February 2004

Pay without Performance, The Unfulfilled Promise of Executive Compensation, Part II: Power and Pay

Lucian Arye Bebchuk* and Jesse M. Fried**

This paper contains a draft of Part II of our forthcoming book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004). The book provides a detailed account of how structural flaws in corporate governance have enabled managers to influence their own pay and produced widespread distortions in pay arrangements. The book also examines how these flaws and distortions can best be addressed.

Part II of the book shows how an understanding of the role of managerial power can help explain executive compensation practices. We provide a framework for assessing whether pay arrangements are a product of managerial influence. We discuss managers' interest in camouflaging the amount and the performance-insensitivity of their pay. Applying our framework, we discuss how managerial influence can help explain, among other things, the evidence on the relationship between managerial pay and managerial power; the use of retirement benefits and other compensation arrangements to provide stealth compensation; and the ability of departing managers to obtain more than their contractual entitlement.

Keywords: Corporate governance, managers, shareholders, boards, directors, executive compensation, stock options, principal-agent problem, pay for performance, agency costs, rent extraction, stealth compensation, camouflage.

JEL classification: D23, G32, G34, G38, J33, J44, K22, M14.

---

* William J. Friedman Professor of Law, Economics, and Finance, Harvard Law School, and Research Associate, National Bureau of Economic Research.

** Professor of Law, Boalt Hall School of Law, University of California at Berkeley.

In the course of writing our book manuscript we have incurred debts to many individuals whom we will thank in the published version of the book. For financial support, we are grateful to the John M. Olin Center for Law, Economics, and Business (Bebchuk) and the Boalt Hall Fund and U.C. Berkeley Committee on Research (Fried). Comments are most welcome and could be directed to bebchuk@law.havard.edu or friedj@law.berkeley.edu.

Pay without Performance:
The Unfulfilled Promise of Executive Compensation

Lucian Bebchuk and Jesse Fried

TABLE OF CONTENTS

TABLE OF CONTENTS OF PART II (THIS PAPER)

CHAPTER 5: THE MANAGERIAL POWER PERSPECTIVE

"What it amounts to is that there's no one representing shareholders. It's like having labor negotiations where one side doesn't care."

Anonymous Fortune 500 CEO, interviewed by *Fortune*, 2002

The arm's length contracting model, then, does not provide an adequate account of executive compensation. An understanding of the role of managerial power is necessary to improve our understanding of this subject. We introduce in this chapter some conceptual building blocks of the managerial power perspective, concepts that we will useful for examining the executive compensation landscape.

We start by explaining the relationship between managerial power and rents. Managers use their power to secure rents – i.e., extra value beyond what they would obtain under arm's length bargaining. Outrage costs and constraints do place some limits on deviations from arm's length contracting. To avoid outrage, compensation designers attempt to hide, obscure, and justify—to "camouflage"—the amount and form of executive pay, and our discussion of camouflage will highlight the role played by these compensation consultants. We conclude by addressing alternative explanations for why executive compensation arrangements may deviate from efficient contracting.

Power and Rents

Like the arm's length contracting approach, the managerial power analysis begins by recognizing the agency problem inherent in the manager-shareholder relationship. The managerial power approach, however, does not view executive compensation as a remedy for this agency problem. On the contrary, the pay-setting process is itself seen as a major part of the problem. And where the arm's length contracting approach takes as a given that the board faithfully represents shareholders' interests when negotiating executive pay arrangements, the managerial power approach views the board as incapable of bargaining at arm's length with the CEO for the same reasons that make us skeptical about the arm's length contracting approach.

Our analysis in the preceding three chapters showed that substantial departures from arm's length bargaining are likely to be widespread among publicly traded companies where there is separation of ownership and control. CEOs and their management teams have considerable influence over boards. Directors have both financial and nonfinancial incentives to favor executives. Social and psychological factors tend to reinforce these incentives. The cost to directors of pay arrangements that hurt shareholders is low, and directors therefore have little economic incentive to resist a CEO's compensation demands. Directors also devote too little time to their board positions to perform effectively the role of informed arm's length bargainers.

For all of these reasons, managers have power to influence their own pay arrangements. We can expect them to use this power to obtain compensation more favorable than they would get under arm's length bargaining. Their power enables them to extract "rents."

Economists use the term "rents" to refer to excess returns that firms or individuals obtain due to their positional advantages. We will use the term to refer to the extra value managers obtain beyond what would be granted by a board that had both the inclination to maximize shareholder value and the necessary time and information to perform that task properly.

Managers, like most people, generally prefer to have more money, rather than less, so we can expect executives to use their power to obtain higher pay than they would receive under arm's length contracting. It is important to recognize, however, that compensation arrangements may also favor managers in nonfinancial ways. For a given amount of compensation, managers prefer to bear less risk and feel less pressure to generate shareholder value. Managers, that is, wish to enjoy as much slack as possible. A primary objective of efficient compensation arrangements is to reduce slack, i.e., to discourage managers from pursuing strategies, such as corporate empire-building, that serve their interests but not shareholders'. When they can get away with it, managers prefer to have their cake and eat it, too; they prefer to receive a given amount of monetary compensation without cutting managerial slack.

Given a certain amount of compensation, managers might prefer to have that compensation decoupled from their performance. The more their compensation depends upon their performance, the more risk managers must bear, the more effort they must exert, and the more they must forgo self-serving strategies such as empire-building.

Consider the following two pay arrangements. In the first, a CEO is guaranteed to receive $5 million regardless of firm performance. In the second, a performance-dependent arrangement, the manager receives $5 million only if the firm meets certain performance targets. Suppose the performance-dependent arrangement will induce the manager to meet the performance target (and thus earn $5 million) by taking steps that are personally costly, such as trimming the size of the corporate empire, abandoning a pet project, firing an unproductive crony, and so forth. Though the CEO should expect to earn $5 million under both packages, the first package is more favorable because it does not require acting against his or her private interests.

Note that if the CEO uses influence to acquire the first arrangement, the personal benefit of the resulting managerial slack may well be smaller than the slack's cost to shareholders. Suppose that in the above example, the benefit of the slack to the manager is $2 million and its cost to shareholders is $20 million. If the manager secures the performance-independent arrangement, the resulting $2 million rent comes at a tenfold cost to shareholders. The important point here is that managers may use their influence not only to obtain more pay, but also to structure that compensation in forms that are less performance-sensitive. And to the extent that deviations from arm's length contracting lead to compensation arrangements that create efficiency costs by, for example, giving managers too much slack, shareholder losses will be larger than managerial gains.

Because of the association between managerial influence and rents, the managerial power approach predicts a correlation between power and rents. All executives have some power and therefore all can secure some rents, but the amount of managerial power varies across firms depending on each firm's ownership and governance structures. The greater the CEO's power, the managerial power approach predicts, the larger his or her rents will tend to be.[1] As we will show in chapter six, empirical evidence confirms this prediction.

---

1 The managerial power approach is in the spirit of the economics literature that focuses on certain agents' power within organizations and the ability of these agents to extract rents. See, for example, Jack Hirshleifer, "Competition, Cooperation, and Conflict in Economics and Biology," *American Economic Review* 68 (1978): 238-243;

The CEO and Other Top Executives

Who receives rents under the managerial power model? The CEO, of course. But sometimes other top executives receive rents as well. Although we focus on the CEO in our discussion of power and rent-taking, influence is often concentrated in the hands of a small number of top executives in a firm, with each executive having some influence on board decision-making.[2] When executives other than the CEO serve on the board, for example, some of the factors that provide the CEO with influence on other directors also benefit the other executives. All the executives on the board, for example, gain from the forces of collegiality, team spirit, and respect for those leading the firm. And, as members of the board, they may also have some influence on future nominations and director compensation.

Even when the CEO alone has power, rents are likely to spill over to the other high-ranking executives.[3] When other officers are friends or protégés, the CEO may use influence to obtain favorable pay arrangements for them. These spillover rents will come largely at the expense of shareholders. Increasing the pay of other top executives can also benefit the CEO, whose own rent extraction becomes less noticeable to outsiders. This lowers "outrage costs," which we will discuss shortly.

Finally, by favoring other top executives, CEOs may reduce resentment of their own high pay, thereby improving working relationships with their subordinates. Indeed, if the effects of resentment prove costlier than the spillover rents, shareholders may be better off with this spillover effect, taking as given the CEO's influence over her own package. The important point is that even when spillover rents benefit shareholders, the

---

Raghuram G. Rajan and Luigi Zingales, "Power in a Theory of the Firm," *Quarterly Journal of Economics* 113 (1998): 387-432; Raghuram G. Rajan and Luigi Zingales, "The Firm as a Dedicated Hierarchy: A Theory of the Origin and Growth of Firms," *Quarterly Journal of Economics* 116 (2001): 805-851. However, most financial economists working in the particular context of executive compensation have largely assumed arm's length contracting and have paid little attention to the role of managerial power.

2 For evidence that power is often distributed among two or more managers, see Sydney Finkelstein, "Power in Top Management Teams: Dimensions, Measurement, and Validation," *Academy of Management Journal* 35 (1992): 505-538.

3 *Ibid.*

officers' pay arrangements differ from those that would exist if the CEO could not manipulate his own compensation.

In sum, the CEO's own compensation will almost always reflect managerial power, and in many companies, the same will be true for other top executives. Thus, our analysis applies to compensation of senior management in general and not only to compensation of the CEO.

"Outrage" Costs and Constraints

Managers' potential rents are not unlimited. Though market forces and the need for board approval do not altogether prevent deviations from arm's length contracting, they do place some constraints on how far plan designers can go. There is a limit to what managers will seek and directors will approve.

In the face of these constraints, how far firms will go in favoring managers will depend not only how favorable considered arrangements will in fact be but also on how they will be perceived by outsiders. Whether directors and managers will be deterred from adopting a given compensation arrangement depends on the extent to which it will be reviewed by relevant outsiders as unjustified or even abusive or egregious. We will refer to negative reactions by outsiders as "outrage," and to the costs that such reactions imposes on managers and directors as "outrage costs." The more widespread and strong negative reactions are – that is, the greater the outrage -- the larger costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of some arrangements that managers would otherwise favor. We shall refer arrangements that are deterred in this way as ones that violate the "outrage constraint."

Why should perceptions – and in particular, outrage – matter? To begin with, market forces penalize and thus discourage some arrangements, and the extent to which markets will penalize managers and directors for the adoption of some arrangements will depend on how these arrangements are perceived. Consider the market for corporate control. The market for corporate control will penalize the adoption of some arrangements if the adoption will increase the vulnerability of managers and directors to a control contest. Such penalty is likely to be significant only if the firm adopts compensation arrangements that appear sufficiently outrageous.

Institutional investors may view such arrangements as a strong signal that the executives or directors are especially insensitive to shareholder interests. These investors may become less likely to support the incumbents should a hostile takeover or a proxy fight occur. In this manner, outrage over compensation can erode support for incumbent and make a control challenge viable despite the barriers that ordinarily protect incumbents from ouster.

Consider also the market reputation of managers and directors. A reputational damage might have an adverse effect on the future career prospects of managers and directors, and it might also affect their current business dealing with others outside the firm. Indeed, some outside directors join boards partly for the prestige and connections that the posts provide, and gaining a bad reputation would take away these benefits and impose costs instead. Reputational losses to managers and directors will likely be significant, however, only if their firms adopts compensation arrangements as sufficiently outrageous. A suboptimal arrangement would be unlikely to impose such costs as long as it falls within the range of what is justifiable and legitimate.

