

Pay without Performance and the Managerial Power Hypothesis: A Comment

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Abstract: Executive compensation and corporate governance problems need to be seen in a larger historical context than is commonly done. The proximate causes of corporate scandals and executive pay problems have been identified, but the real drivers have not. A need for corporate restructuring, which emerged already in the 1970s, led to the remarkable rise in shareholder influence and the relentless pursuit for shareholder value. It placed exceptional demands on boards and led to extreme pay schemes that appear to have served the restructuring purposes well, but had unintended and unfortunate side-effects. In contemplating pay and governance reforms, it is essential to keep in mind the longer chain of events to avoid naive corrective measures that do not take into account the information and incentive constraints under which the various constituents and bodies in the larger governance system, especially the boards and shareholders, operate. Some of the recent advice on executive compensation seems very misguided in a longer historical perspective as is the push for extensive shareholder intervention rights.

Key words: Executive Compensation, Corporate Governance, Corporate Restructuring.

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Pay Without Performance and the Managerial Power Hypothesis

I. INTRODUCTION

Professors Lucian Bebchuk and Jesse Fried have written a timely, thoughtful and provocative book that is bound to become influential.¹ The authors put forward a simple hypothesis of what is wrong with executive pay: CEOs have too much power over their boards. Compensation contracts are not negotiated at arm's-length as they would be if shareholders were at the bargaining table, because board members care more about their standing with the CEO than with the shareholders. The lack of arm's-length bargaining has resulted in excessive pay levels, weak pay-for-performance relationships, and inefficient forms of pay.

The bulk of the book is devoted to evidence of excessive executive power and lack of arm's-length bargaining. The authors show that once we look at executive pay through the power lens many of the anomalies of executive compensation prove to be ills stemming from a flawed pay-setting process. The authors argue that the process cannot be rectified merely by making boards less dependent on the CEO, as recent regulatory changes have tried to do; boards also have to become directly accountable to the shareholders. This leads to the book's bottom line: in order to fulfill the promise of executive compensation, shareholders should be given real say in how the corporation is governed by giving them extensive decision rights, including the right to determine who sits on the board, what kind of corporate charter the company should have, where the company should be incorporated, and so on.

The idea of looking at executive pay from a broader design perspective is excellent. Incentive theories often focus on what is ideal under unrealistic assumptions about how those ideals might be implemented. I also agree with several of the criticisms that the book levies on current executive compensation arrangements, especially the apparent tendency to distort pay schemes in order to camouflage the total cost of the package or distort it in order to circumvent regulations. Transparency, as argued by the authors, is a high priority even if it has its own costs, as I will discuss later. Another important change advocated by the authors is to make incentive pay less liquid by increasing the length of the holding periods and preventing executives from timing the sale of their shares strategically, as they can do now. Lack of transparency and excess liquidity are the book's strongest evidence that executives have too much influence over their own pay.

But it is a big leap from the criticism of executive pay to the authors' main conclusion that there is a need for wholesale reform of corporate governance. Executives are powerful for good reasons, not just bad reasons, a point the book fails to acknowledge. The power imbalance that the book is concerned about is not a recent event; it has been this way for decades. It is too tempting to advocate big changes in shareholder decision rights against the backdrop of pay excesses without thinking about the bigger ramifications such changes would have on the overall system.

The exceptional changes that have taken place in corporate governance recently need to be looked at in a larger historical and institutional context. We need to understand why a system that today is viewed as "fatally flawed" was able to perform so well for so

1. LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

Pay Without Performance and the Managerial Power Hypothesis

many decades before the scandals hit. Why did the problems with executive pay arise in the 1990s, but not earlier? If anything, executives seem to have been robbed of some of their power since the 1980s. Any theory about the current ills of executive compensation better say something about why pay levels increased four-fold within the span of ten years in the 1990s, but not in the 1960s, the previous time the stock market boomed. The power theory on its own fails the timing test.

