, *supra* note 12, at 38.

employee's valuation discount. The option thereby costs the firm more than the \$1 the employee subjectively receives. An option nevertheless might make sense as incentive compensation. But the overall terms of an arm's-length option package will reflect the employee's risk aversion. "Compensation," in Murphy and Hall's view, thus includes rational adjustments that otherwise seem like giveaways, such as exercise prices set at the money rather than at a premium, the failure to index the exercise price,³⁰ and the allowance of both early exercise³¹ and stock sales after exercise.³² Restating Murphy and Hall's point, stock options may be an inefficient mode of compensation, but the inefficiency does not stem from management power.

Murphy and Hall take direct aim at Bebchuk and Fried's power thesis with a reference to payment differentials between inside and outside CEO hires. If power were the generative factor, one would expect to see inside CEO hires paid more than outsiders, given that power accrues to insiders while outsiders deal more at arm's length. In practice the opposite occurs. Outside CEOs earn more, and industries with more prevalent outside hiring pay more.³³ Overall numbers of outside CEO replacements have risen from between 15% and 17% in the 1970s and 1980s to just over 25% today.³⁴ The environment accordingly has become better suited to arm's-length contracting. Yet because compensation has increased overall, Murphy and Hall conclude that power does not account for CEO salaries.

Murphy also seeks to rebut Bebchuk and Fried's assertion of CEO power by noting that lower-level executives and employees also receive stock options. If option practice stems from the power of top managers, then why are most employee options granted to those below the top team? In 1990, less than 85% of option grants went to employees below the top five; in 2002, 90% went to lower-level employees.³⁵ For Murphy, the egalitarian grant pattern compounds the inefficiency problem, presenting the more pressing problem of the two. Since options are worth less to employees than their opportunity cost to the firm, option compensation makes sense only when it provides the best available means to the end of high-powered incentives. This is not the case with lower-level employees for whom internal promotion and the prospect of eventual equity

30. See Hall & Murphy, *supra* note 27, at 3.

31. *Id.* at 27-32.

32. John E. Core et al., *Executive Equity Compensation and Incentives: A Survey* 30 (Jan. 9, 2002) (unpublished manuscript), available at <http://ssrn.com/abstract=276425>, points out that if the executive already holds the firm's stock at the time of the option grant and is allowed to sell on a one-to-one basis as options are exercised, the executive will place the same value on the option as a third-party investor.

33. See Murphy, *supra* note 28, at 853 (describing total compensation packages and executive source).

34. Jensen & Murphy, *supra* note 12, at 32-33.

35. *Id.* at 36.

compensation already provide incentives. In addition, it is impossible to determine whose effort within the general employee population improves the stock price, presenting free-rider problems in an equity-based reward system.³⁶

Summing up this first phase of the defense, even if rent extraction explains the incentive to reward top executives with stock options, it does not explain pay practice as a whole.³⁷ Although compensation policy clearly is suboptimal, managerial abuse of power is not likely the source of the problem.

Bebchuk and Fried answer the risk-and-return criticism with a simple observation: risk can be compensated for without sacrificing performance sensitivity. Recall that Bebchuk and Fried accept Jensen and Murphy's base point that the amount paid to executives matters less than the mode of payment (8-9).³⁸ For Bebchuk and Fried, as for Jensen and Murphy, high compensation by itself does not imply a departure from the shareholder-value norm (20). Therefore, to the extent that risk diminishes the value of performance-sensitive, "reduced-windfall" stock options,³⁹ the executive can be compensated with a larger number of such options (144). Shareholders will always prefer to concede this larger number in exchange for performance-sensitive features (157)⁴⁰—while the rare executive who contributes value to the firm walks away with a bigger payoff, the larger number of executives who fail to outperform the market get no bonus at all. Finally, if pay packages indeed stemmed from an arm's-length risk-return trade-off, we would have seen reductions in cash compensation to make up for the appearance of stock options in the 1990s (72-73). The absence of such reductions rebuts the implication of a trade-off. Managerial-level risk aversion does not independently explain the absence of options with performance-sensitive features.

Bebchuk and Fried concede, as they must, Murphy's point that outside CEO hires make more money than inside hires, despite the apparent differential in bargaining power. It follows that power does not determine

36. Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options* 16-17 (Harvard NOM Working Paper No. 03-33, 2003), available at <http://ssrn.com/abstract=415040> [hereinafter Hall & Murphy 2003].

37. *Id.* at 29.

38. See Jensen & Murphy HBR, *supra* note 4, at 138-39.

39. For instance, the manager's subjective perception of risk might cause the value of the overall pay package to fall below the compensation amount set through arm's-length bargaining.

40. Alternatively, performance-sensitive contracting techniques can be applied in modified form—a standard index need not be used. For instance, the executive instead could be put in the money for outperforming 50% of competing firms. BEBCHUK & FRIED, *supra* note 2, at 156.