Indeed, we believe that outrage costs deter more arrangements than an analysis based solely on the above market incentives suggests. That is, we believe that constraints on rent extraction are somewhat tighter than suggested by an analysis of the (limited) market penalties that outrageous compensation arrangements involve. In Chapter two, we have taken into account that directors are affected not only by "narrow" interests of an homo economics but also by various social and psychological factors (of collegiality, loyalty, and so forth) that pull them in the direction of favoring executives. Similarly, the analysis of the constraints on rent extraction will not be complete if we do not recognize that some social and psychological factors increase the costs that managers and directors will suffer from adopting arrangements that are viewed as sufficiently outrageous.

Managers and directors are likely to care about the extent to which they are viewed with approval and esteem by some relevant social and professional groups. Directors are likely to prefer to avoid criticism or ridicule from the social or professional groups whose opinions they value – even if and to the extent to which such criticism or ridicule does not involve any monetary losses for them.[4] Likewise, fear of embarrassment or criticism may discourage managers, wholly aside from costs arising from markets for control or managerial labor, from seeking outrageous compensation packages in the first place. When Jack Welch gave up some retirements benefits to which he was contractually entitled, he was probably seeking to protect the approval and esteem he had earlier enjoyed and not some narrowly economic interests.

Clearly, for outrage to impose significant costs, it must be sufficiently widespread among a relevant group of observers. It is not enough for a small group of researchers or arbitrageurs to identify a compensation scheme as egregiously bad for shareholders. For executives or directors to be adversely affected in a material way, outrage must spread among those outsiders whose views matter most to them: the institutional investor community, the business media, and social and professional groups to which directors and managers belong.

Camouflage

The main costs to directors and managers of adopting compensation arrangements that favor managers, then, depend mainly not on how costly the arrangements *actually* are to shareholders, but on how costly the arrangements are *perceived* to be by important outsiders. Perceptions matter. Recognizing this brings us to another concept that is critical for understanding the compensation landscape: "camouflage."

Because perceptions are so important, the designers of compensation plans can limit outside criticism and outrage by dressing, packaging, or hiding — in short, camouflaging -- rent extraction. The more reasonable and defensible a package appears, the more rent managers will be able to enjoy without facing significant outrage. Accordingly, under the managerial power approach, managers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance-based than they actually are, and that package pay in ways that make it easier to justify and defend.

One might reasonably ask how, if rent extraction is camouflaged, any observer (including this book's authors) can determine that executives are

4 See Jay W. Lorsch and Elizabeth M. MacIver, "Pawns or Potentates?: The Reality of America's Corporate Boards" (Boston: Harvard Business School Press, 1989), pp. 23-31.

enjoying rents. In theory, rent extraction could be camouflaged so well as to make it absolutely undetectable. In fact, however, camouflage is successful as long as the rent extraction does not upset those outside observers whose outrage would be particularly costly for directors and managers, even if other observers are aware the executives are enjoying large rents.

Thus, the idea of camouflage is consistent with the possibility that an outsider might identify the hidden, camouflaged rents of a compensation arrangement. Such a conclusion would simply reflect the observer's judgment, not yet widely shared, that the compensation program is distorted in favor of managers. In time, of course, such conclusions might become widely accepted, in which case the rent extraction will no longer be camouflaged.

Outrage and Camouflage at Work

Some critics of our earlier work accused us that the idea of outrage costs, and the related idea of camouflage, are not empirically testable.[5] But this is not the case. These is evidence that directors and executives are indeed influenced -- in compensation and other types of decisions -- by strong outside criticism and outrage. And there is evidence that they engage in camouflage.

To begin, there is empirical evidence that negative media coverage affects compensation decisions. One study found that firms whose executive compensation policies received negative coverage in *Business Week, Forbes, Fortune,* and *Institutional Investor* during the years 1992–1994 experienced smaller increases in total compensation than did other firms.[6] These firms also increased the sensitivity of cash compensation to firm performance.

Studies have also examined the effect on executive pay of shareholder resolutions that criticize managers' high compensation and propose that it be limited. As discussed above, such resolutions are non-binding and

5 See, e.g., Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options." *University of Chicago Law Review* 69 (2002): 847-869; Holman W. Jenkins Jr., "Business World: Outrageous CEO Pay Revisited," *Wall Street Journal,* 2 October 2002, p. A17.

6 Marilyn F. Johnson, Susan Porter, and Margaret B. Shackell, "Stakeholder Pressure and the Structure of Executive Compensation," working paper, University of Michigan State University, University of Massachusetts at Amherst, and Notre Dame (1997): 4.

generally fail to pass anyway. However, their appearance might shine a critical light on problematic aspects of the firm's executive compensation policies and to make them more salient. Indeed, a study examining such resolutions in the mid-1990s found that they had a moderating effect on subsequent compensation decisions. The study found that during the two-year period following the passage of shareholder resolutions criticizing executive pay in particular firms, total compensation (adjusted for industry) in those firms declined by a statistically significant average of $2.7 million.[7] In a subsequent study, the researchers also found that higher negative votes in management-sponsored stock option proposals during the late 1990s slowed the increase in CEO compensation in subsequent years.[8]

Another study, by Alexander Dyck and Luigi Zingales, documents the effects of media scrutiny on corporate decisions. They find that such attention leads firms to adopt more environmentally friendly policies, for example. As for issues of corporate governance, they also find that media attention reduces the amount of value that controlling shareholders siphon off.[9]

A well-known example of how outside criticism affects governance decisions involves the campaign of shareholder activist Robert Monks against Sears' directors. During the late 1980s and early 1990s, Monks urged the Sears board to adopt various proposals to improve the firm's dismal performance. In April 1992, having been ignored by the board, Monks took out an advertisement in the *Wall Street Journal* entitled "The non-performing assets of Sears" and identified the directors by name. The presumably embarrassed directors then adopted many of Monks' proposals, generating a market-adjusted price reaction of almost 10 percent when the changes were announced.[10]

---

7 Randall S. Thomas and Kenneth J. Martin, "The Effect of Shareholder Proposals on Executive Compensation," *University of Cincinnati Law Review* 67 (1999): 1021-1065.

8 Kenneth J. Martin and Randall S. Thomas, "When is enough, enough? Market reaction to highly dilutive stock option plans and the subsequent impact on CEO compensation," *Journal of Corporate Finance* 202 (2003).

9 Alexander Dyck and Luigi Zingales, "The Corporate Governance Role of the Media," working paper, Harvard Business School and the University of Chicago, 2002; Alexander Dyck and Luigi Zingales, "Private Benefits of Control: An International Comparison," forthcoming Journal of Finance (2004).

10 Robert Monks and Nell Minow, *Corporate Governance,* Cambridge, M.A.:Blackwell

Another example is the California State Pension Fund for Public Employees' (CalPERS) practice of identifying poorly run companies. For some years CalPERS put poorly performing firms on what it called its "focus list" and suggested various ways to improve their corporate governance practices, such as making compensation and nominating committees fully independent. In many cases, firms placed on the list implemented some of the requested changes. Then, in 1991, CalPERS decided to adopt a "kinder, gentler" approach that did not involve public shaming after several CEOs told CalPERS that being less antagonistic would be even more effective. Absent the threat of adverse publicity, however, firms approached by CalPERS were actually much less cooperative. The then-CEO of CalPERS, Dale Hanson, said at the time, " 'Kinder, gentler' is not working…It has shown us that a number of companies won't move unless they have to deal with the problem because it's in the public eye." In 1992 CalPERS reinstated its policy of publicly shaming uncooperative firms.[11]

In fact, CalPERS' policy of shaming has had a measurable effect on targeted corporations. YiLin Wu finds that firms put on CalPERS' poor governance focus list were subsequently more likely to reduce the number of inside directors on their boards. These firms were also more likely to experience CEO turnover.[12] Shaming also appears to have adversely affected the careers of inside directors that left the targeted firms' boards. They were much less likely than inside directors departing non-targeted firms to land other board positions. As this study makes clear, negative publicity – or outrage -- does impose costs.

Finally, there is substantial evidence of camouflage activities. A testable implication of the camouflage idea is that, when compensation arrangements deviate from arm's length bargains, they should do so in a way that reduces the visibility of rent extraction to outsiders. This prediction is borne out by actual compensation practices. As we shall describe in the course of subsequent the following chapters of this book, many common compensation practices, such as retirement pay, deferred compensation

---

Publishing, 2001.

11 Judith Dobrzynski, "CalPERS is Ready to Roar, but Will CEO's Listen?" *Business Week,* 30 March 1992, p. 44.

12 YiLin Wu, The impact of public opinion on board structure changes, director career progression, and CEO turnover: evidence from CalPERS' corporate governance program, *Journal of Corporate Finance* 10 (2004): 199.

arrangements, company loans, non-indexing of options, and the at-the-money strike prices, serve a camouflage purpose.

The Role of Compensation Consultants

U.S. public companies typically employ outside consultants to provide input on the executive compensation process.[13] From the arm's length contracting perspective, consultants' use can be justified on the grounds that they provide expert assistance in the design of pay packages: they are privy to pay data that are not shared directly among companies. Firms participate in consultants' compensation surveys with the understanding that individual firm data will be kept confidential. The consultants then use the data to improve the design of their clients' compensation arrangements.

Although we agree that compensation consultants can and sometimes do play a useful role, it is important to understand how they are also used to camouflage rents. The fact that directors adopt a pay package recommended by a compensation consultant – rather than developing their own -- provides legitimacy. When challenged, the directors can justify their compensation decision by pointing to the outside expert's recommendation.

Courts in fact have generally given greater deference to board decisions that relied on advice by outside experts. Compensation consultants can provide similarly useful cover for board compensation decisions. In fact, James Wade, Joseph Porac, and Timothy Pollock provide evidence that pay consultants are used strategically to justify executive compensation to outsiders. Their study finds that firms that have more concentrated and more active outside shareholders, who are more likely to monitor and scrutinize pay arrangements, are more likely to rely on consultants.[14]

Unfortunately, the mere fact that a CEO pay's package is recommended by a compensation consultant does not mean that it is good

---

13 It has been reported that at least 65 percent of U.S. firms use compensation consultants. See John M. Bizjack, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contribute to Higher Levels of Executive Compensation?" working paper, Portland State University, 2000, p. 10, 44.

14 James B. Wade, Joseph F. Porac, and Timothy G. Pollock, "Worth, Words, and the Justification of Executive Pay," *Journal of Organizational Behavior* 18 (1997): 657, 658.

for shareholders. Indeed, in their study, Porac, Wade, and Pollock examined the choice of peer firms against whose performance the given firm was benchmarked. They found that, when the firm performed poorly relative to the industry or the CEO was highly paid compared with the industry, the definition of "peer firms" was expanded beyond industry boundaries.[15] Kevin Murphy found that "two-thirds of the largest 1000 corporations reported beating the performance of their industry peers over the last five fiscal years."[16] Such inconsistent assessments were facilitated by the cooperation of pay consultants.

Ratcheting

The combined efforts of consultants, who have incentives to help the CEO, and boards, which are similarly inclined, have led to an escalation of pay levels over the years. John Bizjack, Michael Lemmon, and Lalitha Naveen reviewed the 1997 compensation committee reports of one hundred firms in the S&P 500 index. They reported that the "vast majority" of firms that use peer groups set compensation at or above the fiftieth percentile of the peer group.[17] Such generous benchmarking is likely to boost executive compensation over time even if managerial performance does not improve.

To investigate ratcheting, Bizjack and his co-authors examined the actual compensation decisions of approximately 1,500 publicly traded firms during the period 1992–1998. They found that CEOs who were initially paid below the median amount received much larger than average pay increases, in both percentage and absolute terms, even when their firms had worse accounting and stock price performance. Such practices lead inevitably to ever-increasing compensation and benefit even poorly performing executives.[18]

---

15 Joseph F. Porac, James B. Wade, Timothy G. Pollock, "Industry Categories and the Politics of the Comparable Firm in CEO Compensation," *Administrative Quarterly* 44 (1999): 112-144.