The power hypothesis seems to fail a second important test, the comparative institutional test. I have seen little evidence that executive pay patterns in closely held companies like family firms would significantly deviate from those in widely held companies. I do not have systematic evidence to present; I will only provide a piece of anecdotal evidence, but it would have been incumbent upon the authors to look at that evidence. The contrast in power makes the family firm an obvious control group.

I do not mean to say that executive power is unimportant in setting pay, just that the power hypothesis as an explanation of how executive compensation evolved and got distorted over the past few decades must be missing a crucial ingredient. Steven Kaplan and I have suggested that the missing piece is the dramatic rise in shareholder influence that began in the 1980s.² Shareholder and institutional pressure appears to have done a lot of good by restructuring U.S. corporations and raising profits and market values, but it also planted the seeds for the subsequent scandals.³ Without the shareholder value movement we would not have had the scandals. Evidently, shareholder value can be pursued in wrong ways, and that lesson needs to be taken more seriously by anyone contemplating a wholesale reform of corporate governance.

What is called for is a careful evaluation of how power might be influencing executive compensation arrangements in different settings and, most importantly, whether efforts to curb executive power, either in the compensation arena or more broadly, is associated with benefits that exceed the costs. The costs have to be evaluated alongside the benefits in a manner that takes into account the overall system, including the functioning of boards. Boards should be analyzed as agents (or supervisors) with motives potentially different from those of the shareholders and in need of their own set of incentives. The book does discuss board motives, but in a way that appears to me simplistic. The focus is on the tendency of boards to be complacent because they want so desperately to hang on to their board seats. In my experience, board members have much more integrity and are more thoughtful than many believe. Director behavior is better understood if we realize that they are faced with a complex and difficult set of tasks that partly are in conflict with each other as I will elaborate on later. The strong push on shareholder value increased the tensions and imbalances in the board's job design. This may call for a reevaluation of the boards' duties. In that respect the book is barking up the right tree, but I would hope that the analysis of the issues could be done in a more informed and even-handed way.

2. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 128 (2001) (arguing that leveraged buyouts in the 1980s, among other things, increased efficiency) [hereinafter *Corporate Governance and Merger Activity*]; Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 8 (2003).

3. See sources cited *supra* note 2.

II. AN ANECDOTAL PIECE OF EVIDENCE

Let me start with one anecdotal piece of evidence that explains why I think the book's basic premise that boards should deal with the executives at arm's-length is rather misguided. I have been on the board of my wife's family business for sixteen years. It is a closely held, global company headquartered in Finland with about 3000 employees and one billion dollars in revenue. There is an outside CEO, but the family controls the board and owns over ninety-five percent of the equity. The chairman of the board, my brother-in-law, is the former CEO. I think it is safe to say that the company does not face the sorts of agency problems that Bebchuk and Fried consider crucial. Yet many of the compensation patterns that the book attributes to a toxic combination of CEO power and wimpy boards can also be found in this reasonably successful family firm.

To determine a CEO's compensation, we consider several factors. We call in a compensation consultant. We look at compensation levels in companies of comparable size. We look at the CEO's mix of bonus and salary. We ask the compensation consultants what they think is appropriate. We ask the CEO what he expects to be paid and how. We are concerned about incentive effects, but in the end we closely follow common practice. The CEO has options as well as a bonus plan, with the bonus tied to strategic goals. Currently, we pay him in the top quartile, because we think it is important that he feels appreciated. When all is said and done, it looks pretty much boilerplate.

Why are we this unimaginative? After thirty years of studying compensation and incentives, do I not have better ideas?

