

HOW INCENTIVE PAY FOR EXECUTIVES ISN'T—AND WHAT WE CAN DO ABOUT IT

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION. By Lucian Bebchuk* & Jesse Fried.† Cambridge, Mass.: Harvard University Press, 2004. Pp. ix, 278. \$24.95.

Reviewed by MEREDITH M. STEAD‡

INTRODUCTION

When conversation turns to business, a topic guaranteed to provoke heated discussion is the extraordinary compensation that top American corporate executives enjoy. Periodically, as some new pinnacle is reached, the public reacts with a fresh wave of indignation. A well-known example is the story of Michael Ovitz. Hired as president of the Walt Disney Company by his friend, CEO Michael Eisner, Ovitz left the company after just fourteen months, having failed abysmally at his job by most reckonings.¹ Upon his departure, however, Ovitz collected a “golden handshake”² of not only his annual base salary of \$1 million for the remainder of his five-year contract, but additional earnings from stock options and a generous severance package, totaling approximately \$140 million.³ Outraged share-

* Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School.

† Professor of Law, University of California, Berkeley.

‡ Copyright © 2005 by Meredith M. Stead. B.A., 1978, University of Chicago; B.F.A., 1982, California Institute of the Arts; J.D. Candidate, 2006, New York University School of Law.

¹ See, e.g., Christopher Parkes, *The Case of the \$140m Parachute*, FIN. TIMES, Nov. 8, 2004, at 11 (reporting trial depositions describing Ovitz “as a manipulative liar who ran off the tracks almost as soon as he started”); Frank Rich, *Mickey Mouse Clubbed*, N.Y. TIMES, Dec. 14, 1996, at 23 (characterizing Ovitz as “ineffectual” and inept). Even prior to his departure, press rumors suggested that Ovitz was unsuited to his job as the number two man to Michael Eisner. See, e.g., James Bates & Claudia Eller, *A Bumpy First Year at Disney: From Agent to Exec, Ovitz as Enigmatic as Ever*, L.A. TIMES, Sept. 27, 1996, at D1 (contrasting success of Ovitz’s “arrogant” management style at his own agency with need for diplomacy at new position); Bernard Weinraub & Geraldine Fabrikant, *A Mouseketeer with an Attitude: Ovitz’s Past Haunts Disney’s Future*, N.Y. TIMES, Oct. 6, 1996, at D1 (describing Ovitz as “ma[king] missteps and antagoniz[ing] executives” as well as “struggling to carve out his role” at Disney).

² “A large severance payment made to a director or employee who is dismissed before the expiry of his or her contract.” FRANK LIVESEY, DICTIONARY OF ECONOMICS 99 (1993).

³ See, James B. Stewart, *Partners: Eisner, Ovitz, and the Disney Wars*, NEW YORKER, Jan. 10, 2005, at 46; *Ovitz Says Disney ‘Tainted’ Him*, WASH. POST, Nov. 2, 2004, at E2.

holders brought a derivative suit, and seven years after Ovitz's departure, the case is still wending its way through the courts—and through the headlines.⁴

A glance at recent statistics reveals what the shouting's all about. In 1970, the average CEO of an S&P 500 corporation made about thirty times the salary of an average worker.⁵ In 1991, taking all forms of compensation into account, such a CEO made about 140 times the worker's salary; by 2003, about 500 times as much (p. 1). Median CEO pay at the S&P 500 corporations escalated from \$2.3 million in 1992 to over \$6.5 million in 2000.⁶

Defenders of this trend point out that the percentage of compensation given as stock options (rather than salaries or bonuses) nearly doubled from 1992–2000.⁷ Such equity-based compensation, they contend, links executive pay directly to company performance and aligns managers' interests with those of shareholders, the ultimate beneficiaries of good management (p. 19). Finally, they point to the unprecedented growth of the national economy over the same time period, measured by profitability, productivity, and gross national product.⁸ If corporate value has skyrocketed this much, they argue, executives must be worth the compensation packages that boards of directors are handing out (p. 20). And since directors depend on the good will of shareholders to stay in office, it stands to reason that boards are acting in shareholders' interests when they negotiate executive compensation.