16 Kevin J. Murphy, "Politics, Economics, and Executive Compensation," *University of Cincinnati Law Review* 63 (1995): 736.

17 John M. Bizjak, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contribute to Higher Levels of Executive Compensation?" working paper, Portland State University, 2000, pp 2-3.

18 Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics,* ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), 2485, 2517-2518; Graef

Kim Clark, the dean of Harvard Business School, recently described the process of ratcheting as follows: "[T]he use of consultants….creates what I call the 'the Lake Wobegon effect.' You recall that in Lake Wobegon everybody is above average. And in a lot of companies the way the system works is most CEOs want to be at the 75th percentile of the distribution of compensation….You get a ratcheting-up effect as that information pervades the market, and we get serious distortions in CEO compensation."[19]

Managerial Power and the Past Decade

Kevin Murphy and Brian Hall have criticized our earlier work on the connection between power and pay, suggesting that our approach cannot explain the large increases in executive compensation during the 1990s.[20] *Wall Street Journal* columnist Holman Jenkins attacked our work on similar grounds.[21] These critics assert that CEO power declined during the 1990s as boards added more independent directors. They argue that if the managerial power approach is correct, pay ought also to have declined, rather than increased, during this period.

However, it is not at all clear that CEO influence on pay declined during the 1990s. Although the composition of boards might have improved, takeover defenses were also strengthened. Thus boards and executives were much less concerned about the threat of a hostile takeover during the 1990s than they had been during the preceding decade. In any event, executive pay increases during the 1990s resulted not from changes in the amount of managerial power. Rather, they resulted from developments in the compensation environment – such as shareholders' increased interest in linking pay to performance and the broader stock market boom -- which managers were able to use to their advantage.

S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: Norton, 1991): 219; Shawn Tully, "Raising the Bar," *Fortune,* 8 June 1998, p. 272.

19 Harvard Business School dean Kim B. Clark, prepared remarks, National Press Club, 26 February 2003.

20 Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options." *University of Chicago Law Review* 69 (2002): 847-869; Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives* 17 (2003): 64-65.

21 Holman W. Jenkins Jr., "Business World: Outrageous CEO Pay Revisited," *Wall Street Journal,* 2 October 2002, p. A17.

In the early 1990s, institutional investors and federal regulators, with the support of financial economists, pressed for greater use of performance-based compensation. The enactment in 1992 of Section 162(m) of the Internal Revenue Code, which denies firms a deduction for compensation paid to an executive in excess of $1 million per year unless the excess compensation is "performance-based," was intended to encourage the use of such compensation.

Executives took advantage of this surge of enthusiasm. They used their influence over directors to obtain substantial option pay without sacrificing corresponding amounts of cash compensation. In an arm's length world, an employer is often able to trade an increase in one part of a compensation package for an offsetting reduction in another part of the package. But in the real world of manager-influenced compensation, boards and executives responded to the calls for equity-based compensation by adding more such compensation to existing arrangements, rather than substituting it for performance-insensitive compensation.

Furthermore, and more importantly, executives used their influence to make the design of option plans advantageous to them. As will be explained in part III, conventional option plans do not link pay tightly to the managers' own performance. Rather, they enable managers to reap windfalls from stock price increases that are due solely to market and sector forces beyond managerial control. As a result, managers capture much larger gains than more cost-effective and efficient plans would have provided.

In view of the huge increase in pay during the past decade, critics of our approach might ask why risk-averse managers would not use their influence to get higher cash salaries rather than more options. Holding the value of compensation constant, one would indeed expect this to happen. But managers seeking to increase their pay during the 1990s were not offered a choice between additional cash compensation and additional option compensation with the same expected value. Instead, outsiders' enthusiasm for equity-based compensation created an opportunity for managers to obtain additional option compensation without offsetting reductions in their cash compensation.

Furthermore, because option compensation offers the possibility of improved incentives, the use of options made compensation levels that would have triggered prohibitive outrage had they been in cash more defensible. In 2001, Steve Jobs was able to obtain an option package worth more than half a billion dollars, albeit with some outcry.[22] Cash compensation of this magnitude is still quite inconceivable. As we discuss in detail in chapter eleven, firms could have used better-designed option plans that would have provided the same incentives for significantly less cost. But the large windfall elements of the option plans that firms did use were not sufficiently clear and salient to make these plans blatantly unjustifiable. Managers' influence has enabled them to take advantage of shareholders' understandable desire for more performance-based compensation. As a result, during the 1990s executives captured much larger benefits than they would have received under arm's length arrangements that provided the same incentives.

The stock market boom is a second important factor that worked to managers' advantage in the 1990s. Executive compensation has historically been and is still correlated with a firm's market capitalization. Executives of firms with larger market capitalization tend to receive higher compensation.[23] Thus, the rising stock market of the 1990s, which buoyed up many poorly performing companies, provided most firms with a convenient justification for substantial pay increases.

Furthermore, investors and other outsiders are generally less bothered by excessive and distorted pay arrangements when markets are rising rapidly. The bull market of the 1990s -- the biggest bull market since the Great Depression – weakened the outrage constraint, giving managers and boards more latitude to boost executive pay. The stock market boom thus played a role in the run up of executive compensation during this period. Conversely, shareholders who have seen the value of their investments decline precipitously are more prone to scrutinize managerial behavior and less likely to be forgiving of what they perceive (correctly or incorrectly) to be managerial overreaching. It is no coincidence that many large stock market declines are followed by new laws that seek to curb what is viewed as insider overreaching.[24] Thus, that pay has not continued to

---

22 Geoffrey Colvin, "The Great CEO Pay Heist," *Fortune*, 25 June 2001, p.64.

23 See Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics,* vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), p. 2493.

24 The 1929 crash led to the enactment in 1933 and 1934 of the country's first securities laws. The recent crash has already led to the passing of the Sarbanes-Oxley Act of 2002.

escalate rapidly since 2000 is in part due to some tightening of the outrage constraint.

Alternative Explanations for Inefficient Contracts

In the coming chapters we will describe various compensation practices that appear to be inefficient and thus inconsistent with arm's length contracting. They are, however, completely consistent with the predictions of the managerial power approach. Before proceeding, however, we wish to discuss briefly two alternative explanations for inefficient compensation practices, and how their predictions differ from those of the managerial power approach.

Norms and Conventions

The desire to conform to prevailing norms and conventions influences individuals' behavior in many contexts. In recent years, a number of legal scholars have studied the role of norms in the context of corporate law and corporate governance.[25] It is natural to ask whether norms play a role in executive compensation. Inefficient arrangements might arise and persist, one could argue, simply because boards have a tendency to conform to the practices of other firms, whether or not those practices serve shareholder interests.

The tendency to conform likely plays a significant role in board decisions about executive compensation. Directors will be more willing to approve pay arrangements that are similar to those of other firms. Following the herd requires less explanation, less justification, and less confidence in one's own judgment than does carving out a new path. Thus, compensation committees and boards have a natural desire to conform to "the norm," or at least to be perceived as conforming to the norm.

The desire to conform makes any change in the status quo –- any move from one "equilibrium" to another -- slower than it would otherwise be. The evolution of compensation arrangements is slowed down or made "sticky" by compensation committees' preference for adhering to

---

25 See, for example, Melvin A. Eisenberg, "Corporate Law and Social Norms," *Columbia Law Review* 99 (1999): 1253-1292, and the articles appearing in *University of Pennsylvania Law Review,* Symposium on Norms and Corporate Law, 2001.

conventions and their reluctance to deviate substantially from established pay practices.

However, the desire to conform cannot explain the ways in which compensation arrangements have evolved in the past –- and thus the current landscape of executive compensation. Nor can it predict the direction in which compensation arrangements will evolve in the future. The stickiness arising from the tendency to conform implies only that movement from one equilibrium to another will be gradual and slow. It can neither explain why we should arrive at any particular equilibrium rather than another, nor what the next equilibrium is likely to be.

Patterns of executive compensation do change substantially over time. Some of the practices to be discussed in coming chapters either have emerged or have become dramatically more important in just the past decade. The stickiness arising from the desire to conform cannot tell us much about why arrangements evolved in one direction rather than another.

To provide a full account of executive compensation, norms and conventions must be combined with another theory, such as arm's length contracting or managerial power. A theory combining norms with the arm's length contracting approach would predict that the evolution of executive compensation arrangement, although slowed by the tendency to follow established practices, is shaped by market forces. In this model, as changing circumstances make an existing equilibrium inefficient, market pressures induce boards to adopt arrangements that are efficient in the new circumstances. Although the desire to conform prevents instantaneous adjustment, market forces reshape arrangements so they become more efficient. Ultimately, the efficiency gap created by the new circumstances may be eliminated.

In contrast, the managerial power approach predicts that the evolution of executive compensation over time is shaped, at least in part, by executives' desire to secure rents. When changing circumstances create an opportunity to enjoy more rents or to better camouflage their rents, managers will try to take advantage of the opportunity. The stickiness due to the desire to conform will slow the pace of these changes, but the changes will tend to be in directions favorable to managers and to reflect their ability to influence their own pay.

In the following chapters, we will discuss a variety of potentially inefficient but executive-friendly compensation practices that have developed during the last decade or two. We will also discuss some potentially efficient compensation practices that failed to emerge during the same period. Why did one set of arrangements arise and not the other? The stickiness caused by the desire to conform combined with arm's length contracting should not systematically yield outcomes that are favorable to managers. However, the tendency of changes to favor executives more than the interest of shareholders is consistent with such stickiness combined with the operation of managerial influence.

Mistakes and Misperceptions

There is another natural explanation for inefficient compensation contracts: human error. Even in an economic context where arm's length bargainers have incentives to reach efficient outcomes, they can make mistakes. They misperceive, miscalculate, misestimate, and suffer from a variety of cognitive biases. These human imperfections may lead to the adoption of inefficient compensation contracts. One observer has referred to this explanation for inefficient compensation packages as "honest stupidity."[26]

To assess this mistakes-based explanation, it is first necessary to specify the identities of those making the errors. Under one version of this explanation, all those involved in the pay-setting process – including executives, their advisers, and compensation consultants – make mistakes. But this is a highly implausible explanation for the persistence of the inefficient practices we will be discussing in subsequent chapters.

The problems we will discuss are hardly complex. It is highly unlikely that they have so long escaped the attention of managers and their sophisticated, well-paid advisers. Furthermore, this version of the explanation cannot account for the fact that apparent departures from arm's length contracting systematically favor managers. "Honest stupidity" should occasion departures that are both favorable and unfavorable to managers.

A more plausible version of the honest mistakes explanation focuses on independent directors, who have little at stake in compensation decisions and devote little time to them. One might argue that they are honestly likely

26 Andrew Balls, "Ill-judged incentives: Share options are a poor way to make executives act in shareholders' interests," *Financial Times,* 12 November 2002, p.13.

to fail to grasp the problems we will be discussing. In a response by Kevin Murphy to our earlier study, and in a subsequent paper by Brian Hall and Murphy, these authors have advanced such an explanation – which they label "the perceived cost view" -- for the prevalence of seemingly inefficient option plans.[27]

As we will discuss in chapter eleven, it is puzzling from an arm's length contracting perspective that conventional option plans make little effort to filter out stock price increases that are not due to managerial efforts. Hall and Murphy argue that boards use conventional option plans because they fail to perceive the true economic cost to shareholders of such options. They argue that conventional options are perceived as inexpensive because they can be granted without any cash outlay and without an accounting charge, and thus boards are overly willing to grant them. In truth, options that filter out windfalls cost less, but boards erroneously view them as more expensive because reduced-windfall options do require an accounting charge.