My answer comes in three parts. First, and most importantly, we want to avoid arm's-length bargaining. Compensation is a sensitive matter. We benchmark to remove potentially contentious negotiations from the agenda. If we err, we rather err a bit on the generous side. Second, we have tried to be more creative about structure, including the use of relative performance evaluation. But the executives did not like the use of relative performance evaluation much and in the end we felt that it would cost us more than it was worth to force acceptance. Third, years of experience with incentive design has made me cautious about experimenting too much. The law of unintended consequences never fails to surprise (we have certainly made our share of mistakes), and when it does it can cause a lot of frustration. Following norms and relying on outside expertise is not so bad after all— let the others be guinea pigs.

One data point does not prove a broader thesis, of course, but I would be rather surprised if my experience differed much from the experience of most family boards. I feel fairly confident in saying that CEO pay is very unlikely to be determined by arm's-length bargaining in most companies, whether they are publicly traded or closely held. But that does not mean that a board should go along with whatever the CEO demands. Benchmarking and staying within norms provide a good defense against overly aggressive demands. The biggest pay excesses have occurred in firms that have used unusual structures (the use of mega-grants is illustrative) and that have not benchmarked properly (Oracle, Siebel Systems and Apple are three examples). For this reason, it is surprising that the Conference Board's recent expert panel on executive compensation recommends that boards should avoid benchmarking and use their own judgment in its place. I know of no economic price which individuals can reliably determine by looking at intrinsic value without regard to the price of comparable products or services. Why

Pay Without Performance and the Managerial Power Hypothesis

should executive markets be any different?

III. WHAT EXPLAINS THE LEVEL OF PAY?

We would not be here talking about executive compensation had the use of stock options not exploded and pay levels not quadrupled in the 1990s. Exorbitant levels of executive pay have upset the public and the politicians. How can executives be worth millions of dollars a year, given that there are so many substitutes willing to take on the job for much less? That is the question that bothers people. For most of them the answer is obvious: executives have too much influence over their own pay.

It seems puzzling that Bebchuk and Fried say so little about levels. They often come back to the theme that executives can grab rents, because pay is not determined in an arm's-length bargain, but for them, distortions in the structure of pay are the larger evil and the more telling evidence of executive power. One reason may be that it is hard to judge whether pay levels are excessive. Both Himmelberg and Hubbard⁴ and Murphy & Zbojnik⁵ have offered models and empirical evidence suggesting that the rapid rise in pay can be understood as a shift in the demand for top executive talent. One should keep in mind that in the second half of the 1990s, executives had lucrative opportunities outside their traditional jobs—as investors or partners in the red-hot venture and buy-out markets, for instance, or as entrepreneurs.

While I think increased demand is part of the explanation, I have a hard time believing that it alone can explain a quadrupling of pay in eight years. The executive market is not a regular labor market. First, the argument that there are many close CEO substitutes, who should keep the pay level much lower, is misguided. There are a lot of potential substitutes, but the board does not know who and where they are. In this event, a bird in the hand is better than ten in the bush. A CEO that is doing well and is trusted can be worth billions of dollars more than the second best alternative. Yes, I said billions. To give a hypothetical and perhaps extreme example, suppose Lord John Browne, the CEO of BP, would announce that he has decided to quit because the board did not want to pay him what he asked for. What would happen to the stock price? I think it is safe to predict a price drop of at least five percent, which is well over \$10 billion in market capitalization today. John Browne would probably lose financially, too, but it would surely be an order of magnitude less than what BP shareholders would lose. So, one might well ask, who is really the rent-seeking party in this case? My guess is that we are often closer to the reservation level of the CEO than the shareholders. This would be an empirically interesting question to study, though a difficult one. For instance, one will seriously overestimate the compensation given to CEOs in a downmarket as options expire out of the money and get replaced with new ones.

The key point here is that there is often a big wedge, perceived or real, between the

4. Charles Himmelberg & Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* (June 2000) (unpublished manuscript, presented at the Columbia Business School Tuck-JFE Contemporary Corporate Governance Conference), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236089.