One open question is whether public outrage would restrain grants of reduced-windfall options in larger numbers. I tend to doubt it: the occasional high-profile big pay-off would go to a manifestly successful executive; simultaneously, less successful executives' options would lose their value in plain view. Shareholders never question winners and would be happy. In addition, fears of populist backlash are overdone in the present environment. See *infra* text accompanying note 75.

pay all by itself (85). If power were the only factor, we would also expect to see radically different compensation practices in firms controlled by large shareholders, which is not in fact the case.⁴¹ But Bebchuk and Fried still manage to push back a couple of steps against this line of reasoning. They suggest that new CEOs will still have significant bargaining power because the newcomer attains power on a prospective basis. For instance, driving a hard bargain yields incumbent directors nothing, whereas rewarding an incoming CEO could help them retain their board seats (39-41). This point does not fully answer Murphy's, but it does deflate it somewhat.

Bebchuk and Fried do not confront the point about option compensation to lower-level employees; instead, they limit their analysis to the top team's pay package. But one can extrapolate a partial response from their description of camouflaging tactics. A CEO, they say, will use her power to inflate the pay package of other top executives in order to obscure her own rent extraction (64). There is no reason why these "spillover rents" should not trickle down the hierarchical ladder. But the extrapolation does not explain the use of equity compensation to motivate lower-level employees. While Bebchuk and Fried may legitimately cabin their description to top team compensation, it does appear that factors in addition to CEO power and greed shape the use of stock-option compensation.

Note that one could infer an arm's-length trade from Jensen and Murphy's risk-and-return reading of executive pay practice. According to Bebchuk and Fried, this is exactly what the financial economists have been doing. The "'official' view" of economics, they say, assumes an arm's-length framework, dismissing inconsistent practices as anomalies or puzzles (2-3). This description does not neatly characterize Murphy's analysis, however. Certainly, Murphy talks of puzzles and disputes Bebchuk and Fried's description of the bargaining context. But inferring strong assumptions from Murphy's analysis as to either the quality of the contracting framework or the evolutionary trajectory of compensation practices is difficult. After all, Jensen and Murphy themselves, in their famous 1990 paper, criticized the pay practice of an earlier era for its inconsistency with formal models of optimal contracting.⁴² Nor does their later writing assume that optimal contracting has reduced agency costs to a minimal figure. For Jensen and Murphy, agency costs are a salient and persistent problem.

41. Robert Daines et al., *The Good, the Bad, and the Lucky: CEO Pay and Skill* 4-6 (U. of Penn. Inst. for Law & Econ Research Paper May 7, 2005), available at <http://ssrn.com/abstract=622223> (establishing a statistical link between firms with large shareholders, high incentive pay, and successful performance). The link in turn supports the power hypothesis—to the extent firms with large shareholders have more defensible performance-based pay structures and lower pay levels, the inference of power is reinforced. See BEBCHUK & FRIED, *supra* note 2, at 82.

42. Jensen & Murphy, *supra* note 4, at 242-44. Of course, their complaint then was that CEOs were compensated more like bureaucrats than like entrepreneurs, with only a trivial portion of their compensation being tied to increases of shareholder value. *Id.* at 261-63.

But putting Jensen and Murphy to one side, what Bebchuk and Fried consider the “official view” does prevail in a body of economic work on executive compensation.⁴³ This school, unlike the Jensen-Murphy approach, makes a qualified prediction of evolutionary convergence on efficient outcomes. In the short term, rents can be extracted, but only because transaction costs prevent continuous recontracting in response to events that change the parties’ appraisals of the values exchanged. Significant agency costs will thus persist but will become smaller and increasingly anomalous over time.⁴⁴ These writers infer optimality from pay practice, citing empirical studies showing correlations between pay and “theoretically sensible economic factors” such as firm size and transparency.⁴⁵ But they also make an important admission: the studies show correlations without providing evidence of high or low points and do not reveal a robust relationship between incentives and performance.⁴⁶

Two economists from this school, John E. Core and Wayne R. Guay, writing with law professor Randall Thomas, have joined the debate with Bebchuk and Fried.⁴⁷ Interestingly, Core, Guay, and Thomas concede that corporate contract structures reflect executive power and that more power means more pay.⁴⁸ But they nonetheless hold to an optimality claim, at least in the first-best-second-best sense.⁴⁹ That is, given contracting costs, results will never be first best. Compensation contracts nevertheless can achieve optimal results within a second-best framework, anticipating problems such as CEO power and adjusting in advance.⁵⁰ Core, Guay, and Thomas accuse Bebchuk and Fried of making an excessive demand with their normative base point of arm’s-length bargains. Bebchuk and Fried, they charge, complain about a Nirvana that does not exist,⁵¹ seeking theoretical perfection in a second-best world. A contract, they say, can be “optimal” without being arm’s-length.⁵²

Core, Guay, and Thomas’s concept of optimality is intelligible enough. But it is difficult to make sense of its application in the context of executive compensation. Certainly, recognizing that first-best outcomes are impossible and seeking the best possible second-best ones makes sense as a

43. See generally Core et al., *supra* note 32 (summarizing the literature).

44. See *id.* at 2-3.

45. *Id.* at 17.

