Pay Without Performance: The Unfulfilled Promise of Executive Compensation

Lucian Bebchuk and Jesse Fried

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The problem of executive compensation is not new but neither is it resolved. It concerns the level of compensation paid to senior executives at publicly held companies. More specifically, it focuses on the question of whether some or many of these executives are paid significantly more than they deserve to receive. (The question of whether some of these executives are underpaid is rarely a matter of controversy.)

Many commentators on this question simply observe that the absolute level of compensation (which can easily be in the tens of millions of dollars) is obscene and without possible justification. It is unfair to shareholders and demoralizing to other employees, whose own compensation may only be a tiny fraction of what the executives receive. Furthermore, it can easily lead to distorted behaviors such as those evidenced by executives at Enron, Tyco, and other notorious companies.

On the other hand, defenders of these compensation plans draw parallels with the earnings of movie stars or professional athletes and argue that rare talents command high prices. As a consequence, they say, a market exists for the abilities of skillful executives, and the compensation they receive is determined by that market. Furthermore, because a great deal of the compensation is actually received in the form of stock options, a considerable incentive is created for executives to align their behavior with the interests of the shareholders.

So goes the theory. Viewed in this way, the structure of executive compensation is an effort to deal effectively with what economists call the “agency problem.”

Major publicly held companies have large numbers of widely dispersed shareholders. Even if they were empowered and inclined to do so, the shareholders could not exercise effective and efficient control over the day-to-day operations of the company. As a result, they are compelled (acting through the board of directors) to hire managers to run the company. While these managers may not be the agents of the shareholders in the strict legal sense, the economic theory of the firm (the theoretical foundation for the study of financial management) assumes them to be agents in a functional sense. It is here that the problem arises.

Experience shows that agents normally face a conflict between their own interests and the interests of their principals. Managers may therefore not always act in ways that will maximize the wealth of the shareholders but may instead compromise the wealth of shareholders in favor of other goals. Wise principals seek accountability, which in turn permits them to shape the behavior of their agents through threats and incentives.

Ethics and Economics

There are serious questions being raised today about the soundness of the economic theory of the firm. That is to say, about whether the principal responsibility of managers really is to maximize the wealth of shareholders or whether managers have a broader cluster of duties to employees, customers, and communities as well as to shareholders. Nevertheless, in most business schools and courts of law, the conventional theory of the firm is the prevailing conviction.

Given this conviction, it is common practice among larger publicly held companies to design compensation packages for chief executive officers (CEOs) and other senior executives in ways that seek to align their interests with the interests of shareholders. As a consequence, in recent decades, we have seen annual compensation packages that may be worth tens of millions of dollars and, in some cases, more than $100 million.

Do these compensation schemes work? Do they effectively solve the agency problem so that managers really do devote their full attention to maximizing the wealth of shareholders? This question is the starting point for an important new book examining executive compensation and corporate governance. In *Pay Without Performance*, Lucian Bebchuk and Jesse Fried take a careful look at executive compensation practices in major corporations and find them seriously flawed.

The common wisdom is that corporate boards of directors truly represent the shareholders who have elected them and that these boards negotiate with executives to develop compensation packages that benefit shareholders. While compensation can be quite high for some executives, much of the compensation is tied directly to the performance of the company. Executives only do well when shareholders do well. Additionally, even if compensation is high, talented executives are scarce and the marketplace for their abilities demands that they be well paid.

Bebchuk and Fried argue that, while this common wisdom may be appealing in principle, it often fails in practice. Drawing upon a number of studies and illustrations, they show that boards frequently do not negotiate objectively with executives but instead fall subject to managerial power.

In a variety of ways, executives can influence board members. Not all board members are truly independent, for example. They may be obligated to the CEO for the work that he provides to the member's law firm or for the contributions given to a charitable organization with which the member is associated. (A member of the audit committee of Enron's board of directors, for instance, was a professor at a university to which Enron had made large donations.)

CEOs may also shape the compensation that directors receive and in some cases may even sit on the board of another member's company. Furthermore, executives come to work closely with board members, and experience shows that board members may come to identify more closely with the executives than with the shareholders they ought to represent. CEOs are often in a position to influence nominations to the board and can ingratiate themselves with board members in this way as well.

In principle, shareholders can act to review the decisions of the board, but there are significant obstacles to doing so. On the other hand, the costs to board members for rewarding executives are relatively small. The sum of causes and effects, according to Bebchuk and Fried, often results in situations in which boards do not act objectively and do not serve the interests of the shareholders well.

Nor is it clear that pay really is linked to performance. Shareholders might overlook excessive compensation packages if the company performs exceptionally well. The authors provide evidence and examples to show that the link between pay and performance is often quite tenuous. Executives commonly earn bonuses when the industry or the market as a whole does well, and they are rarely punished when the company performs poorly. Indeed, the authors provide striking examples of board decisions to revise goals downward to ensure that executives receive bonuses even when they have not performed well or even to pay them handsomely if they are terminated. (Hewlett-Packard's board recently compelled its CEO to resign for performance failures but reportedly gave her a severance package in excess of $21 million.)

After identifying the failures of current practices, Bebchuk and Fried propose several measures to be pursued as remedies. These include making boards (or at least compensation committees) more genuinely independent of managerial influence and making compensation packages more transparent to shareholders. This latter would include expens-ing options and calculating a value for all forms of compensation paid to executives. Furthermore, they would require shareholder approval (not merely board approval) of equity-based compensation plans.

Moreover, the authors regard this issue as an element of the larger problem of corporate governance. The final chapter of the book proposes changes in the discretion, compensation, and election of directors aimed at ensuring that board members will properly represent the interests of shareholders.

Pay Without Performance is a significant book. It is a well-researched, careful study of a problem that has attracted considerable attention since the 1980s. The authors write well and manage at once to make the book readable and to satisfy the scholar's need to see evidence and documentation.

Not all scholars are satisfied, however. *Pay Without Performance* is an expansion upon an earlier work by the authors (with a third colleague), and the whole body of work has come under criticism from experts in law and business.

These critics point out, for example, that the evidence that Bebchuk and Fried present does not tell the whole story. Other evidence suggests that efforts to align the interests of executives and shareholders through compensation often do work well. Furthermore, they note, while the authors illustrate failures in the system, they do not address the extent of the problem. Are the examples offered typical or unusual? The answer, not provided, would allow the reader to determine whether an *ad hoc* or systemic remedy is required.

Finally, Bebchuk and Fried completed their work before the effects of such corporate governance regulations as the Sarbanes-Oxley Act can be measured. Some of the recommendations have been eclipsed or nullified by events. The corporate situation is different now from when they did their research, and so perhaps some elements ought to be reconsidered.

Nevertheless, *Pay Without Performance* is an important contribution to the continuing discussion about corporate governance. It will repay a careful reading, and it is likely to achieve the influence it deserves to have.

—Robert G. Kennedy
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