5. Kevin J. Murphy & Jan Zbojnik, *Managerial Capital and the Market for CEOs* (Sept. 2004) (unpublished manuscript, on file with the Marshall School of Business, University of Southern California), *available at* <http://www-rcf.usc.edu/~kjmurphy/CEOCapital.pdf>.

Pay Without Performance and the Managerial Power Hypothesis

reservation levels of the executives and the shareholders, creating indeterminacy in the equilibrium level of pay. The level must be determined in some non-standard way. Benchmarking is the mechanism of choice for a good reason. The executive market is not competitive in the normal sense, but there is an important element of competition stemming from the ability of executives to see what other executives make in similar situations. Paying CEOs less than they think they are worth based on comparative data is demoralizing. This is well understood in the context of regular workers.⁶ An underpaid person, whether a janitor or a CEO, will have a way of getting even.⁷

Benchmarking is an essential piece of the puzzle of why executive pay rose so dramatically in the 1990s. It does not alone explain the rapid rise in pay, but it makes it possible for pay to rise rapidly if there is a sudden external shock. What could that shock have been? In my view, there is only one natural candidate: the rise of shareholder value, which first manifested itself as hostile takeovers in the 1980s and later drove companies to use stock options aggressively.⁸ Indeed, we know that almost all of the growth in executive pay came from stock options.⁹ The idea was to align CEO incentives with the interests of the shareholders. In retrospect, this may seem naive, since there is increasing evidence that stock options led to short-termism and in many cases outright fraud.¹⁰ But then we should not forget that stock options also played a central role in changing the mindset of executives and getting them to embrace shareholder value, which contributed to the successful restructuring of corporate America. While the scandals that followed could have been avoided with better incentive designs or changes in corporate governance mechanisms, we have also learned that the single-minded pursuit of shareholder value, narrowly construed as share price maximization, came with significant costs. This lesson about imbalanced incentives, which the new multitask agency models illuminate,¹¹ is worth keeping in mind as reform proposals are being evaluated.

IV. THE STRUCTURE OF PAY

The authors focus on features of executive pay that they see as inconsistent with the “official” agency theoretic view but readily consistent with the power hypothesis. At

6. See TRUMAN F. BEWLEY, *WHY WAGES DON'T FALL DURING A RECESSION* (1999).

7. For years, *BusinessWeek* and other magazines contributed to the upward bias by reporting values of exercised options rather than values of granted options. In addition, Hall and Murphy have argued that stock options were too liberally granted, because boards did not understand the cost. See Brian Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49 (2003). Bebchuk and Fried do not buy this argument. My explanation is a compromise: board members, at least some of them, may have understood the cost, but this was not relevant given benchmarking.

8. See *Corporate Governance and Merger Activity*, *supra* note 2 (arguing that deregulation and improved information and communication technology resulted in the rise of shareholder value).

9. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 653 (1998) (analyzing the relationship between company performance and CEO pay).

10. See, e.g., Daniel Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management*, J. FIN. ECON. (forthcoming 2006); Kedia Simi & Thomas Philippon, *The Economics of Fraudulent Accounting* (Nov. 2005) (unpublished paper), available at <http://pages.stern.nyu.edu/~tphilipp/papers/sktp.pdf>.

11. See George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 63 J. FIN. 593 (1988) (evaluating various corporate incentive structures and comparing them to economic theories); Bengt Holmstrom & Paul Milgrom, *Multi-Task Principal-Agent Problems: Incentive Contracts, Asset Ownership and Job Design*, 7 J.L. ECON. & ORG. 24 (1991).

Pay Without Performance and the Managerial Power Hypothesis

times this comes across as a horse race between two theories, but that is rather misleading. The power hypothesis is not a well-articulated theory, but a novel point of view that is awaiting formalization. And agency theory is not a single theory, but a broad framework that today encompasses a variety of strands having substantially different predictions. From an academic perspective, it would have been useful had the book connected better with the larger agency theoretic literature. The book makes a compelling case that executive influence over pay is something that we should incorporate into our models, but the traditional moral hazard model is not the right reference point, since power makes no real difference for the structure of contracts in that model. Dynamic models, where commitment problems and implicit incentives arise out of incomplete contracting and renegotiation, would have been better. In these models bargaining power is a crucial element.