46. *Id.* at 24.

47. See Core et al., *supra* note 6.

48. *Id.* at 1160.

49. First-best outcomes yield zero welfare losses. A second-best world is one in which constraints respecting either incentives or institutional context prevent the achievement of a first-best outcome. See JEAN-JACQUES LAFFONT, *FUNDAMENTALS OF PUBLIC ECONOMICS* 167 (1988). “First best-second best” means that actors are doing the best that can be done in an imperfect environment.

50. Core et al., *supra* note 6, at 1160-61.

51. *Id.* at 1167.

52. *Id.* at 1162-63.

policy objective in an imperfect world. But why, given the concession of management empowerment, should we assume that pay practice is optimal even in a second-best sense? A rational, empowered actor presumably takes more than does a rational, unempowered actor. The excess is rent and is not even second-best within the normative framework of a competitive market. So the point carries only if arm's-length contracting and the competitive market are inappropriate bases for normative evaluation. From a legal perspective, that point cannot carry: arm's-length contracting is the time-honored normative yardstick of the fiduciary law concerning self-dealing contracts. From an economic point of view, things could be different. It certainly is conceivable that parties who are not at arm's length might contract optimally. For that to happen, however, the parties need a theoretical template directing them to the maximum payoff. Unfortunately, economics has not yet offered such an "objective optimality" template for CEO compensation. So we are left with the question as to how the field can expect the practice to evolve in a first-best-second-best direction based on trial and error when the bargaining parties are not dealing at arm's length. That calls for marketplace magic of a high order.

If we extend Core, Guay, and Thomas's concept of robust governance practice to its logical end, then Jensen and Murphy were out of line in criticizing pay practice for performance insensitivity back in 1990. But because Core, Guay, and Thomas did not likely intend this implication, their defense of pay practice implicitly relies on an expertise-based argument: that Bebchuk and Fried, unlike Jensen and Murphy, have no business attacking pay practice despite their accurate diagnosis of executive power. This implicit assertion is unpersuasive. Bebchuk and Fried have standing to call a windfall a windfall.

Finally, Core, Guay, and Thomas's "Nirvana fallacy" charge misses the mark. That accusation made sense forty years ago when post-New Deal public-interest regulators posited that real-world imperfections would automatically justify regulation. In that era, citing the Nirvana fallacy implied that *laissez-faire* was cost beneficial—that is, effective in view of a cost-benefit analysis. Bebchuk and Fried, in contrast, argue that cost-beneficial changes are within easy reach through free bargaining, making no plea for direct regulation of contract terms.

B. Information Breakdowns

Recall Murphy's criticism of stock-option compensation for lower-level employees. For Murphy, the persistence of pay arrangements that fail a cost-benefit test reflects a lack of appreciation of the costs. Board members incorrectly believe that stock options are a bargain mode of compensation and overestimate the advantages of option payments in comparison to

cash payments by underestimating an options' cost to the shareholders whose stakes they dilute.⁵³

Jensen and Murphy use this point to account for a number of practices. For example, during the 1990s, firms continued to grant the same number of stock options year after year, even as their stock prices doubled, causing the value of incentive grants to balloon. The number of options would have dropped as the market rose had pay plans been laser focused on performance sensitivity. Contrariwise, when the market fell after 2000, option value fell in lockstep. Had the center of attention been value rather than numbers of shares, upward adjustments would have been necessary.⁵⁴

For Jensen and Murphy, the fallacious "free money" view of options better accounts for prevailing compensation practice across the past fifteen years than power does. Lack of sophistication also explains the absence of indexing: prior to 2005, Generally Accepted Accounting Principles (GAAP) required firms to expense the value of indexed options from their earnings but did not require deductions for fixed-price, unindexed options.⁵⁵ Boards thus gave up performance sensitivity not because of CEO domination but because they were naively fixated on earnings per share (EPS) and GAAP rules on EPS were ill conceived.⁵⁶

Murphy combines the information-breakdown argument and the risk-and-return argument to describe a robust bargaining dynamic. A firm grants options not to incentivize employees but because options appear to be cheap compensation.⁵⁷ It follows that concessions keyed to managers' risk aversion—the fixed exercise price set at the market and the absence of restraints on alienation—will little bother a firm that does not view the concessions as costly. While the manager would prefer an exercise price set below the market, the firm would prefer an exercise price above the market; they subsequently split the difference when they set the price at the market.⁵⁸

Note that Murphy has smuggled in a normative assertion. In his account of a robust deal, the mistaken perception of low cost begins as a positive observation but transforms into a statement of purpose. For Murphy, equity compensation and cash compensation have the same simple purpose—to compensate. For Bebchuk and Fried, in contrast, the purpose of equity compensation is to incentivize; absent an incentive effect, nothing justifies big upside payoffs at the shareholders' expense. With

53. Jensen & Murphy, *supra* note 12, at 37-39.

54. *Id.* at 37. Indeed, if management were all-powerful, the market decline alone should have caused a gross increase in the numbers.