In their provocative book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Lucian Bebchuk and Jesse Fried argue that this analysis is fundamentally flawed. Bebchuk and Fried posit that “managerial power” is the underlying cause of the

⁴ See, e.g., Bruce Orwell & Chad Bray, *Disney's Eisner Paints His Own Picture of Ovitz: CEO Testifies on Displays of Pettiness and Bad Deals; 'Giant Scene' at a Funeral*, WALL ST. J., Nov. 17, 2004, at A1. The current trial concluded January 19, 2005; a ruling is expected within the next few months. Nic Hopkins, *Directors at Disney Under Fire as Investors Seek \$262m*, TIMES (U.K.), Mar. 9, 2005, at 47; see also *In re Walt Disney Co.*, No. CIV.A.15452, 2004 WL 2050138 (Del. Ch. Sept. 10, 2004) (granting motion of Ovitz for summary judgment in part and denying in part); *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (denying motion of Walt Disney Co. to dismiss shareholder derivative action).

⁵ Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS, 2485, 2553 (Orley Ashenfelter & David Card eds., 1999).

⁶ Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847 (2002).

⁷ *Id.*

⁸ See generally, e.g., J. Steven Landefeld & Barbara M. Fraumeni, *Measuring the New Economy*, SURV. CURRENT BUS., Mar. 2001, at 25–40 (providing background information on performance of economy and relation to changes in form of compensation and profitability).

decoupling of pay from performance. The crux of the managerial power thesis is that existing structures persist because executives exert previously unrecognized control over boards of directors. The book first lays out the traditional model of executive compensation and raises several questions about its viability. The authors then demonstrate how widely-used executive compensation structures are not truly tied to performance and therefore are not reflections of managerial competence. Finally, Bebchuk and Fried propose changes in current compensation arrangements to more effectively reward executive performance. The managerial power thesis is persuasive, but ultimately inadequate in explaining some persistent trends. The contrary evidence demonstrates that the thesis cannot sustain as much of the explanation for the phenomenon as the authors suggest.

I

HOW INCENTIVE PAY ISN'T

Pay Without Performance addresses how nonequity-based compensation (salaries, bonuses, loans and retirement benefits) fails to provide performance incentives (pp. 123–33). But its chief argument is that even equity-based compensation, as currently structured, fails as well. While Bebchuk and Fried do not dispute the general advantages of equity-based compensation in theory,⁹ they offer compelling evidence that the most commonly used form—fixed option grants—does not effectively tie performance to compensation.

A. *Fixed Option Grants vs. Indexed Option Grants*

Many publicly traded firms “use stock options to form a significant part of the compensation they pay their more highly compensated employees.”¹⁰ A fixed option grant gives an employee the right to purchase a specified number of shares of her company’s stock at a prespecified price (the exercise or “strike” price), usually set at the time the options are granted. If the company does well, its stock price will go up, and the employee stands to make a profit. For a company’s CEO, who can have a potentially enormous effect on a company’s worth, this form of compensation seems like a good way to reward performance.

The problem with conventional fixed options is that they reflect not only changes in the individual firm’s share price, but any changes

⁹ “We should emphasize at the outset our strong support for the general idea of equity-based compensation” (p. 137).

¹⁰ Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1901 (2001).

in the market as a whole. Thus they “reward employees for gains they could not have produced and lose their incentive feature when share prices drop.”¹¹ While fixed options can in theory “punish” poor performance (i.e., if the market goes down), this potential can be dissipated if firms either reprice options or “reload”—that is, issue additional options—when the market drops (pp. 165, 169–70). In other words, firms often simply compensate for market dips.¹²

Indexed options, on the other hand, tie the exercise price to a benchmark such as a “basket”¹³ of stocks in the corporation’s industry. If the company does poorly in comparison to other industry players, an employee will not be rewarded; but if the company does relatively well, the employee can be rewarded even if the market as a whole does poorly, thereby maintaining incentive value.¹⁴

Indexed options therefore offer two advantages over fixed options. First, they avoid giving employees undeserved windfalls during periods when the market as a whole is on an upswing. Second, they maintain their incentive nature during periods when the market as a whole is falling. Yet despite these clear advantages, very few companies utilize indexed options (pp. 142–43).

B. Other Underutilized Ways of Linking Compensation to Performance

Bebchuk and Fried bolster their argument by pointing to other features that could more effectively tie equity-based compensation to performance. For example, performance-conditioned vesting of option grants would reduce possible windfalls to executives from general market upswings. This means that the employee cannot exercise the grant unless the company meets a certain performance target.

¹¹ See *id.* at 1904–05 n.3.