As an illustration, consider the discussion of camouflage, which I found both novel and interesting. The presented evidence indicates that pay is often structured in a way that disguises the true cost to shareholders. Hidden costs of pensions, large golden handshakes, and complex incentive schemes are examples offered. But how much is executive power responsible for these practices? As outrage over high executive pay has started to have an influence on boards, pay schemes appear to have become more distorted. Consistent with this, Singh has presented a theoretical model that shows that a more entrenched board, less concerned with its market reputation will engage in less camouflage than a board that is more sensitive to shareholder pressure.¹² The entrenched board will pay the executive more, but it will not distort the contract as much. Whether such distortions are worse than the higher pay is an empirical issue. Given that the authors are so concerned with contract distortions, implicit incentives should have been especially relevant for their discussion.

Career concerns can create powerful but perverse incentives,¹³ especially when transparency across pay components is uneven. For this reason, a little transparency can be worse than no transparency. This is more than an academic possibility and should be given serious attention in the policy discussions. Proposals to use performance based options and other pay schemes contingent on accounting targets should be treated with caution. They tend to make pay less transparent, because companies do not want to reveal the precise targets. Also, accounting numbers are more readily manipulated than stock prices, a point we learned in the 1970s, when long-term performance plans of the type now proposed were widely used. The move to stock options in the 1980s was in part due to dissatisfaction with these plans.

12. Ravi Singh, Board Independence and the Design of Executive Compensation (Feb. 2005) (unpublished paper, presented at the European Finance Association 2005 Moscow Meetings), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=673741.

13. Mathias Dewatripont et al., *The Economics of Career Concerns, Part II: Application to Missions and Accountability of Government Agencies*, 66 REV. ECON. STUD. 199 (1999) (studying incentives for government officials); Bengt Holmstrom, *Managerial Incentive Programs—A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999) (studying the incentive effects of individual career goals); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989) (studying whether corporate managers risk long term profits in order to achieve short term stock price increases); Leonard Martinez, *A Dynamic Agency Perspective on Firing Incentives for Leaders in Business and Politics* (2004) (unpublished Ph.D. dissertation, Univ. of Rochester) (illustrating how the fear of being fired affects decision making).

Pay Without Performance and the Managerial Power Hypothesis

The book is critical of the way options have been designed. It is easy to agree that there have been mistakes, but one should keep in mind that there are no perfect incentive plans and mistakes tend to come to light over time. Stock options have the virtue that they can provide powerful incentives at a lower cost than equity, but unlike equity, the incentives are sensitive to changes in stock prices. Options are especially beneficial in inducing executives to make value-enhancing changes, which are visible and easily identified. For instance, offering options can give strong incentives for executives to sell underperforming parts of the company. I believe executive options did a very good job in lubricating transactions and restructuring companies.

Options become more problematic once the connection between executive actions and share price becomes less clear. When the obvious value enhancing decisions have been made and the objective is to give executives a steady incentive to improve long-term value, it may be more cost effective to pay with straight equity, for instance using restricted shares.

The book is especially critical of windfall gains from general price movements and the apparent lack of relative performance evaluation. According to the traditional agency model, optimal incentives should filter out factors that make performance measures noisy. The absence of indexation is seen again as a sign of executive power over incentive pay. I am skeptical of this argument for two reasons. First, incentive theorists have been puzzled by the scant use of relative performance for decades, well before there was any concern about executives' pay-setting power. Second, family firms do not seem to use relative performance evaluation. Bertrand and Mullainathan provide evidence that widely held firms forgive poor performance more readily than closely held firms, but that is implicit, not explicit.¹⁴ Finally, it is even harder to explain why leveraged buy-out firms, which are known for their innovative incentive designs, do not use explicit relative performance incentives. The power hypothesis, as an explanation of the lack of indexation, seems to fail both the timing and the comparative institutional tests. There must be other reasons why firms have been hesitant to use relative performance evaluation.