We are skeptical that directors fail to recognize that conventional options involve substantial costs for shareholders, whose holdings are diluted by the option grants. We likewise doubt that directors are unaware that the cost of conventional options exceeds the cost of options that filter out stock price increases not due to the executives' own efforts.

But for the sake of argument, let us suppose that—when appointed to boards—directors, many of whom are executives or prominent figures in the business world, are oblivious to the true cost of conventional options. Let us suppose further that—once these ignorant directors are on the board—compensation consultants fail to educate them about these costs. If so, the possibility of misperceptions by these directors is best seen not as an alternative to the managerial power explanation but rather as additional evidence that supports it.

As we discussed in chapter two, there are several reasons why boards are unlikely to negotiate compensation arrangements that best serve shareholders. Directors tend to have financial and nonfinancial incentives to please or at least not to displease the CEO; even absent such incentives, a

27 Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," *University of Chicago Law Review* 69 (2002): 847; Brian Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives* 17 (2003): 49-70

host of social and psychological factors are likely to lead directors to favor managers. In addition, directors lack adequate time and information for the investigation of alternative, efficient compensation arrangements with executives, and thus their misperception of the cost of options is but one example among many of the general problem.

For many purposes, it does not matter whether managers' influence over their own compensation comes from the pliability of the board or from directors' naiveté. Whether the problem is conscious favoritism, honest stupidity, or a combination of both, the important fact is that directors are at least to some extent willing to approve option arrangements that favor managers at the expense of shareholders.

In other instances, however – such as the effort to improve compensation arrangements – it might well matter whether inefficient contracts arise from conscious favoritism or honest stupidity. If misperceptions were the only source of past departures from arm's length contracting, for example, outsider observers could simply correct the misperceptions— by educating directors or providing them with more accurate information —to achieve arrangements much closer to the efficient, arm's length ideal.

Thus it is worth noting briefly that evidence indicates that managers' influence on their pay is due not only to directors' "honest stupidity" but also at least partially to directors' willingness to favor managers. For one thing, even if the failure of firms to filter out windfalls results from directors' misapprehension of the costs of conventional options, managers are also favored in other ways that cannot be so easily explained away. Misapprehensions cannot explain why, as we discuss in chapters eight and nine , firms have designed retirement plans and executive loans in ways that seem calculated to make compensation less noticeable.

Furthermore, if managers could not influence their own pay and were simply benefiting form directors' misperceptions, one would not expect executive pay to correlate with executives' power. As we explain in the following chapter, however, considerable evidence indicates the existence of such a correlation. This pattern indicates that directors' conscious willingness to favor the CEO, not merely directors' misperceptions, plays a significant role in shaping compensation arrangements.

CHAPTER 6: THE RELATIONSHIP BETWEEN POWER AND PAY

"I think that in the future, historians will look back on this period of time and they will say this was a time when there was great corporate power, maybe too much corporate power, and the smoking gun was CEO pay."

Shareholder Activist Robert A.G. Monks, CEO Pay- The Smoking Gun, 2004

"[W]e find that CEO compensation is higher when …. the outside directors are appointed by the CEO…"

John Core, Robert Holthausen, and David Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," 1999.

In companies with dispersed ownership and no controlling shareholder, executives will generally have enough power to enjoy more compensation and managerial slack than they would under an arm's length arrangement. The extent of managerial power, however, is not uniform across all such companies. Managers will have more or less power depending on the company's ownership structure, on the antitakeover arrangements in place, and on various features of the board. The managerial power approach predicts that compensation packages will be more favorable to managers – i.e., that pay will be higher and/or less sensitive to performance -- in firms in which managers have relatively more power. Other things being equal, managers will tend to have more power when (i) the board is relatively weak or ineffectual; (ii) there is no large outside shareholder; (iii) there are fewer institutional shareholders; and (iv) managers are protected by antitakeover arrangements. The empirical evidence indeed indicates that each of these factors does indeed affect executive compensation in the way predicted by the managerial power approach.

Strength and Independence of Boards

Although CEOs generally influence the board, the degree of influence differs from company to company depending on whether the board is relatively weak or relatively strong. The evidence indicates that CEOs obtain more favorable pay arrangements the more powerful they are vis-à-vis the board.

A CEO is likely to be relatively more powerful as the size of the board increases. Larger boards are likely to be less cohesive because each director may feel less "responsible" and therefore may focus less on the firm's affairs in general and on management pay in particular. Individual members of large boards are less likely to be constrained in their decisions by the threat of public outrage; the larger the board, the harder it is for outside observers to direct their outrage at any one member in particular. Additionally, any directors interested in challenging the CEO will find it more difficult to convince a majority of the board to join them, there being more directors to convince. For all these reasons, the managerial power approach predicts that a larger board will allow managers to obtain more favorable pay arrangements. Indeed, John Core, Robert Holthausen, and David Larcker find that CEO compensation is higher when the board is larger.[28] Similarly, a study conducted by David Yermack finds that pay-performance sensitivity decreases as the size of the board increases.[29]

The presence of directors who serve on multiple boards, and are therefore less focused on the affairs of any one company, is also likely to increase the relative power of the CEO.[30] The managerial power approach predicts, then, that pay arrangements will be more favorable to the CEO when outside directors sit on multiple boards. In fact, the Core, Holthausen, and Larcker study indicates that CEO compensation increases, all else equal, with the number of outside directors serving on three or more other boards.[31]

---

28 John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 372-373.

29 David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics* 40 (1996): 205.

30 John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 372-373.

31 John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 372-373.

A CEO who also serves as chair of the board is likely to be more powerful. The board chair runs board meetings and sets their agendas. It is hardly surprising, then, that CEOs occupying that position are less likely to be fired by the board for poor performance.[32] The managerial power approach to executive compensation further predicts that a CEO who is also chairman of the board will obtain more favorable pay arrangements. Indeed, numerous studies conclude that compensation tends to be higher when the CEO serves in these two roles.[33]

The presence of directors who have ties to or feel an obligation to the CEO is also likely to increase the latter's power. In fact, studies indicate that pay is higher, and the CEO is more likely to get a golden parachute, when more of the outside directors have been appointed under — and thus may feel a greater sense of gratitude or obligation to — the current CEO.[34]

As we noted in chapter two, interlocking directorships increase the CEO's ability to influence the board. CEO-interlocking directorships -- where the CEO of company A sits on company B's board and the CEO of company B sits on company A's board –- are likely to afford both CEOs a particularly significant amount of power vis-à-vis their boards. As the managerial power approach predicts, CEO pay increases when a board contains interlocking directors.[35]

---

32 Vidhan K. Goyal and Chul W. Park, "Board Leadership Structure and CEO Turnover," *Journal of Corporate Finance* 8 (2002): 49-66.

33 Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence." *Management Science* 48 (2002):: 453-469; James Wade, Charles A. O'Reilly, III, and Ike Chandratat, "Golden Parachutes, CEO's, and the Exercise of Social Influence," *Administrative Science Quarterly* 35 (1990): 592-593; Martin Conyon and Kevin Murphy, "The Prince and the Pauper? CEO Pay in the U.S. and the U.K.," *Economic Journal* 110 (2000): F640-671; John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Officer Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 371-406.

34 John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 372-373; Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence." Management Science 48 (2002):: 453-469.

35 Kevin Hallock, "Reciprocally Interlocking Boards of Directors and Executive Compensation," *Journal of Financial and Quantitative Analysis* 32 (1997): 332.

Turning from the board to its compensation committee, the makeup of that committee itself also affects the structure of CEO pay in the way suggested by the managerial power perspective. First, evidence indicates that a CEO's pay is higher if the chair of the compensation committee has been appointed during the term of that CEO (an appointment that might reflect a good relationship between the two).[36] Second, when at least one member of the compensation committee is an insider and therefore subordinate to the CEO, the sensitivity of pay to performance is lower.[37] Finally, the managerial power approach predicts that compensation committee members who own significant amounts of stock will tend to be more involved in firm affairs and more attentive to shareholder value. Indeed, a study confirms that CEO pay is negatively related to the share ownership of the board's compensation committee.[38]

Presence of Large Outside Shareholders

The presence of large outside shareholders will also affect managerial power. A large outside shareholder has more incentive than dispersed shareholders have to monitor management and invest effort in reducing managerial opportunism.[39] Thus, the managerial power approach predicts that the presence of a large shareholder, even one who does not have a controlling or dominant stake, will lead to executive compensation arrangements that are better for shareholders and worse for managers.

This prediction is borne out by a study that finds a negative relationship between the equity ownership of a firm's largest shareholder and the amount of CEO compensation. Firms that have a shareholder with a stake larger than the CEO's ownership interest pay their CEOs 5 percent less

36 Brian G. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 293-332.

37 Harry A. Newman and Haim A. Mozes, "Does the Composition of the Compensation Committee Influence CEO Compensation Practices?" *Financial Management* 28 (1999): 41-53.

38 Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Ownership Structure, and CEO Compensation: Theory and Evidence," *Management Science* 48 (2002): 453-469.

39 Andrei Shleifer and Robert W. Vishny, "Large Shareholders and Corporate Control," *Journal of Political Economy* 94, no. 3 (1986): 461-688.

in total compensation than firms without such a shareholder.[40] Two other studies have looked at the effect of a 5 percent or larger blockholder (other than the CEO) on CEO compensation. They find that the existence of such a 5 percent blockholder also reduces CEO compensation.[41]

As might be expected, these studies also find that pay is less sensitive to performance in companies that do not have a 5 percent external shareholder.[42] The arm's length contracting view would not predict such a relationship. Agency problems are likely to be more severe absent a large external shareholder. The arm's length contracting model would therefore predict that, if anything, boards would make pay-performance sensitivity higher in such cases, in order to counteract these more pronounced agency problems.

A creative empirical study by economists Marianne Bertrand and Sendhil Mullainathan provides additional evidence that managers' pay is less performance-sensitive in the absence of large external shareholders.[43] The study examines whether the presence of a 5 percent (or larger) shareholder affects how managers are compensated for "luck" – that is, for changes in company performance beyond their control. The study finds that CEOs in firms lacking large external shareholders tend to receive more "luck-based" pay. Another study by the same authors finds that CEOs in

---

40 Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Ownership Structure, and CEO Compensation: Theory and Evidence." *Management Science* 48 (2002): 453-469.

41 John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 372-373; Richard A Lambert, David F. Larcker, and Keith Weigelt, "The Structure of Organizational Incentives," *Administrative Science Quarterly* 38 (1993): 438-461.

42 Donald C. Hambrick and Sydney Finkelstein, "The Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises," *Strategic Management Journal* 16 (1995): 175-193; Henry L. Tosi Jr. and Luis R. Gomez-Mejia, "The Decoupling of CEO Pay and Performance: An Agency Theory Perspective," *Administrative Science Quarterly* 34 (1989): 181.

43 Marianne Bertrand and Sendhil Mullainathan, "Are CEO's Rewarded for Luck?: The Ones without Principals Are," *Quarterly Journal of Economics* 116 (2001): 929.

firms without large shareholders experience smaller reductions in cash compensation per increase in options-based compensation.[44]

The significance of outside shareholders as a check on managerial power may depend not only on the presence of a large shareholder but also on the percentage of shares held by institutional investors. Although institutional investors are often reluctant to fight management about pay issues, they are generally more vigilant than are individual investors, who have little at stake in any given firm.

In a study of S&P firms during the 1990s, financial economists Jay Hartzell and Laura Starks have found that a higher concentration of institutional ownership leads not only to lower executive compensation,[45] but also to more performance-sensitive compensation. This evidence indicates that the presence of institutions serves to reduce both excess pay and managerial slack.