55. See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123:1, Share-Based Payment (revised Dec. 2004).

56. See, e.g., Jensen & Murphy, *supra* note 12, at 37-39.

57. Murphy, *supra* note 28, at 864-65.

58. *Id.* at 863-64.

incentives as the sole purpose for equity-based pay, the positive account takes on a different hue. Any instance of performance-insensitive equity compensation implies management empowerment.

What then is the purpose of equity-based pay—compensation or incentive? In a strictly positive sense, the answer is both. But in a normative sense, the answer must be incentive under Murphy's own analysis. He sees stock options as an intrinsically inefficient form of compensation; they therefore only make sense if they carry incentives more valuable than their opportunity cost. In this view, it follows that management power can be excluded from a plausible positive account only if ignorance independently explains everything.

Bebchuk and Fried reject this "honest stupidity" explanation for five reasons (76-78, 147-48). First, if lack of sophistication were the cause, we would see firms use a wider range of techniques, with more sophisticated firms offering plans less favorable to managers and unsophisticated firms offering even more favorable plans.⁵⁹ Second, if lack of knowledge were the cause, education would be the obvious cure, but Bebchuk and Fried see the problem lying at a deeper level. Third, lack of sophistication is implausible when most independent directors are themselves CEOs—people who presumably are quite sophisticated in matters related to executive compensation. Fourth, given the prevalence of CEOs within the ranks of independent directors, residual boardroom misunderstandings only further support Bebchuk and Fried's reliance on CEO power as the explanation. If less sophisticated directors misunderstand the economic implications of stock options they approve despite readily available expert education, then some other constraint must be skewing the approval process. Finally, as to the perverse effects of the old GAAP rule that required indexed options to be expensed but required no similar deduction for unindexed options, Bebchuk and Fried ask why an independent board would focus on short-term EPS (implicating only numbers on a page) instead of on a long-term, value-enhancing strategy. Putting EPS first would make sense only if the stock market very inefficiently punished the stock price for the EPS sacrifice and if that short-term cost outweighed the performance benefit of indexing (147-48).

These are strong points, but they are not strong enough to defeat completely the explanatory force of the ignorance-based argument. Business people *do* react differently to cash and scrip, and EPS *does* matter in the boardroom, in part because it matters to noise traders in the markets.⁶⁰ In addition, there is nothing new about management's using options to write

59. I have a question here. Given firms' tendency to herd around focal-point solutions, ignorance might prevail without diversity.

60. Of course, EPS also matters to the pocketbooks of many executives whose cash-bonus schemes reward EPS increases.

scrip for itself in order to exploit under-appreciation of the long-term economic costs that bargain options impose on the rest of the shareholders. Consider for example Delaware, which amended its corporate code to facilitate the practice in the late 1920s. In those days warrants distributed to insiders in connection with new equity offerings facilitated exploitation.⁶¹ But the economic principles of this practice do not differ at all from those that underlie stock-option compensation. The practice's persistence suggests that a boardroom seminar on basic financial economics would fall short as a cure. For whatever reason,⁶² the economic costs of equity kickers are not perceived as equivalent to those of cash payments.

Admitting lack of sophistication into the picture, however, only detracts from a power-based explanation if we narrowly define power as the authority to direct the actions of others—the power of a sovereign or a military superior, for example. If we relax the definition slightly to describe power in terms of being in a position to exploit others economically, persistent lack of sophistication fits neatly into Bebchuk and Fried's description. Indeed, lack of sophistication is nothing more than unequal bargaining power as understood in contract law. In the end, then, lack of sophistication and accounting concerns dovetail nicely with Bebchuk and Fried's explanation of management power.

Now that GAAP requires the expensing of option costs, we will get a real-world test of these explanations. Bebchuk and Fried would predict no general move to indexing. I join them. Today's boards lack the independence to hold managers' feet to the fire on pay. Absent a significant shift in boardroom norms or radical reform empowering shareholders, the practice will not change materially.

C. *The Normative and Political Environment*

Just as management power is hard to prove, so is its presence hard to deny. Bebchuk and Fried's interlocutors have by now conceded that power does help explain the problem of inefficient compensation.⁶³ Dispute continues over power's implications, and that debate quickly expands to cover the governance system as a whole. To what extent does the system succeed

61. See Bratton & McCahery, *supra* note 13, at 19.

62. Concerns about cash flows explain this in part.

63. See Core et al., *supra* note 6, at 1160-61 (agreeing that pay structures reflect power and a positive correlation between power and pay); Hall & Murphy, *supra* note 36, at 27-28 (reporting sympathy with the view that pay decisions are not made by truly independent boards, but contending that rent extraction is not a compelling explanation); Holmstrom & Kaplan, *supra* note 5, at 13 (agreeing that the biggest payees use "positions of power to command excessive awards"); Jensen & Murphy, *supra* note 12, at 54 (recommending changes in structural and psychological environment and noting that "[c]hanges in practices will require a major change in the power relationship between the board and the CEO").

or fail in cost-effectively channeling the energy of empowered managers to productive ends that serve the shareholder interest?