¹² However, this practice (repricing options) has declined since Financial Accounting Standards Board rules were changed to require that firms report the difference as an expense, thereby reducing earnings. See *Number of Companies Repricing Options has Plummeted, IRRC Finds*, 11 CORP. GOVERNANCE HIGHLIGHTS 105, 105 (2000) (“[T]he number of companies that reported repricing stock options in fiscal year 1999 dropped off dramatically from the previous two fiscal years. New [FASB] rule changes have made it . . . expensive for companies to replace or reprice . . . stock options.”); Jerri Stroud, *Wall Street’s Wild Ride Cuts Total Executive Pay by 30 Percent; Stock Options Still Increased the Pay of Many*, ST. LOUIS POST-DISPATCH, July 30, 2000, at E1 (“Repricing is less likely now because accounting rules discourage it, and institutional investors frown on it.”).

¹³ “[A] group or range [e.g., of currencies].” OXFORD DICTIONARY FOR THE BUSINESS WORLD 65 (Alan Isaacs & Elizabeth Martin eds., 1993). Such a group or sample can be used to compare the performance of an individual item with the overall performance of several items. For example, “The European Currency Unit’s value is determined by taking a weighted average of a basket of European currencies.” *Id.*

¹⁴ Levmore, *supra* note 10, at 1919–22.

Very few firms use such a performance standard even though it links compensation more closely to performance (pp. 142–43). Companies also can set the exercise price of option grants so as to avoid possible market windfalls. Setting the price at the market price at the time of grant (“at-the-money”) will reward executives for market changes rather than for their own performance, while setting the price higher than the market price at the time of grant (“out-of-the-money”) will require firms (and by extension, executives) to meet a higher target (p. 160). Yet ninety-five percent of firms that grant options set an at-the-money strike price (pp. 159–61).

Finally, companies usually do not restrict an executive’s ability to sell options and shares. Such sales remove the possible incentive effects of options (pp. 174–83). The opportunity for an executive to time his sale of shares also encourages “earnings management”—the manipulation of periodic reports of revenues in order to meet or exceed the earnings projections of Wall Street analysts. For example, a CFO might present earnings that reflect revenue to which the company is not yet actually entitled.¹⁵ When this happens, share value increases artificially, allowing the executive to sell high. These structures—conditioning the vesting of options on specific goals, setting option prices at a level that requires executives to hit a higher target, and controlling the timing of option and share sales—are demonstrably superior ways to connect performance more directly to compensation. Yet, as with fixed versus indexed options, firms have tended to prefer the inferior methods. The obvious question is, why is this so?

II HOW WE GOT HERE

The authors present a very persuasive argument that the most common form of stock option does not effectively tie executive performance to compensation and therefore is disadvantageous to shareholders.¹⁶ They attribute this to what they describe as managerial

¹⁵ See, e.g., Gretchen Morgenson, *Pennies that Aren’t from Heaven*, N.Y. TIMES, Nov. 7, 2004, § 3, at 1 (discussing prevalence, methodology, and detrimental effects of earnings management). However, this practice may diminish in light of the recent enactment of the Sarbanes-Oxley Act. Among other provisions, § 304(a) of the Act provides that the CEO and CFO of any firm required to restate earnings must reimburse their company for any incentive pay received during the twelve months following the misleading financial statement. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7243 (2000 & Supp. II 2002)).

¹⁶ Bebchuk and Fried further demonstrate that other common forms of executive compensation, such as gratuitous payments upon retirement or firing (i.e., payments not included in an executive’s original contract) are not linked to performance. Such payments

power. Bebchuk and Fried also present a very persuasive argument that the most common form of incentive compensation, the fixed stock option, is typically structured so that it does not effectively tie executive achievement to payment. The authors then examine how this has come about. Their own hypothesis, managerial power, departs significantly from the accepted paradigm of corporate structure, especially in terms of predictions about the behavior of managers and directors.

A. *The Managerial Power Explanation*

The current academic model for a publicly traded company is this: A widely dispersed group of people jointly own a company and rely on experienced individuals to actually run the company. This separation of ownership and control is typical of a modern firm; however, implicit in this model are “agency costs”—reductions in the firm’s possible value due to the differences between shareholders’ interests and those of managers (p. 16). Since managers are not owners, they do not reap the full benefits of their own work effort and therefore are not necessarily inclined to work as hard as shareholders might prefer. On the other hand, they do not incur the full cost of perks they receive, and thus are inclined to take full advantage of those. Conversely, it is not worthwhile for any individual shareholder to invest time and money in directly overseeing management. The board of directors, under this model, acts to safeguard shareholder interests and reduce these agency costs (p. 17). The shareholders elect the board, which in turn hires executives to do the day-to-day work. Since dissatisfied shareholders can vote out a board with whom they are unhappy, the board makes decisions, including decisions about compensation, with the interests of the shareholders in mind (pp. 17–20).