Another study by Parthiban David, Rahul Kochar, and Edward Levitas divides institutional shareholders into two categories. One category includes those that have no other business relationship with the firm and are thus concerned only with its share value ("pressure-resistant" institutions). The second category includes those institutions that have other business relationships with the firm (e.g., managing a pension fund) and are thus vulnerable to management pressure ("pressure-sensitive" institutions). As the managerial power approach predicts, CEO pay is negatively correlated with the presence of pressure-resistant institutional investors and positively correlated with the presence of pressure-sensitive ones. [46]

44 Marianne Bertrand and Sendhil Mullainathan, "Are CEO's Rewarded for Luck?: The Ones without Principals Are," *Quarterly Journal of Economics* 116 (2001).

45 Jay C. Hartzell and Laura T. Starks, "Institutional Investors and Executive Compensation," *Journal of Finance* 58 (2003): 2351-2374. See also Parthiban David, Rahul Kochar, and Edward Levitas, "The Effect of Institutional Investors on the Level and Mix of CEO Compensation," *Academy of Management Journal* 41 (1998): 200-208.

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

Antitakeover Protection

The market for corporate control – the threat of a hostile takeover – does not exert sufficient force to prevent substantial departures from arm's length contracting. It does, however, provide some constraint on managers' desire and ability to obtain favorable pay arrangements. Thus, the managerial power approach predicts that the more protected incumbents are from a takeover, the higher and less performance-sensitive their compensation will be.

One study by Kenneth Borokhovich, Kelly Brunarski, and Robert Parrino reports that CEO compensation increases significantly after antitakeover provisions are adopted — that is, after CEOs have become less vulnerable to a hostile takeover.[47] This is not readily explainable by arm's-length contracting; if managers' jobs are more secure, shareholders should be able to pay managers less because managers' risk-bearing costs are lower.[48]

Another study finds that CEOs of firms that become protected by anti-takeover legislation reduce their holdings of shares, apparently because the shares are less necessary for maintaining control.[49] This finding, again, is not readily explained by arm's length contracting. Arm's length contracting might in fact predict the opposite -- that a CEO protected by takeover legislation would, if anything, be required by a shareholder-oriented board to *increase* equity holdings to maintain adequate incentives to maximize shareholder value.

It is worth noting that managers who are less vulnerable to a hostile takeover take advantage of their power in other ways as well. Several studies report that, when protected by strong antitakeover laws or by corporate charter provisions, managers generate less value for shareholders.[50] One study indicates that when managers have fewer reasons

---

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

48 Anup Agrawal and Charles R. Knoeber, "Managerial Compensation and the Threat of Takeover," *Journal of Financial Economics* 47 (1998): 219.

49 Shijun Cheng, Venky Nagar, and Madhar V. Rajan, "Control versus Risk in Stock-Based Incentives: Evidence from Antitakeover Regulation," *Review of Financial Studies*. Forthcoming.

50 Marianne Bertrand and Sendhil Mullianathan, "Is There Discretion in Wage

to fear a hostile takeover, they tend to operate their firms less efficiently, producing narrower profit margins and slower sales growth.[51] This study further reports that insulation from takeover threats results in greater consumption of private benefits by managers and a greater tendency to engage in empire building.

The New CEOs Objection

In a critique of our earlier work, Kevin Murphy, one of the country's leading academic experts on executive compensation, presented a finding that, he argues, is inconsistent with the predictions of the managerial power approach.[52] Murphy found that CEOs hired from the outside receive in their first year almost twice the total compensation received by CEOs promoted from within. Outsider CEOs do not yet have power to influence their pay, Murphy argues. Their higher compensation therefore must be inconsistent with the managerial power hypothesis.

As we explained in chapter two, however, boards cannot be expected to bargain at arm's length even with outside CEO candidates. Among other things, directors negotiating with a new CEO expect that, once hired, the CEO will influence the re-nomination of directors. It is therefore not in the directors' financial interest to engage in hard bargaining. In addition, directors recognize that the person whose compensation they are structuring will soon become the firm's leader and one of their colleagues—that he is, in short, a person with whom they would like to have collegial relations. This further reduces directors' incentive to engage in true arm's length bargaining with the would-be CEO.

Furthermore, once a candidate has been identified as the top choice for the CEO position, it is embarrassing for directors if he or she walks away.

Setting? A Test Using Takeover Legislation," *Rand Journal of Economics* 30 (1999): 535; Gerald T. Garvey and Gordon Hanka, "Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage," *Journal of Finance* 54 (1999): 519, 520; Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118 (2003): 107-155.

51 Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118 (2003): 107-155.

52 Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options," *University of Chicago Law Review* 69 (2002): 853.

Indeed, failure to close the deal is personally costly to the directors by forcing them to return to the CEO selection stage. In comparison, the personal cost to directors of overpaying the incoming CEO is quite small, given their negligible equity interest in the firm. Finally, and importantly, time limitations force directors to rely on information shaped and presented by the company's staff and compensation consultants, all of whom have incentives to please the incoming CEO.

We agree with the central point of Murphy's argument: although bargaining with outside CEO candidates still differs from true arm's length bargaining, such persons should have less power and influence over their prospective pay than inside candidates. The managerial approach suggests that, all else equal, managers with less power should obtain less favorable arrangements.

However, in Murphy's comparison between outside and inside CEO candidates, all else is not equal. The managerial power approach does not suggest that managerial power is the sole determinant of managerial pay. Other characteristics, such as managers' abilities and their bargaining positions, will also affect executive compensation. Outside candidates, as a group, are likely to differ from internal candidates.

Companies generally have an incentive to hire inside the firm if they can find a suitable candidate. Insiders are preferred because of their familiarity with the firm and perhaps also because of their existing ties to the board. As a result, 75 percent to 80 percent of CEOs are hired from the inside.[53] Because of boards' reluctance to extend their search beyond a firm's ranks, the outside hires who are chosen are likely to be, on average, a stronger group.

Finally, and importantly, outside hires are often already CEOs of other firms, while inside candidates, by definition, are not. Those outside candidates who are already CEOs are likely using their current positions to extract rents, which the hiring firm will need to match in its compensation offer. No such additional compensation is needed for an in-house promotion. The managerial power approach thus predicts that attracting outside hires will require offering higher pay.

---

53 Robert Parrino, "CEO Turnover and Outside Succession: A Cross-Sectional Analysis," *Journal of Financial Economics* 46 (1997): 168.

The Pattern

A clear pattern emerges from the many empirical studies described in this chapter. As predicted by the managerial power approach, there is a link between managerial power and pay arrangements. The more power managers have, the more favorable their compensation arrangements are.

Unlike most financial economists studying executive compensation, some of the researchers conducting these studies concluded that rent extraction might occur where managers are especially powerful. Bertrand and Mullainathan, for example, concluded that some "skimming" occurs in companies without a 5 percent shareholder.[54] These researchers appear to believe, however, that rent extraction does not occur in companies that do have a such a shareholder.

In our view, once the connection between power and rents is recognized, there is reason to believe that significant rent extraction will be discernible even in companies with a 5 percent shareholder. To be sure, managers in such companies may have somewhat less power, and thus less ability to extract rents than managers in companies without a large external shareholder. However, these managers still have considerable influence.

Consider cases in which a 5 percent or even a 10 percent external shareholder is present. Such a shareholder may well have some influence, but not likely enough to oust management, given the power that managers have to issue poison pills and control the proxy machinery. Executives in such cases are likely to wield a substantial amount of power – and to extract considerable rents.

Indeed, the compensation practices we discuss in the coming chapters of this book – practices that, we show, reflect both power and camouflage – are not limited to companies without a 5 percent shareholder. These practices occur even at companies with a significant blockholder or substantial institutional investment. This evidence indicates that rent extraction may well take place, even if to a reduced extent, in companies where managers are relatively less powerful.

---

54 Marianne Bertrand, and Sendhil Mullianathan, "Agents With and Without Principals," *American Economics Review* 90 (2000): 205.

CHAPTER 7: MANAGERIAL INFLUENCE ON THE WAY OUT

"It's quite normal for a board to want the departing CEO to be a friend, not an adversary."

Corporate lawyer interviewed by *Fortune* magazine, 2000

CEOs leaving a firm commonly receive substantial payments. Some of these departure-related payments are mandated by the CEO's employment contract. It is questionable whether promises of such payments, which reduce the sensitivity of pay to performance, provide the CEO with good ex-ante incentives. Our focus in this chapter, however, is not on contractually determined severance payments but on gratuitous departure payments.

We call a departure payment or benefit "gratuitous" when it is not mandated under the CEO's contract at the time he or she decides (or is asked) to leave. These payments are made at the board's discretion, over and above anything required by the executive's contract. As we discuss below, such gratuitous payments have often been made (1) when CEOs are fired, (2) when they agree to have their companies acquired, and (3) when they retire.

Gratuitous payments and benefits have taken a number of different forms. These include forgiveness of loans, accelerated vesting of options and restricted stock, increases in pension benefits (e.g., by "crediting" CEOs with additional years of service), awards of lump sum cash payments, and promises of consulting contracts that will provide the departing CEO with a generous annual compensation for little or no work.

Most employees who are fired, pushed out, or retire receive whatever benefits or payments they are contractually entitled to, and little else other than symbolic gifts. An employer in an arm's length relationship with these employees is very unlikely to give them large, uncontracted-for payments upon termination of employment. The gratuitous departure payments received by CEOs thus provide strong evidence that directors do not deal at arm's length with CEOs, even in those rare cases where they push the CEO out the door.

When CEOs Are Fired

As we noted earlier, boards rarely compel CEOs to resign. Because many directors –- even nominally independent directors -- are likely to be influenced by or loyal to the head of the firm, boards have been generally reluctant to fire the CEO, especially one whose performance is at least passable. If the CEO's performance is extremely poor, however, the need for a replacement becomes obvious to almost every observer. At that point, directors may succumb to the pressure for change at the top.

In many cases, when a board replaces a CEO, it grants various benefits to ease the executive's exit. For example, when Mattel CEO Jill Barad was forced out by her board, she had a $4.2 million loan forgiven and received an additional $3.3 million in cash to cover the tax liability arising from the forgiveness of another loan. In addition, her unvested options were allowed to vest automatically and to remain exercisable until the end of their original terms. These gratuitous benefits accompanied the severance benefits already guaranteed under her contract, which included a termination payment of $26.4 million, annual retirement benefits of more than $700,000, and other benefits. [55]

Another example is the departure arrangement for Webvan CEO George Shaheen. He resigned shortly before Webvan declared bankruptcy, saying that he felt there was a need for "a different kind of an executive to lead the company." He had a $6.7 million loan forgiven in exchange for $150,000 of Webvan stock, a benefit to which he had not been contractually entitled.[56]

Likewise, when Bank One CEO John McCoy was eased out of his job in 1999 for poor performance, he met with his friends on the board to hammer out a separation agreement. The package included a $10.3 million cash payment (in addition to $7.5 million in "special recognition" awards for 1997 and 1998), plus a pension of $3 million annually beginning in 2001.[57]

---

55 Mattel proxy statement filed with SEC, April 28, 2000, pp. 24-25.

56 Joann S. Lublin, "As Their Companies Crumbled, Some CEO's Got Big-Money Payouts," *Wall St. Journal*, 26 February 2002, p. B1.

57 Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs,* Princeton, N.J.: Princeton University Press (2002), pp. 3-4.

Presumably, this arrangement made it easier for his friends on the board to go along with other board members' desire to end his service.

It is difficult to reconcile such gratuitous payments with arm's length contracting. A board has authority to fire a CEO, paying only the severance benefits required by contract. There appears to be no need to "bribe" a poorly performing CEO to step down. In addition, the "signal" sent by a gratuitous departure payment will, if anything, only weaken the next CEO's incentive to perform.