Answering this question requires a judgment call. Bebchuk and Fried's interlocutors stress the bright side. Bengt Holmstrom and Steven Kaplan offer a prominent contribution. They concede that some managers take excessive rewards, that equity compensation of top executives is more liquid than shareholders would want, and that perverse incentives have cropped up in the form of accounting manipulation.⁶⁴ But they contend that shareholders should overall be pleased with the way things have gone in the last fifteen years. Returns, measured net of the cost of executive compensation, have been generally higher since the switch to option-based compensation. And the shift did succeed in aligning management interests with those of the shareholders to a greater extent than in the past. Meanwhile, from 1992 to 2000, growth of the gross domestic product in the United States was higher than in Italy, France, Britain, Germany, or Japan. Finally, problems with executive compensation after 2000 have mainly concerned isolated cases of abuse, and regulatory agencies have quickly addressed breakdowns resulting from the strain of the 1990s' boom market.⁶⁵ Core, Guay, and Thomas second this view, noting that one can identify and deal with cases where high pay and poor performance coincide. The existence of bad apples, they argue, does not compel the conclusion that the whole economy suffers from governance problems.⁶⁶

Murphy, variously writing with Brian Hall and Michael Jensen, also follows this line of reasoning, pointing to governance improvements initiated in the 1990s: boards became smaller and more independent, shareholders became more vigilant, compensation committees became the norm, and federal disclosure regulations required greater transparency than ever before.⁶⁷ Shareholders apparently welcomed the shift to option compensation as they enjoyed the bull market of the 1990s. In contrast, a much smaller net pay increase to management during the 1980s had triggered a populist backlash, due to the association of high salaries with layoffs, plant

64. Holmström & Kaplan, *supra* note 5, at 3-4, 12-14.

65. *Id.* at 3-4.

66. Core et al., *supra* note 6, at 1166. Patrick Bolton, José Scheinkman & Wei Xiong, *Pay for Short-Term Performance: Executive Compensation in Speculative Markets* 4-8 (ECGI Finance Working Paper No. 79/2005), available at <http://ssrn.com/abstract=691142>, makes a contrasting point. In their view, problems with executive compensation followed from the technology stock bubble, which in turn implies that compensation packages that encouraged inaccurate financial reports followed from the interests of shareholders with short-term holding perspectives. This point is quite correct, but problematic. The problem concerns the mediation between the short- and long-term holding perspective and management duties. For an extended discussion, see William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 452-63 (2003).

67. Hall & Murphy 2003, *supra* note 36, at 27-28 (citing Holmström & Kaplan, *supra* note 5).

closings, and downsizing.⁶⁸ For Murphy, outrage is more notable for its absence than for its limiting role in respect to current practices.⁶⁹

Bebchuk and Fried deny none of this but are unimpressed by apparent shareholder acquiescence. Outrage costs, they contend, do not register for equity-based compensation because it is based on a sound idea (145).⁷⁰ In any event, investors do not find excessive or distorted pay arrangements bothersome during bull markets. Meanwhile, taking management rent seeking together with the business world's tendency to follow a norm of conformity, movement toward an equilibrium more responsive to shareholders will be expectedly sticky. Bebchuk and Fried's very purpose is to destabilize the equilibrium so as to jumpstart change (72, 74-76).

The two sides here debate the appropriateness of contrasting normative inferences drawn from a commonly held positive account. There is no objective resolution. Meanwhile, we should note the institutional postures of the combating parties. Bebchuk and Fried, legal academics, emerge as pit-bull monitors of boardroom practice, relentlessly making the case for shareholder value. Murphy and the other economists, as apologists, approach criticism of boards with circumspection, even as they embrace the shareholder-value norm. How should we account for the contrast?

Fear of regulation helps to explain this law/business split. Jensen and Murphy suggested in their famous paper of 1990 that political forces led to performance-insensitive pay structures.⁷¹ The upper tail of reward distribution trailed off because employees, labor unions, consumer groups, Congress, and the media, all well informed due to mandatory public disclosure, combined forces in the political milieu to constrain the effectiveness of boards.⁷² Writing in 2004, Jensen and Murphy recall in detail the populist outburst of the early 1990s, mentioning not only legislation enacted at the time but an initiative that died in the House, a bill that would have disallowed corporate tax deductions for any compensation exceeding that of the lowest-paid worker by a factor of twenty-five.⁷³ Murphy, looking back on the period, has noted an overlap between academic and populist attacks on pay. The academics wanted then, as they do now, performance sensitivity without concern about level of pay, while the populists did not care about pay level, and adopted the academics' performance-sensitivity

68. Murphy, *supra* note 28, at 1; Jensen & Murphy, *supra* note 12, at 1 (pointing out the resurgence of outrage directed to the amount of pay in connection with recent scandals). They are impressed by the negative publicity attracted by the Jack Welsh and Richard Grasso retirement packages, noting that nobody questioned the quality of the performance of either.