Bebchuk and Fried argue that directors acting according to this model—in shareholders’ best interests—would enter into rational and efficient transactions. Yet the prevalence of nonperformance-linked options discussed in Part I illustrates that the current academic model provides inadequate explanation. The authors offer the managerial power thesis to explain the departure from the model.

Bebchuk and Fried suggest several reasons for possible CEO influence over the directors who hire him. First, directors wish to be reelected, and CEOs often serve on nominating committees (pp. 25–26). CEOs can provide benefits to directors by hiring their firms or by directing contributions to a director’s favored charities

include forgiveness of loans, accelerated vesting of options, increases in pension benefits, promises of consulting contracts, and cash (pp. 87–89, 92–94).

(pp. 27–28). Interlocking directorships also tend to create interdependence among directors and CEOs (pp. 29–30).¹⁷ Moreover, directors who are nominated and elected while a CEO is in office tend to award that CEO higher pay (pp. 31–33). Such factors certainly strengthen Bebchuk and Fried's contention that CEOs exercise influence over directors. Whether managerial power can fully explain the current trends in executive compensation is another matter.

B. *Contrary Evidence to Managerial Power*

As persuasive as managerial power seems, several trends in compensation seem to challenge the authors' hypothesis. For example, Kevin Murphy points out that CEOs hired from outside a firm earn ninety-six percent more total compensation than inside hires,¹⁸ often in the form of "golden hellos."¹⁹ These payments cannot easily be attributed to CEO influence, since outside hires are not in a position to influence the board before they are hired. Bebchuk and Fried acknowledge that "outside CEO candidates should have less power" (p. 85) than insiders, and that their hypothesis suggests that "managers with less power should obtain less favorable arrangements" (p. 85). They counter that outside hires are likely to be CEOs already, which means that they may already be compensated at a level reflecting managerial power at their current positions and that hiring firms will need to match or exceed their expectations. However, the existence of this trend suggests that managerial power alone cannot completely account for high levels of executive compensation.

The increased incidence of boards firing CEOs (p. 41) suggests that executives may be demanding correspondingly higher compensation to make up for the increased risk.²⁰ The authors counter this hypothesis with the observation that some features designed to reduce the risk of manager job loss, such as antitakeover provisions, actually correlate with *increases* in CEO compensation (p. 84). However, the higher dismissal rate in recent years does provide some countervailing evidence of managerial power over boards.

Some economists have demonstrated not only a direct correlation between CEO remuneration and share price, but an increase in that

¹⁷ In an interlocking directorship, X, CEO of company A, sits on company B's board, while B's CEO, Y, sits on A's board (pp. 29–30).

¹⁸ Murphy, *supra* note 6, at 853–55.

¹⁹ Bebchuk and Fried define the "golden hello" as "a large initial payment on top of the annual compensation package" (p. 130).

²⁰ Saul Levmore relies on this theory—that employees will demand higher wages to compensate for perceived increases in risk—in explaining employee preference for conventional options. See Levmore, *supra* note 10, at 1919.

correlation over time.²¹ This is inconsistent with the hypothesis that higher CEO pay is not in shareholders' best interests, which is at the heart of the authors' theory that boards are captured by executive interests. Finally, considerations other than maximizing the incentive power of compensation may actually cause some boards to prefer the seemingly inferior fixed option structure.

C. *Fixed Option Grants vs. Index Option Grants (Revisited)*

A closer look at the difference between the treatment of fixed options and index options reveals that boards may have reasons other than managerial influence to prefer fixed options.²² For one thing, the reporting requirements for fixed options differ from those for indexed options. Publicly traded corporations must issue annual financial reports, in which compensation expenses such as salaries are subtracted from a firm's reported earnings. Higher expenses reduce earnings, and lower earnings may result in diminished share value. Firms must report indexed options, but not conventional fixed options, as expenses. This is because firms must report the compensation expense on the date that both the number of granted options and the exercise price are known, and the expense is based on the difference between a stock's quoted market value and its exercise price. Therefore conventional options permit higher reported earnings, which can enhance share prices (pp. 147–48).²³

²¹ See Murphy, *supra* note 5, at 2522–25 (showing increase in correlation from 1971–1996); see also Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, J. ECON. PERSP., Aug. 2003, at 62–64 (showing strong correlation between CEO pay and stock prices, including dip from 2000–2002).