One simple reason, which I alluded to earlier, is that indexed option contracts are hard for people to value. Another important reason is that relative performance evaluation may distort decisionmaking by changing relative prices. If John Browne's incentive pay were insulated from oil price shocks, it would affect the way he thinks about exploration and how he reacts to price shocks once they occur. Even comparisons with other oil companies or the overall stock market could influence his risk choices. Finally, ex post judgments may already embed too strong relative performance evaluations. Executives care about their legacy and their longevity, and both depend on how well they perform relative to other companies. Concern for implicit relative performance evaluations often shows up as herding behavior.¹⁵ Bank lending to Latin America in the 1980s is a good illustration of this phenomenon. The problems of implicit incentives are likely to become much larger as shareholders are becoming more impatient and boards respond by

14. Marianne Bertrand & Seudhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principles Are*, 116 Q. J. ECON. 901 (2001).

15. David Scharfstein & Jeremy Stein, *Herd Behavior and Investment*, AM. ECON. REV., June 1990, at 465 (discussing the causes of herd behavior).

Pay Without Performance and the Managerial Power Hypothesis

increasing executive turnover.

I believe that the biggest problem with the structure of executive incentive plans has been excess liquidity, a flaw the authors appropriately emphasize. CEOs have been able to unwind positions too early and with too much discretion, tempting some of them to manipulate stock prices. Mega-grants with longer duration have also been a problem, because an option plan of that kind has built into it a de facto re-pricing rule. I am less concerned with executive gains from re-pricing or reloading, because they can in many contexts be optimal; the bigger issue is the lack of transparency that comes with re-pricing and similar complex pay strategies.

To deal with transparency, re-pricing and excess liquidity all at once, my recommendation is to award options or stock in smaller amounts and more frequently, say, quarterly. Indexation could be achieved by fixing the dollar value of each batch (or portion of it) in advance and pricing the options to market, as is common. The timing of the sale of each batch should also be predetermined to reduce the temptation to manage earnings. I believe this type of scheme would be simple, robust and transparent, but I would experiment with it in limited settings to see whether it works as I imagine or whether there will be unintended consequences as so often happens.

V. CHANGING THE BALANCE OF POWER

The most important question raised by Bebchuk and Fried's book is whether shareholders should be given the possibility to intervene in corporate decisions. As the authors note, shareholders today have extremely limited rights. Bebchuk has argued that shareholders should be given access to the ballot and extensive intervention rights, including the right to propose and veto board members, change the corporate charter, decide on the state of incorporation, determine payouts, initiate scale downs, and make termination decisions.¹⁶ These initiatives, if adopted, would imply dramatic changes to the way corporations are governed. The book discusses these issues at some length, using the problems with executive compensation as evidence of the need to correct the power imbalance between executives and boards.

Some of the arguments sound reasonable, but the main problem with the analysis is that it takes place without any attempt to understand the role of the board and the position it finds itself in as an intermediary between the executives and the shareholders. Like so many recent corporate governance discussions, the book seems to reflect the view that boards should be police officers, who monitor what executives do and intervene when executives try to deviate from shareholder value maximization.

This is a narrow view of the role of boards. Boards are charged with many different tasks, creating tensions between some of them. Keeping an eye on executive pay, for instance, has historically not been one of the board's primary tasks, I think for a good reason. If the main task of the board were to make sure executives do not abscond with corporate funds, then the board should consist of accountants and lawyers who are good at detecting fraud and other illegalities.

The reason CEOs and other people with business expertise sit on boards is that they

16. Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005) (discussing power allocation in U.S. corporations).