On the other hand, such payments can readily be explained by the existence of managerial power over the board. First, at least some directors may be reluctant to fire a CEO, even for poor performance. To coax them to acquiesce, it may be necessary to induce the CEO to resign voluntarily or at least to offer very generous terms. When such directors constitute a majority of the board, the CEO cannot be replaced without a gratuitous departure payment. Even as a minority, CEO-captured directors can make the replacement process contentious and unpleasant for their colleagues. The other directors may wish to avoid this by being generous to the departing CEO. In either case, the gratuitous payment acts as a "bribe" to secure the cooperation, or reduce the resistance, of the CEO and his or her friends on the board.

Second, even directors who are willing to replace their CEO may prefer to sweeten their action with a gift. They may wish to alleviate the general discomfort caused by the firing, to please or to console the CEO, to express their gratitude or friendship, or to make themselves more attractive, or at least less threatening, to the CEOs of other companies who might consider appointing them to their boards.

Underlying all of these explanations, the directors' preference for treating the CEO generously reflects a relationship that differs substantially from what is assumed to exist in the arm's length model. The fact that the gratuitous goodbye payment is paid with shareholders' money, at very little cost to the directors themselves, makes the latter even more likely to act on this preference.

It is important to note that, taking managerial power as given, gratuitous payments to fired CEOs may sometimes benefit shareholders. Given the loyalty of many directors to the CEO, providing such a sweetener may be necessary to obtain a board majority in favor of replacing a poor performer. If so, the gratuitous departure payments benefit shareholders as long as the CEO's departure increases shareholder value by more than the cost of the payment. For our purposes, however, what is important is that the practice of gratuitous goodbye payments demonstrates the existence of managerial power over the board.

When Companies Are Acquired

Managers of firms that are being acquired often receive acquisition-related benefits beyond those required by their employment contracts. These gratuitous acquisition payments can take a variety of forms, such as special cash payments or increases in the value of a previously negotiated golden parachute. For example, the U.S. West board voted to boost CEO Sol Trujillo's golden parachute by an estimated $46 million shortly before the firm was acquired by Qwest Communications.[58] A study by Jay Hartzell, Eli Ofek, and David Yermack reports that in 27 percent of acquisitions, the target board gives the CEO a special cash payment at the time it approves the merger. In 12 percent of the cases where the target CEO has a golden parachute, the target board increases the golden parachute payout at the time it approves the merger.[59]

The two types of possible explanations for gratuitous acquisition-related payments parallel the explanations for gratuitous departure payments. First, some directors may vote in favor of an acquisition that is good for shareholders only if the CEO supports the deal or is at least treated generously in the transition. When such directors constitute a majority, sweetening the acquisition for the CEO may be necessary for the deal's success. And even when such directors are in the minority, the desire to avoid a confrontation with them may be sufficient to induce the majority to sweeten the CEO's acquisition-related departure.

Second, even if the entire board is willing to approve the acquisition without special treatment for the CEO, the directors may still prefer an acquisition with a golden goodbye. They may wish to favor a CEO who is about to be displaced in a takeover for the same reasons they may confer benefits on a CEO who is being forced out by the board. They may be

58 Dan Sabbagh, "Orange Chief Received $70m in Two Severance Payments", *The Times (London)*, 12 March 2003, p. 25.

59 Jay Hartzell, Eli Ofek, and David Yermack, "What's In It for Me? CEOs Whose Firms are Acquired." *Review of Financial Studies* 17 (2004): 37-61.

swayed by loyalty, gratitude, or friendship. They may seek to alleviate their own unease as they take control away from the CEO. And because the directors personally bear only a negligible fraction of the cost of such a payment, they see little reason not to make one.

Again, we wish to make clear that, taking managerial power as given, providing the target CEO with a gratuitous payment may well be beneficial for shareholders. When such sweetening is necessary to obtain board approval for a beneficial acquisition, shareholders are likely to be better off with both the gratuitous payment and the acquisition than with neither. Thus, accepting the reality of managers' power and influence over the board, prohibiting such payments is unlikely to be desirable. For our purposes, however, the critical point is that these payments indicate the existence of managerial power over directors.

Acquirer-Paid Sweeteners

In addition to benefits received from their own boards, target firm managers have often received substantial benefits from acquiring firms. An acquirer, of course, is not contractually obligated to give anything to the CEO of the firm being acquired. Nevertheless, such payments have often been made. The reason is simple: compensating these managers allows the acquirer either to proceed with the acquisition or to complete the deal on more favorable terms .

For example, when MCI was negotiating to be acquired by British Telecommunications in 1996, MCI's president, Timothy F. Price, arranged for a $170 million "retention pool" for himself and other key employees as part of his company's deal with BT.[60] Interestingly, the retention pool's existence did not depend on the deal's closing on the original agreed terms. When BT reduced its offer by 20 percent, Price acquiesced, telling shareholders the lower price was "a win-win arrangement for both companies." In the end, Worldcom outbid BT and acquired MCI, but only after it, too, agreed to pay retention bonuses to MCI's top executives.

A prominent mergers and acquisitions lawyer interviewed in the *New York Times* has said about the phenomenon of the acquirer-paid sweetener: "I have had a number of situations where we've gone to management

60 The story told in this paragraph is more fully covered in Andrew Ross Sorkin, "Those Sweet Trips to the Merger Mall," *New York Times*, 7 April 2002, sec. 3, p. 1.

looking to do a deal and been stopped at the door until a compensation arrangement was signed, sealed, and delivered." Another lawyer described it this way: "Publicly, we have to call these things retention bonuses. Privately, sometimes it's the only way we would have got the deal done. It's a kickback. And sometimes it's my job to negotiate the kickback."[61]

Hartzell, Ofek, and Yermack investigate the phenomenon more systematically. Examining 311 large-firm mergers completed between 1995 and 1997, they found that target CEOs accept lower acquisition premia when the acquirer promises them a high-ranking managerial post after the acquisition.[62] Another study by Julie Wulf found that, in 40 merger negotiations between equal-sized companies during the 1990s, CEOs were willing to trade higher acquisition premia for better managerial positions in the merged firm.[63]

The willingness of acquirers to pay off target executives provides further evidence of managerial power. Because CEOs can exert influence over their boards, they can prevent the acceptance of offers that are attractive to shareholders but harmful to the CEOs themselves. Conversely, they can convince their boards to accept acquisition offers that are in the CEOs' own interests, even if they are not in the best interests of the shareholders. Given this managerial power, treating CEOs of target firms generously has often been in acquirers' interest.

When CEOs Retire

Boards have often conferred large gratuitous benefits on CEOs who choose, for example, to retire because of age, even when substantial retirement payments are already specified by contract. For example, in 1999, when the market was rising but Kodak's stock price had fallen, Eastman Kodak gave its retiring CEO a $2.5 million parting gift in recognition of the company's financial performance.[64] In 2000, GE's CEO, Jack Welch, received

61 *Ibid*.

62 Jay Hartzell, Eli Ofek, and David Yermack, "What's In It for Me? CEOs Whose Firms are Acquired." *Review of Financial Studies* 17 (2004): 37-61.

63 Julie Wulf, "Do CEO's in Mergers Trade Power for Premium?: Evidence from "Mergers of Equals," *Journal of Law, Economics and Organization*, forthcoming 2004.

64 "Retired Kodak CEO Received 47% Boost in His Bonus in 1999," *Wall Street Journal*, 14 March 2000, p. A8.

a retirement gift of three million stock options, worth approximately $20 million.[65]

Golden retirement goodbyes sometimes have taken subtler forms. One way to provide substantial additional value to retiring CEOs is to make last-minute alterations to their retirement plans. For example, when CEO Terrence Murray retired, FleetBoston Financial Corporation modified his retirement plan to more than double the annual payouts: from 60 percent of his average salary and bonus over the last five years to 60 percent of the average of the highest three years of taxable compensation between 1996 and 2000. Taxable compensation was defined to include not only salary and bonus, but also option-exercise gains, the proceeds of sales of vested restricted shares, and the payout before retirement of some of Murray's deferred compensation. On the whole, the change boosted Murray's annual pension from an estimated $2.7 million to an estimated $5.8 million.[66] Reacting to this change, a Prudential Securities banking analyst noted that FleetBoston's shares "underperformed the average bank for a decade…" and wondered: "What happened to [just] getting a gold watch?" [67]

From the perspectives of the board and the retiring CEO, an important advantage of boosting post-retirement benefits is that the additional value given to the CEO is never reported in the firm's public filings. As we will discuss in Chapter eight, even though companies must disclose in their SEC filings the formulae used to calculate post-retirement benefits, they need not place a dollar value on these benefits. More importantly, the benefits' value is omitted from compensation tables, greatly reducing the salience of the benefits to the media and other outside observers. In the case of FleetBoston, the bank did not have to disclose (and in fact did not disclose) that the change in Murray's retirement plan would cost the company an additional $3.1 million each year. We know this only because a newspaper took the unusual step of retaining an actuary to calculate the figure. The camouflaging of retirement benefits in general is a subject to which we will return shortly.

---

65 Justin Fox, "The Amazing Stock Option Sleight of Hand," *Fortune,* 25 June 2001, p. 86-92.

66 Joann S. Lublin, "Executive Pay under the Radar," *Wall St. Journal*, 11 April 2002, p.B7.

67 *Ibid.*

Executives' contracts generally provide them with substantial retirement benefits. The practice of gratuitously augmenting these hefty benefits when a CEO retires does not reflect arm's length contracting. We will later question whether companies should even be in the business of providing retirement benefits for executives, rather than letting them save for retirement themselves. For now, however, we are focusing on gifts made to CEOs on the way out. One could argue that the prospect of a retirement gift might provide executives with an incentive to perform well during their tenure. It is hard to see, however, why well-designed option and bonus plans that reward excellent performance are not a better means of providing incentives than retirement gifts given at the discretion of the board.

Large retirement gifts are easier to understand in light of the personal relationships that directors have with departing CEOs. Directors may wish to take this last opportunity to confer value on the CEO to honor their collegial ties or express gratitude for what the CEO has done for them. According to one compensation consultant, the consulting contracts frequently given to retiring CEOs "often have more to do with favors for past deeds" than with future services.[68] And because the cost of these extra payments is generally borne by shareholders, there is little real cost to directors in making such personally satisfying gestures.

It's Now or Never

In each of the above contexts –- when CEOs are fired, when the firm is acquired, or when CEOs retire -- there is a common factor enhancing the willingness of the CEO to request gratuitous payments and increasing the willingness of the board to provide them. That factor is the end-game nature of the situation. In each case, the CEO leaves the company. And in one situation – acquisition of the firm – the directors are likely to leave the company as well. For this reason, they have little to lose.

As long as companies are expected to continue to exist independently, their CEOs know they will be able to use their influence to get favorable future treatment from their boards. At the same time, directors know they can reward their CEOs in the future. But impending change – whether resulting from forced resignation, acquisition, or voluntary retirement –

68 Gary Strauss, "CEO's Cash In after Tenure," *USA Today*, 25 April 2002, Money Section, p. B1.

presents both CEOs and boards with a "now or never" choice. CEOs have every reason to extract rents aggressively, cashing in whatever friendship and loyalty chips they have accumulated with directors. Likewise, directors know that this is their last opportunity to confer substantial financial benefits on their CEO at others' expense.

In addition, because each of these cases represents the last period of play for a CEO, the potential outrage costs of accepting a large package of additional benefits are likely to be low. When the firm is being acquired and the end of the company's independent existence is near, the directors, too, have little reason to be concerned about shareholder anger. Additionally, the acquirer usually pays a substantial premium over the pre-offer price, thereby conferring benefits on shareholders. All these factors likely lead to less shareholder outrage than might exist under other circumstances.