²² Ironically, the general preference for stock options is due in part to tax regulations meant to curb excess compensation. In 1993, Congress promulgated Internal Revenue Code § 162(m), which prohibits a corporation from deducting executive salaries in excess of \$1 million per year but places no limit on performance-based compensation such as bonuses and stock options. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a), 107 Stat. 312, 469–70 (codified as amended at 26 U.S.C. § 162(m) (2000)).

²³ Levmore illustrates with this example: A firm grants employee X the option to purchase 1000 shares of its stock, at \$20 per share, on January 1, 1997, exercisable until January 1, 2002. X exercises the option in 2001, when the share price is \$30. Because the number of shares and their exercise price are known in 1997, but the difference between the exercise price and the market price is nil, the firm has no resulting compensation expense to report in 1997. The firm also reports nothing in 2001, first, because it has already complied with the reporting requirement, and second, because its per-share cost is effectively \$20, which it received when the employee exercised his option.

Now suppose the firm grants the same option on the same date with the same exercise period, but indexes the exercise price to the rise and fall of that industry's market. Again X exercises the option in 2001 at a share price of \$30. Here the exercise price isn't known until the employee exercises his option, in 2001; and on that date the difference between

Thus, the firm appears to benefit when it chooses fixed options over indexed options.²⁴ In addition, if most firms do not expense their options, a firm that does so may appear less attractive to investors by comparison (p. 148).

III

WHERE DO WE GO FROM HERE?

Bebchuk and Fried do not claim to have a complete solution for the problems they identify. But they do offer recommendations.²⁵ These recommendations reflect their view that managerial influence is a major culprit in flawed compensation structures. For example, they suggest changes in reporting requirements to make these arrangements more transparent to shareholders, and changes in elements of corporate governance to reestablish arm's-length dealing in compensation negotiations (pp. 189–216). Because current reforms don't eliminate "the reality that the key to reelection is remaining on the company's slate" (p. 203), Bebchuk and Fried would increase shareholder powers over boards by making proxy contests easier and by adding a requirement of shareholder approval to certain board actions.

Making proxy contests easier, for instance by requiring companies to include shareholder-nominated director slates in the company's proxy materials, would definitely increase shareholders' practical ability to vote out those directors with whom they're dissatisfied.²⁶ However, requiring shareholders to approve specified board actions seems more problematic. Any individual investor is unlikely to have the economic incentive to invest time and money in becoming well-informed enough to adequately address such decisions as com-

the exercise price and the market price is \$10. Ergo, the firm must report compensation expenses of \$10,000. See Levmore, *supra* note 10, at 1909–10.

²⁴ Of course, as Levmore points out, this assumes irrational or uninformed shareholders, who don't understand the true cost of providing fixed options in comparison to that of indexed options. *Id.* at 1911. Bebchuk and Fried agree, pointing out that not only are investors probably more sophisticated than Levmore assumes, but that *institutional* investors actually favor indexed options (pp. 148–49).

²⁵ These recommendations include: closer investor evaluation of executive compensation plans; changes in GAAP to require expensing of all options; changes in SEC reporting to require monetization and disclosure of all compensation forms, plus greater transparency; and improved director education regarding the benefits of various compensation forms (pp. 189–216).

²⁶ The SEC recently made a similar proposal. See Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785 (Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249 & 274) (proposing mechanism through which nominees with significant holdings are included in proxy materials "where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process").

plex compensation structures. His payoff (in the form of a better-run corporation) would be shared by all shareholders, while he alone would have incurred the costs. This “solution” seems to reproduce the problems of dispersed multiple owners that boards of directors are supposed to solve in the first place.

CONCLUSION

While Bebchuk and Fried’s managerial power thesis does not seem to explain adequately all the forces at work in the field of executive compensation, it is hard to argue with their well-documented and succinct critique of current compensation structures. Though incomplete, *Pay Without Performance* is nonetheless a wake-up call for directors to rein in executive compensation in the best interest of shareholders as well as a road map for legislators and agencies to reform corporate governance in order to stem the tide of public outrage.