Pay Without Performance and the Managerial Power Hypothesis

are better placed to learn about the firm's strategy and understand how management thinks about it. This information is especially important when a CEO retires or when the firm runs into trouble and the board needs to figure out whether the current management has what it takes to get out of the trouble. These are crucial times for the board. The board's primary duty is to make sure it has the information necessary to make these important decisions and that it uses the information with judgment. Few people understand how challenging that task is. The degree of uncertainty is high. The cost of staying informed is high. The price of making an error is high.

Analysts and outside observers, like sports spectators, are quick to leap to conclusions about what should be done when things start to go wrong. They usually want to see the CEO fired much before it happens. Boards are seen as too passive, but the appearance can be deceptive. It takes time and information to figure out what role external factors have played and what responsibility current management carries.

It is crucial to gather such information in time and not start when the crisis hits. Getting information requires a trusting relationship with management. If the board becomes overly inquisitive and starts questioning everything that the management does, it will quickly be shut out of the most critical information flow—the tacit information that comes forward when management trusts that the board understands how to relate to this information and how to use it. Management will keep information to itself if it fears excessive board intervention. A smart board will let management have its freedom in exchange for the information that such trust engenders. Indeed, as long as management does not have to be concerned with excessive intervention, it wants to keep the board informed in case adverse events are encountered. Having an ill-informed board is also bad for management, since the risk of capricious intervention or dismissal increases.¹⁷

A much overlooked fact in today's corporate governance debate is the cost of an overbearing board. Powerful boards can be disastrous for a company. Family firms often have to struggle with this problem. The Ford Corporation under Henry Ford was famous for the rotating CEO door. Lee Iacocca, who subsequently turned around Chrysler, was his last victim. A recent article in *BusinessWeek* discussed the struggles of Coca-Cola.¹⁸ The board was implicated, as it usually is, but interestingly the fault was not complacency. Instead, the Coca-Cola board was criticized for having intervened too much in executive decisionmaking, vetoing important strategic decisions. The board member most strongly implicated was none other than Warren Buffett, the icon of Corporate America. Actually, his record as an outside board member does not appear to be that great, whether we look at Coca-Cola or the other company boards he sits on. If he is struggling, the job cannot be all that easy.

It can be hard for outsiders to distinguish a board that is inactive—because it is captive—from one that is inactive because it is still trying to figure out what the facts are and what course of action is right. Thus, there are two difficult communication problems that a board has to deal with. First, it has to gain the trust of the executives so that it gets

17. See John Roberts et al., *Beyond Agency Conception of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 *BRIT. J. MGMT.* S5 (2005) (providing an account, based on extensive surveys, of how board members see their roles). This description fits well with my own experience.

18. Dean Foust, *Gone Flat*, *BUS. WK.*, Dec. 20, 2004, available at http://www.businessweek.com/magazine/content/04_51/b3913001_mz001.htm.

Pay Without Performance and the Managerial Power Hypothesis

the inside information it needs to make informed decisions. Second, it has to gain the trust of the investors and shareholders so that it can make use of the expertise it has acquired. In today's prosecutorial atmosphere, the pressure from shareholders and investors is such that boards often have a hard time using their expert information. The dramatically increased rates of CEO dismissal we have recently seen show that boards have become a lot more sensitive to outside pressure, despite the inability of shareholders to intervene directly in company affairs.

Problems with pandering have been analyzed both in corporate and in political settings.¹⁹ Pandering is again a manifestation of a concern for one's reputation, which ends up distorting decisionmaking. If the pressure on boards and executives is increased further by giving shareholders stronger intervention rights, this may exacerbate the pandering problems. It is hard to evaluate the strength of these effects, but one cannot dismiss them as easily as Bebchuk²⁰ and Bebchuk and Fried²¹ do. Our theories clearly demonstrate, and the evidence amply supports, the logic and strength of pandering. The difficulty for the layperson is to understand that what is most desirable ex post can create perverse incentives ex ante and therefore should not be pursued necessarily with the vigor advocated by those who want shareholders to have the right to intervene whenever they want to do so. The argument that shareholders know what is best for them breaks down in a world where commitment to an ex post inefficient course of action is valuable ex ante.