69. Murphy, *supra* note 28, at 855-56.

70. One might well challenge Bebchuk and Fried on this point, who seem to assume that shareholders lack understanding, which in a way actually endorses Murphy's arguments.

71. Jensen & Murphy 1990, *supra* note 4, at 253-60.

72. *Id.*

73. Jensen & Murphy, *supra* note 12, at 30.

critique only as a means to capping executive pay.⁷⁴ One suspects that the specter of populist intervention lingers in the minds of those who resist Bebchuk and Fried's reform initiative: reform talk rouses populism, and populism means deadweight loss as it lowers both pay levels and pay-to-performance sensitivity.⁷⁵

Like the concept of power, the impact of politics, the force of populism, and the likelihood of regulation are all difficult to observe and therefore difficult to gauge. But one could reasonably expect general agreement on the proposition that the likelihood of political intervention increases with the level of outrage over management misbehavior. Thus does the absence of outrage over recent pay practice, emphasized by Bebchuk and Fried's opponents, reemerge to suggest that any fear over the "populist threat" is presently overstated. Shareholder capitalism is a public as well as a private phenomenon. Median voter demands have moved away from early- and mid-twentieth century populist concerns over big business and labor relations. The politics of the Enron scandal show that shareholder value tends to drive national political demands. We have indeed seen a recent spate of popular outrage, but reporting breakdowns triggered this anger. Today's populist agenda concerns compliance with laws designed to assure accurate market prices. Outrage in the 1990s concerned pay practice only to the extent it contributed to short-term focus on stock prices and reporting failures, not because it implicated a wealth transfer from working people.

Legislatures responded by building in more shareholder responsiveness through strengthened committee systems and extended shareholder ratification requirements.⁷⁶ Only two sections of the Sarbanes-Oxley Act clamp down on pay—those prohibiting loans to executives and those disgorging incentive compensation triggered by accounting restatements.⁷⁷ Neither restriction inhibits the level of pay. And in any event, the surge of neo-populist political energy has abated. Management is returning to its accustomed place of political influence in Washington.⁷⁸ Thus, a refractory fear of populist hordes seems unfounded. The question in this debate is how seriously one should take shareholder value.

74. Murphy, *supra* note 28, at 22.

75. *Cf. id.* at 51.

76. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 202(i)(1)(A), 204, 116 Stat. 787 (requiring audit-committee approval and reports to the audit committee); New York Stock Exchange Manual, §§ 303A.05, 303A.8 (requiring an independent compensation committee and shareholder ratification of all equity compensation plans).

77. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 304, 402(a), 116 Stat. 787.

78. See Kurt Eichenwald, *Reform Effort at Businesses Feels Pressure*, N.Y. TIMES, Jan. 14, 2005, at A1, C2 (describing changes in the political environment).

III RETRENCHMENT

Slack in the governance system lengthens during bull markets. When the stock price goes up, few investors question generous pay deals. Market reversals, in contrast, trigger heightened scrutiny of governance practices—and not just from within the financial community. Scrutiny becomes especially exacting when market reversals coincide with well-publicized cases of executive noncompliance with the law. But when the market recovers and memories of scandal fade, management regains its political influence and good governance loses its prominence on the political agenda.

We see this pattern in the recent twists and turns of the executive-pay debate. Some significant adjustments have crept into the financial economic defense, at least as Professor Murphy and Michael Jensen presented it in a co-written paper in 2004. At the same time, the political environment after the 2004 election looks friendlier to management, foreboding negative implications for Bebchuk and Fried's reform agenda.

A. *Jensen and Murphy and the Normative Cycle*

Murphy has long been a critic of the boardroom negotiating environment, even as he has defended it against Bebchuk and Fried. He has acknowledged that CEOs exercise influence over the pay-setting process, pointing out that pay recommendations emanate from firms' human-resources departments (working in tandem with outside consultants) and pass through a management-approval stage before going on to boards.⁷⁹ Murphy has sharply criticized the survey evidence presented to justify pay increases, pointing out the narrow compass of criteria referenced in determining levels of pay. He also has criticized the ratchet effect across certain industries:⁸⁰ a pay increase in one firm often triggers industry-wide increases because the industry's firms gauge their competitiveness by reference to one another. Despite these criticisms, Murphy made no concessions on the basic question of the legitimacy of pay increases, at least prior to 2004. He then admitted that compensation committees tend to err on the high side and will always defer to management given a choice between a slightly inferior plan the CEO favors and a more sensible plan. Yet Murphy rejected the "cynical scenario" of "entrenched compensation committees rubber-stamping increasingly lucrative pay programs."⁸¹ For Murphy, the approving directors were "keenly aware of the conflicts of interest between managers and shareholders over the level of pay," and management influence did not mean a corrupt process or systemic failure.⁸² Even though

79. Murphy, *supra* note 8, at 24.

80. *Id.* at 9.

81. *Id.* at 25.