CHAPTER 8: RETIREMENT BENEFITS

Camouflage is an important element of the managerial power approach to executive pay. Compensation plan designers have an incentive to hide or make less salient the total value of an executive's compensation package. They also have an incentive to disguise the extent to which the form of compensation deviates from what best serves shareholders' interests. In this chapter and the next, we discuss various practices that have enabled plan designers to camouflage the amount of executive pay, and we start by discussing in this chapter the practice of conveying substantial value to executives after they retire.

As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to post-retirement payments and benefits as ways to compensate managers. These methods enable firms to provide a substantial amount of performance-insensitive value in a less salient form than, say, salary. Below we discuss four channels through which companies have been providing post-retirement value to executives: guaranteed retirement pensions, deferred compensation, post-retirement perks, and guaranteed consulting fees.

Before discussing each channel in detail, it is worth highlighting two attributes that they all share. First, these arrangements differ substantially from those that firms elect to provide to other employees. Although firms often provide pensions and deferred compensation to lower-level employees, they do so only to the extent that these arrangements receive a tax subsidy. This pattern suggests that, absent such a subsidy, pensions and deferred compensation are generally not efficient—and yet the arrangements provided to executives do not enjoy similar tax advantages. Furthermore, consistent with economists' belief that in-kind benefits are inefficient, firms do not generally provide retired employees with coverage for specified consumption expenses. Such benefits are, however, given to high-level executives. And although firms occasionally use retired employees as consultants when the need arises, they generally do not guarantee lifetime consulting fees to any employees other than executives.

The second shared attribute of these various retirement payments is that they all provide a way to obscure large amounts of performance-decoupled compensation. As we shall see, firms do not have to disclose the value transferred to executives through these channels in the same way that other forms of compensation -- such as salary, bonuses, and stock options – must be disclosed. Hence we use the term "stealth compensation."[69] Indeed, the dollar figures used by the media in reporting compensation levels, and by financial economists in their studies, usually do not include the large value provided to executives via these various retirement benefits.

Retirement Pensions

Many employees are covered by pension plans that provide payments to workers after retirement. At first glance, it seems only natural for firms to provide such benefits to their executives. A closer look, however, raises serious questions about whether the extensive use of executive pensions as a form of compensation reflects arm's length bargaining.

Differences from Regular Pensions

Most of the pension plans used for firm employees are designed to be "qualified" for favorable tax treatment. The firm gets a current deduction for contributing to a qualified plan for employees: the same deduction it would have taken had it paid the amount of the contribution to workers in the form of salary. Workers, however, do not pay income taxes on the pension money until after they retire and begin receiving payouts from the plan. In the meantime, the funds invested by the firm grow tax-free. Neither the firm nor the employees must pay any taxes while the fund's investments increase in value. Thus, the plans provide a tax benefit to employees at no cost to the firm.[70]

---

69 We borrow the term "stealth compensation" from Robert Monks, who used it to refer to executives' stock option compensation because that form of payment is not expensed on the firm's income statement. Robert A.G. Monks, *The Emperor's Nightingale: Restoring the Integrity of the Corporation in the Age of Shareholder Activism* (Boston: Addison-Wesley Pub Co, 1999), 59-62.

70 To illustrate how the tax subsidy provided to a qualified plan operates, consider the following examples involving a hypothetical firm and employee. Assume both face a 40 percent tax rate on all of their income, including capital gains. And assume that both

Given the opportunity, boards might well prefer to offer executives qualified retirement plans. A qualified pension plan, however, can use only about $200,000 of annual compensation as the basis for determining benefits under the plan. For example, a plan that promises to pay all retirees, annually, 50 percent of the compensation earned during their last year of service cannot pay a retired executive more than $100,000 annually, even if the executive earned $1 million of compensation during that final year. As a result, firms cannot use qualified plans to provide executives with pensions that are similar in size to their annual compensation. For this reason, most of the pension benefits that firms provide to executives come from non-qualified "supplemental" executive retirement pensions (known as "SERPs").[71]

SERPs differ from typical qualified pension plans in two critical ways. First, they do not receive the favorable tax treatment enjoyed by qualified plans. Unlike the case of a qualified plan, no investment income goes untaxed under a SERP. The company pays taxes on the income it must generate in order to pay the executive in retirement. If the money had been

---

are able to earn, between the pre-retirement period and retirement period, a pre-tax return of 100 percent on their investments.

Example 1: The employee invests for retirement outside a qualified plan. Suppose that the firm pays the employee $100 in the pre-retirement period. The firm deducts $100 from its taxable income, reducing its tax liability by $40. The employee pays $40 in taxes, takes the after-tax income of $60, and invests it. The $60 grows to $120 by the retirement period – a gain of $60. This $60 gain triggers a tax liability of $24 (40 percent of $60), leaving the employee with $96 ($60 + $36) when he or she retires.

Example 2: The firm invests for the employee's retirement under a qualified plan. Now suppose the firm contributes the $100 to a qualified pension plan in the pre-retirement period. The firm again deducts $100 from its taxable income, reducing its tax liability by $40. The $100 grows to $200 by the time of the employee's retirement – a gain of $100. The $200 is distributed to the employee, who pays a tax of $80 (40 percent of $200), leaving the employee with $120 -- $24 more than if the employee had received $100 from the firm in the pre-retirement period and saved for his or her own retirement. The gain to the employee does not come at the expense of the employer: in both examples, the employer incurs an after-tax cost of $60 in the pre-retirement period. It pays the employee or contributes to the employee's qualified plan $100, and has its tax liability reduced by $40.

71 Clark Bardes Consulting reports that almost 80 percent of responding firms use SERPs. Clark Bardes Consulting, "Executive Benefits: A Survey of Current Trends: 2001 Results," p. 33.

distributed as salary, on the other hand, the executive who invested the money for retirement would have to pay taxes on any income generated. Thus, the effect of the SERP is to shift some of the executive's tax burden to the firm.[72]

If the employee and the firm are subject to the same tax rate and are able to earn the same pre-tax rate of return on their investments, a SERP cannot reduce the amount of taxes paid by the parties. For every dollar the employee's tax burden is reduced, the firm's tax burden is increased by one dollar. Unlike a qualified plan, the SERP provides no tax efficiency benefit to the parties.[73]

---

72 A firm can shelter from taxation the investment income on funds set aside for financing executive pensions by investing these funds in life insurance policies on the lives of its executives and other employees. This tax-sheltering mechanism, however, involves significant costs, which are borne by the company rather than the executive. If, on the other hand, the executive received the funds to begin with, he or she would also be able to shelter the investment returns from taxation by purchasing a variable annuity, at no cost to the company.

73 To illustrate the effect of a SERP on the tax burdens of the parties, consider the following example and explanation, which builds on the examples provided in note 2. Assume again that both the firm and the executive face a 40 percent tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pre-tax return of 100 percent on their investments.

Example 3: The firm invests for the executive's retirement under a nonqualified plan. Suppose a firm seeks to use a SERP to give an executive the same retirement payment that it gives the employee in example 2 using a qualified plan. As in the case of the employee, the firm sets aside $100 to fund the executive's pension, which grows to $200 by the time the executive retires. The $200 is distributed to the executive, who, like the employee, pays a 40 percent tax on the retirement distribution – a tax of $80. This leaves the executive, like the employee in example 2, with $120, $24 more than the employee in example 1 made.

Now let us consider the effect of the SERP on the firm. In examples 1 and 2, discussed in note 2, the firm reduces its tax liability by $40 in the pre-retirement period when it pays the worker $100 or contributes $100 to the worker's qualified pension plan. In example 3, the firm reduces its tax liability by $80 in the retirement period when it pays the executive $200. However, the firm must add to its taxable income in the retirement period the $100 gain on the funds it previously invested for the executive's retirement, and this *increases* the firm's tax liability in the retirement period by $40. The net effect of the $200 payment to the executive and the $100 gain is to reduce the firm's tax liability by $40 during the retirement period.

In reality, of course, the situation is more complicated.[74] In many cases the total tax liability faced by the parties will be affected by whether the executive or the firm saves for the executive's retirement. Even if the firm and the executive are able to earn the same return on their investments, they may face different tax rates. Suppose, for example, that an executive investing his or her own funds for retirement in the stock market, paying a low long-term capital gains tax rate of 15 percent, while the firm pays taxes on the income generated for the executive's retirement at the highest corporate tax rate of 35 percent. In such a case, shifting retirement savings from the executive to the firm would be tax inefficient and reduce the amount of value available to the two parties. On the other hand, if the firm had no taxable earnings and was not expected to pay taxes for a considerable amount of time, the reverse might be true: shifting retirement savings from the executive to the firm might be tax efficient.[75]

Similarly, even if the firm and the executive face the same tax rate, the investment returns available to the firm may be higher than those available to the executive. For example, firms having difficulty raising capital may enjoy a higher expected rate of return on new investments than the market

---

Had the firm reduced its tax liability by $40 in the pre-retirement period, rather than during the retirement period, it could have invested the $40 and earned a pre-tax return of $40 (100 percent) by the retirement period. That $40 would also have been taxed at 40 percent, leaving the firm with $64. But by reducing its tax liability in the retirement period, the firm has only an extra $40, $24 less. The firm is thus worse off than in example 2, where it received the same $40 reduction in its tax liability in the pre-retirement period. The $24 gain to the executive from the use of a nonqualified plan designed to put the executive in the same position as an employee under a qualified retirement plan comes at the expense of the firm.

74 For an explanation of the tax effects of using arrangements such as SERPs to defer compensation under various scenarios, see Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Mayview, and Terry Shevlin, *Taxes and Business Strategy: A Planning Approach,* 2nd edition (Upper Saddle River, N.J., Prentice Hall., 2002), pp. 181-85.

75 The tax efficiency of a SERP will also be affected by expected changes in the firm's (or the executive's) tax rate change over time. For example, if the firm is losing money and thus unable to get a current tax benefit by deducting executive compensation in the current period, but is expected to be subject to a higher tax rate in the future, deferring an executive's compensation will , be tax efficient, all else being equal.

generally. (This is unlikely to be the case for companies with easy access to capital, as such companies are unlikely to have unutilized investments with returns much higher than the market.) If the firm has better investment opportunities, having it invest for the executive's retirement will be efficient for both parties, even if their tax rates are identical.

However, there is no reason to believe that, absent a tax subsidy, it is generally efficient to have the firm save for the executive. On the contrary, there are good reasons to think that it is *inefficient* for many firms to save for their executives' retirement, given individuals' low long-term capital gains tax rate. It is telling that firms providing SERPS to executives do not offer nonqualified retirement plans to other employees. Consider the case where it is efficient for a firm to provide a SERP to its executives because the firm has better investment opportunities than they do. In such a case, it should also be efficient for the firm to provide nonqualified retirement to its non-executive employees who supplement their qualified pensions with personal retirement savings. Yet firms rarely if ever do so. That fact suggests that there is little benefit to shifting employee retirement savings from the employee to the firm, absent the tax subsidy provided to qualified plans. Yet in 2002 more than 70 percent of firms provided non-qualified SERPs to their executives.[76] The second important difference between executive SERPs and qualified pension plans for non-executive employees concerns the risk borne by the firm and by the participant. Qualified pension plans offered to lower-level employees are usually based on a *defined contribution*. The firm commits to contribute a specified amount each year. The value available to an employee upon retirement depends upon the performance of the plan's investments. The risk of poor investment performance falls entirely on the worker.

In contrast, SERPs are *defined benefit* plans, which guarantee fixed payments to the executive for life. All of the CEOs in the S&P ExecuComp database have defined benefit plans.[77] These plans shift the risk entirely to the firm and its shareholders. No matter how poorly the firm and its

---

76 Clark Bardes Consulting, "Executive Benefits: A Survey of Current Trends: 2003 Results," p. 26.

77 Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002): 175.

investments perform, the executive is guaranteed a lifelong stream of payments.