Instead of being single-mindedly focused on pressuring boards to adhere to shareholder value in every ex post contingency, we should think more about the board's intermediary role and the two communication problems that I have raised: the board's ability to acquire information from management and its ability to use the information effectively. Let me illustrate this thinking with two examples.

One regulatory change that has facilitated communication between executives and boards is the requirement that boards hold non-executive sessions. Before this regulation, executives had reason to wonder why a board would want to hold a non-executive session. Jack Welch, GE's former Chairman and CEO, said that if his board ever asked for a non-executive session he would resign. This has been interpreted as an illustration of an excessively powerful CEO exceeding his rights. But for those who appreciate that CEOs, even seemingly powerful ones, do respect the formal power of boards and therefore worry about unexpected calls for non-executive sessions, Welch's statement has a very different ring. What he probably was saying is that a non-executive session was a vote of no confidence. And with that, the delicate relationship of trust would be broken.

Another regulatory change, which could help the board to deal both with its internal and external credibility, is to change the process of executive compensation so that an external body would act as an intermediary in the same way that the auditors do.

19. Ray Fisman et al., *Governance and CEO Turnover: Do Something or Do the Right Thing?* (Aug. 12, 2004) (unpublished manuscript), available at <http://www2.gsb.columbia.edu/faculty/rfisman/govmodel05.pdf> (studying the causes and consequences of dismissing CEOs); Stephen Morris, *Political Correctness*, 109 J. POL. ECON. 231 (2001); Eric Maskin & Jean Tirole, *The Politician and the Judge: Accountability in Government*, 94 AM. ECON. REV. 1034 (2005); Paul Milgrom, *Employment Contracts, Influence Activities and Efficient Organizational Design*, 96 J. POL. ECON. 42 (1988); Lars Stole & Canice Prendergast, *Impetuous Youngsters and Jaded Old-Timers: Acquiring a Reputation for Learning*, 104 J. POL. ECON. 1105 (1996).

20. Bebchuk, *supra* note 16.

21. BEBCHUK & FRIED, *supra* note 1.

Pay Without Performance and the Managerial Power Hypothesis

Executive compensation is already increasingly in the hands of compensation consultants. As I have indicated, it is futile, even irresponsible, to ask the boards of individual firms to be responsible for the escalating levels of executive compensation or to change the structure of compensation in a dramatic fashion because benchmarking is an important part of the process. The current climate of accountability to shareholders pushes boards even more towards doing whatever is the common practice in order to avoid the equivalent of malpractice. Given this trend, it may be better to formalize the practice by creating a set of generally accepted compensation practices that will be audited. Outsourcing the decision would have its costs, no doubt. But the same can be said about some of the constraints imposed by Generally Accepted Accounting Principles (GAAP) rules.

VI. CONCLUDING REMARK

Bebchuk and Fried's book has given a scientific voice to many of the frustrations felt by the public regarding executive power, and it rightly argues that we should think about executive compensation more expansively, paying more attention especially to process. It is also a natural time to debate whether the division of responsibility between boards and shareholders should be altered and whether other intermediaries are needed for a more effective corporate governance design. My hope is that we can look beyond the recent scandals and place the analysis in its proper historical context and that we also acquire a realistic view of what boards can and should aspire to do. This requires appreciation for the problems of communication, commitment and the trade-offs of ex post efficiency and ex ante incentives. The expansive agenda of the book should be matched by an expansive mindset in the way these problems are approached. All incentive designs and systems are imperfect and due consideration should be given to the many problems and surprising responses inherent in complex systems. We will undoubtedly learn that the pursuit of shareholder value is a more subtle matter than the prevailing mood suggests.

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