82. *Id.* at 24.

truly independent boards did not make the decisions at arm's length, rent extraction did not afford a compelling explanation for the practice.⁸³

Writing with Jensen in 2004, Murphy describes the same process infirmities and continues to stress the good faith of compensation-committee members.⁸⁴ But negative characterizations have crept into the normative bottom line: "the governance system itself is corrupted and tilted in the direction of management in a way that will almost inevitably lead to excesses in executive pay levels,"⁸⁵ requiring a change in the very structure of the evaluation and pay-setting process.⁸⁶ Lucrative termination agreements earn Jensen and Murphy's strongest condemnation—as they are so "extreme" and "abusive" as to "call into question the integrity of important parts of the remuneration process."⁸⁷ Jensen and Murphy also are highly critical of the expertise and negotiating skills of compensation committees, which they see as particularly likely to give away the store when hiring outside executives. Skilled professional negotiators represent incoming CEOs and run rings around the hiring company, which itself pays the negotiator's fee. Jensen and Murphy recommend that boards refuse to pay the fee and hire their own professional contracting agents.⁸⁸ But Jensen and Murphy concede nothing in their final evaluation, insisting that "poor negotiating expertise" provides a better explanation than board captivity.⁸⁹

Views have also shifted on the crucial matter of stock-option design. Some years ago, Murphy judged prevailing stock-option practice favorably when compared to alternatives importing greater performance sensitivity. Overall evidence, he said, supported the basic hypothesis that equity incentives drove management performance. But little evidence supported the proposition that more aggressive performance-based plans would enhance expected shareholder returns.⁹⁰ In Murphy's schemata, indexing alone would not be a Pareto improvement because the corporation would have to compensate for the increased risk with an increased payoff to the executive.⁹¹ The more recent Jensen and Murphy paper, in contrast, strongly advocates indexing, backing a formula tied to the firm's cost of equity capital net of the dividend yield.⁹² Jensen and Murphy also now support restraints

83. Hall & Murphy, *supra* note 27, at 27-28.

84. Jensen & Murphy, *supra* note 12, at 50.

85. *Id.* at 51.

86. *Id.* at 54.

87. *Id.* at 29.

88. *Id.* at 52 (noting Joseph Bachelder as a particularly successful agent). Jensen and Murphy also recommend that the firm hire different compensation consultants to assist with lower-level employee and top-team compensation. *Id.* at 56.

89. *Id.* at 53-54.

90. Murphy, *supra* note 8, at 44.

91. Hall & Murphy, *supra* note 36, at 17-19. Putting GAAP to one side, they predict that indexed options will appear only in tandem with below-market exercise prices. *Id.*

92. Jensen & Murphy, *supra* note 12, at 61-63.

on alienation, calling for ongoing monitoring of executives' portfolios and a ban on hedging risk in the capital markets.⁹³ They also concede the danger of insider trading, endorsing Fried's suggestion of pre-trading disclosure.⁹⁴

We see a similar shift on restricted stock. Murphy formerly projected that if executives and firms were left free to bargain in a space undistorted by the accounting and tax regimes, then restricted stock would replace stock options.⁹⁵ Restricted stock, Murphy claimed, better addressed executives' risk aversion; it imported more stable incentives, holding out gain on both the upside and the downside without perverse incentives for investment policy.⁹⁶ Now, writing with Jensen, Murphy denounces restricted stock as a giveaway, citing the same problem Bebchuk and Fried note.⁹⁷ For Jensen and Murphy, the cure lies in making sure that the executive really does make a tradeoff rather than simply receiving equity compensation as a free add-on to cash salary. Thus, salary and bonus payments should be formally exchanged for options or restricted stock.⁹⁸ Bebchuk and Fried would not disagree.

Jensen and Murphy do retain Murphy's earlier information-based characterization of the problem, even as they step up the criticism of the practice and acknowledge management influence. They avoid using the term "rent" and attribute the mess to lack of information and bargaining expertise. Jensen and Murphy underscore this position at the prescriptive level: since the problem results from deficient expertise and information, enhanced board independence will not, by itself, import a solution.⁹⁹

Jensen and Murphy concede every salient point except the final deduction as to the source of the problem. Avoiding recourse to a characterization of the problem as one of "power," they say boards just do not "get it." This is true in a sense: if all the boards wake up tomorrow and "get it," they will indeed possess legally vested "power" to change the practice. But critical questions arise. First, why has this not happened already? Second, how can we expect boards to be sufficiently motivated—absent enhanced independence—to invest in the expertise and information necessary to "get it" and solve the problem? If the economics of corporate governance teach us anything, it is that agency problems will not be solved unless actors have an incentive to solve them. The necessary technologies are on the shelf, and the compensation-consulting firms would be happy to

93. *Id.* at 66-67.

94. *Id.* at 68.

95. Hall & Murphy, *supra* note 27, at 24.

96. *Id.* at 19.

97. Jensen & Murphy, *supra* note 12, at 58. Jensen and Murphy also denounce the design of bonus plans. *Id.* at 69-73.

98. *Id.* at 59.

99. *Id.* at 53-54.

sell them. There is no supply-side problem; rather demand is what is missing. Bebchuk and Fried's book explains its absence, answering the question as to why boards do not "get it." We can select from a whole palette of terms in explaining why—influence, dominance, imbalance, tilt, skew, agency cost, and, yes, power.

B. *Bebchuk and Fried and the Political Cycle*

Bebchuk and Fried offer a menu of governance improvements. Some of these would tweak the present system to make it more likely that the shareholder voice registers inside boardrooms. For example, transparency could be enhanced, shareholders being unlikely to complain about practices they cannot see. All compensation could be reported with a dollar value attached, and the corporation could report executive stock sales directly (192-94). In addition, the shareholder vote could become more meaningful, with separate votes on different segments of compensation plans giving shareholders the opportunity to pinpoint objectionable provisions (197). Other proposals on the menu are more radical and would empower the shareholders, fundamentally changing the system. At present, shareholders have no power to place binding resolutions on the ballot at the annual meeting. Bebchuk and Fried would relax this constraint to permit binding shareholder initiatives on compensation (198). They would not stop there. They would break the board's legally vested agenda control over important corporate legislation so that shareholders could propose charter amendments that removed provisions that entrench management (211-12). Finally, shareholders should be granted access to the ballot on terms broader than those recently proposed by the Securities and Exchange Commission (210).

Others are debating the costs and benefits of shareholder-empowerment measures in various arenas.¹⁰⁰ Here I note only two points. First, political feasibility presents a more monumental stumbling block today than it did only two years ago. The post-Enron political climate has faded, and management influence again registers.¹⁰¹ Just as corporate directors lack incentives to appreciate the opportunity costs when they pay employees in equity scrip, so too do politicians lack incentives—absent the

100. For Bebchuk's intervention, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005). For a review of *Pay Without Performance* that focuses critically on the shareholder-empowerment proposals, see Stephen M. Bainbridge, *Executive Compensation: Who Decides?* 83 TEX. L. REV. 1615 (2005).

101. See, e.g., William H. Donaldson, *U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers*, Jan. 25, 2005, <http://www.sec.gov/news/speech/spch012505whd.htm> (signaling relaxation of Sarbanes-Oxley requirements on foreign issuers); Roel C. Campos, *The SEC's Shareholder Access Proposal*, Jan. 10, 2005, at <http://www.sec.gov/news/speech/spch011005rcc.htm> (describing objections to the SEC's access proposal and terming it a "long shot"); Eichenwald, *supra* note 78, at C2.

shock of major losses and political scandal— to appreciate the opportunity costs of poor governance institutions. *Pay Without Performance* appears late in the reform cycle, but it has already jolted actors at the SEC into rethinking their disclosure mandates to import greater transparency.¹⁰² Disclosure reform still may have a reasonable chance of success. But the more radical proposals on the menu look more visionary every day. Thus does the separation of ownership and control return at the end of the discussion not only to help us diagnose the problem but to explain why it remains unsolved.

Second, boardroom power relationships can change. Hierarchical directive is not the only way to improve practices. Sometimes communicative action can do the job.¹⁰³ It follows that failure for Bebchuk and Fried's radical shareholder empowerment agenda does not necessarily imply failure for the argument in favor of performance-sensitive pay. To be sure, radical steps to empower shareholders would hasten movement to a more productive result. But persistent, cogent criticism has affected corporate governance—including pay practice—in the past. It certainly could do so again, causing boards to insist on incremental improvements in the design of pay packages. It is at this level that Bebchuk and Fried will likely make the biggest impact.

CONCLUSION

The closer one looks at the debate over executive pay, the smaller the substantive stakes appear. Bebchuk and Fried make no attempt to deny the presence of the factors their interlocutors emphasize, and subsequently, the interlocutors have moderated their objections. Jensen and Murphy, in their recent writing, go so far as to note that their account is consistent with Bebchuk and Fried's and only object that the latter pair "somewhat overstate[s]" the case in not explaining why stock options exploded in the 1990s.¹⁰⁴ But, as all agree, an historical shift toward shareholder responsiveness occurred in the wake of the takeover wars of the 1980s, due in no small part to the influence of writers like Jensen and Murphy. Management incorporated shareholder-value maximization into its own job description, pursuing voluntarily matters like unbundling and cost reduction that the market for corporate control had once forcibly imposed. But that normative shift to shareholder capitalism occurred within familiar and comfortable precincts. Management retained considerable boardroom influence and took the occasion to extract a substantial raise, a raise which would not

102. See Jesse Eisinger, *Follow the CEO's Money*, WALL ST. J., Feb. 16, 2005, at C1 (reporting on comments of William Donaldson and Alan Beller).

103. I refer to the concept of power articulated by Arendt. See HANNAH ARENDT, *THE HUMAN CONDITION* 200-05 (1958).

104. Jensen & Murphy, *supra* note 12, at 53.

have been forthcoming to a party lacking bargaining power. To take the shareholder-value norm seriously is to follow Bebchuk and Fried and to get serious about performance sensitivity.