Given that arm's length negotiations with most employees lead to defined contribution arrangements, why should arm's length bargaining with executives yield such a different result? If anything, defined benefit plans should be *more* valuable to regular employees and thus a form of compensation that is more efficient for these workers than it is for executives.

Unlike most executives, ordinary employees are unlikely to accumulate substantial wealth over their lifetimes. They are likely to be more dependent on their pensions to meet their financial needs in retirement and less able to bear the investment risks associated with defined contribution plans. Executives faced with defined contribution plans, on the other hand, could easily insure themselves against poor investment performance by using some of their already high salaries and option-based compensation to buy fixed annuities that would provide them with guaranteed payments. If only one of the two groups could receive defined *benefit* plans, arm's length contracting would predict that employees, not executives, would get them.

Camouflage Benefits

Although the efficiency benefits of providing executives with defined-benefit SERPs is far from clear, such plans do considerably reduce the visibility of a substantial amount of performance-insensitive executive compensation.

In their annual public filings, firms must publish compensation tables indicating the dollar value of different forms of compensation received by the current CEO and the four other most highly paid executives of the firm. The numbers in these tables are the most visible indicators of executive compensation in public firms. They are easily accessible to the media and others reading the public filings. Indeed, the standard databases of executive compensation, which are used by both financial economists and compensation consultants, are based on these numbers.

Although deposits to a defined contribution plan must be reported in the compensation tables, the increase in the present value of an executive's defined benefit plan is largely hidden from view: firms are not required to include that data. Furthermore, because the executive is no longer an officer of the firm when the pension payments begin, his or her compensation need not be included in the published tables then, either. Thus, the value of an executive's pension *never appears* in the place where the media and researchers collect most of their information about executive compensation. And because the value of an executive's pension payouts is obscured, the performance-insensitivity of such payments also gets little notice.

Consider a situation in which a CEO serves a company for ten years and then receives a payment annually, for life, that almost equals the compensation earned during his or her last year of service. In such a case, the total value of the pension payments may in the end exceed the value of the salary payments made during the CEO's actual tenure. Unlike the salary amounts, however, the pension values will never appear in the firm's public compensation tables.

For example, when IBM CEO Louis Gerstner retired after about nine years of service, he was entitled to a $1,140,000 annual pension beginning at age 60. In addition, he received a SERP plan that, according to the formula provided in IBM's proxy filings, would pay out over $2 million per year after he retired.[78] If Gerstner were to receive these two pensions for 20 years, their $60 million total would easily dwarf the approximately $18 million in salary he received while CEO. The retirement sums will comprise the largest single component of his fixed compensation, which is completely decoupled from company performance. GE's former CEO, Jack Welch, left his firm with an annual pension of almost $10 million.[79] Given his age, he is likely to receive more than $100 million in retirement payments, none of which will ever appear in the firm's compensation tables.

Not surprisingly, SERP plans are designed and marketed specifically as ways to increase compensation "off the radar screen of shareholders."[80] Indeed, according to media reports, some directors have voted to adopt

78 See http://www.aspanet.org/publications/COLUMNS/archives/2003/07/thayer0703.html (last visited March 15, 2004).

79 Paul Hodgson, "Golden Parachutes and Cushioned Landings," The Corporate Library (February 2003), p. 14.

80 Cynthia Richson, quoted in Liz Pulliam Weston, "Despite Recession, Perks for Top Executives Grow," *Los Angeles Times*, 1 February 2002, p. A1.

SERPs only after being reassured that the amounts involved do not have to be reported to the public.[81]

To be sure, although neither the increase in value of the SERP plan before retirement nor the amount of payments after retirement appears in the compensation tables, the existence of SERPs and the formulae under which payouts are made must be disclosed in the firm's SEC filings.[82] But it is difficult for anyone without actuarial or financial training to estimate accurately the value – and thus the cost to the company – of these future payments.[83] As noted above, firms are not required to supply, and usually do not provide, any estimate of the value of a particular executive's defined benefit pension plan.

Indeed, it is often difficult even to figure out the total SERP liability of a firm with respect to its executives as a group. A firm must report only one figure: the sum of the liabilities associated with all of its plans that are "unfunded" or "underfunded" (i.e., plans for which the firm does not have assets set aside to cover the plans' liabilities fully).[84] The Financial Accounting Standards Board (FASB) does not require that liabilities associated with SERPs be itemized separately.[85] Thus, firms can simply report one number that represents all the liabilities associated with underfunded qualified plans and unfunded SERPs.

---

81 See Glenn Howatt, "HealthPartners Ex-CEO Reaped Board's Favors: Secret Deals Contributed to $5.5 million Package," *Star Tribune* (Minneapolis), 17 January 2003, p. A1. The *Star Tribune* reported that the HealthPartners board adopted a SERP for the CEO "after receiving assurances that the supplemental retirement plan wouldn't have to be reported to the public…" and "rejecting a suggestion that awards in the plan be tied to company performance."

82 In addition, firms are required to file a letter with the Labor Department indicating the number of executive pension plans and the number of participants. However, not all firms comply with this requirement. Ellen E. Schultz, "Big Send-Off: As Firms Pare Pensions for Most, They Boost Those for Executives," *Wall Street Journal*, 20 June 2001, p.A1.

83 See Joann S. Lublin, "Executive Pay under the Radar," *Wall St. Journal*, 11 April 2002, p.B7; Anne Fisher, "Proxies: The Treasure Is Still Buried," *Fortune,* 8 June 1998, p. 285.

84 See Financial Accounting Standard no. 132 (revised 2003).

85 See Financial Accounting Standard no. 87 (1985).

Although they are not required to do so, some firms do report the total obligations arising under SERPs. These figures can be staggering. In 2000, for example, GE reported a $1.13 billion pension liability for executives.[86] Unfortunately, GE did not report what portion of this amount was due specifically to its CEO and other top executives. Most companies, however, do not even break down pension liabilities into separate categories for executives and other employees.

Before concluding our discussion of retirement plans, it is worth noting at least one way in which executives' plans may not be as advantageous to their beneficiaries, relative to the plans of lower-level employees. Firms using qualified plans are required, as a condition for favorable tax treatment, to set aside assets to ensure that they can pay their liabilities under the plans. Given that executives' SERP plans would not qualify for the favorable tax treatment even if they were so funded, firms do not bother funding SERP plans. Executives' retirement benefits are thus at greater risk of nonpayment than the benefits of ordinary workers—and Congress is considering legislation that would make it difficult for firms to shelter executives from this risk.

In the past, however, firms facing financial problems often purchased insurance policies that guaranteed payment of executive retirement benefits, simply gave the money to the executive or a designated trust, or took other steps to guarantee the benefits against insolvency.[87] Delta Airlines, for example, set up an executive-protecting arrangement shortly after September 11, 2001, when it appeared that terrorist attacks could ruin the airline industry.[88] Although putting the money beyond the reach of the firm's creditors triggers a tax liability for the executive, firms often "gross

86 Ellen E. Schultz, "Big Send-Off: As Firms Pare Pensions for Most, They Boost Those for Executives," *Wall St. Journal,* 20 June 2001, p. A1.

87 Clark Bardes Consulting reports that 86 percent of firms responding to a survey use security devices to protect SERPs to the greatest extent possible. See Clark Bardes Consulting, "Executive Benefits: A Survey of Current Trends, 2001 Results," p. 33; Ron Suskind, "More Executives Get Pension Guarantees to Protect against Takeovers, Failures," *Wall St. Journal*, 5 July 1991, p. B1; Theo Francis and Ellen Schultz, "As Workers Face Pension Cuts, Executives Get Rescued," *Wall Street Journal,* 3 April 2003, p. C1.

88 Theo Francis and Ellen Schultz, "As Workers Face Pension Cuts, Executives Get Rescued," *Wall Street Journal*, 3 April 2003, p. C1.

up" the payment to cover part or all of that liability.[89] It was reported in 1991 that approximately 50 major companies had set up fully guaranteed executive pension plans.[90] This practice may have been much more widespread; many firms, fearing criticism that they are insulating managers from the effects of their own failures, fail to announce the existence of such guarantees.[91]

Deferred Compensation

Deferred compensation is a second technique used to transfer large amounts of mostly performance-insensitive value to executives without attracting much shareholder attention. Many executives choose, or are sometimes even required, to defer receipt of compensation until some future date. In the meantime, the deferred compensation "builds" according to a formula devised by the firm. Executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company. At that time, the firm takes a tax deduction for the amount paid. Most large companies have plans of this kind.[92]

Deferred compensation plans differ. Some firms require that managers receiving salary in excess of $1 million, which would otherwise be nondeductible under Section 162(m), defer the excess. Other firms have purely elective plans. Some arrangements permit deferral of salary only; others also allow deferral of long-term incentive compensation and gains from the exercise of stock options or the sale of restricted stock. Companies frequently provide matching contributions, with the amounts varying from

---

89 Theo Francis and Ellen Schultz, "As Workers Face Pension Cuts, Executives Get Rescued," *Wall Street Journal,* 3 April 2003, p. C1.

90 See Ron Suskind, "More Executives Get Pension Guarantees to Protect against Takeovers, Failures," *Wall St. Journal,* 5 July 1991, p. B1.

91 See Ron Suskind, "More Executives Get Pension Guarantees to Protect against Takeovers, Failures," *Wall St. Journal,* 5 July 1991, p. B1.

92 Clark Bardes Consulting reports that close to 93 percent of firms responding to a survey say they had such plans in 2002. Clark Bardes Consulting, "Executive Benefits: A Survey of Current Trends: 2003 Results" p.2.

firm to firm. At some companies, contributions are awarded at the board's discretion. At others, they are determined by formulae.[93]

Plans also differ in how the deferred compensation is "invested," i.e., how the amount owed to the executive at the end of the deferral period is determined. Many companies provide a guaranteed rate of return (or a guaranteed minimum rate) on the funds.[94] Firms grant extra benefits to executives by providing rates of return that are higher than the market rate. For example, in 2001, at a time when one-year Treasury bills offered returns of 3.39 percent to 4.63 percent, both GE and Enron guaranteed executives a 12 percent rate of return. Other firms offer a market return plus a premium. For example, Lucent has offered the return on the ten-year Treasury bill, plus 5 percent. [95]

Difference from 401(k) Plans

Deferred compensation arrangements appear analogous to the familiar 401(k) plans used by many employees. But, as in the case of SERPs and the qualified retirement plans offered to lower-level employees, there are some important differences.

The 401(k) plans give workers an opportunity to put money in designated investment instruments; whatever the investments, employees get the same pre-tax returns they would receive by investing in similar instruments outside the 401(k) plan. In contrast, executives' deferred compensation arrangements often provide higher returns than those available in the market.

In addition, 401(k) plans are given a tax subsidy, while executive deferred compensation plans are not. Under a 401(k) plan, a fraction of the employee's salary is placed in a tax-deferred account. The firm may also

---

93 For example, when Sears Roebuck & Co. executives postpone bonuses and long-term incentive pay, they receive an additional contribution equal to 20 percent of the amount deferred. Ellen E. Schultz and Theo Francis, "Well-Hidden Perk Means Big Money for Top Executives," *Wall St. Journal*, 11 October 2002, p. A1, A9.

94 Liz Pulliam Winston, "Despite Recession, Perks for Top Executives Grow," *L.A. Times*, 1 February 2002, p. A1.

95 See Joann S. Lublin, "Executive Pay under the Radar," *Wall St. Journal*, 11 April 2002, p.B7.

make a separate contribution to the account. As in a qualified retirement arrangement, the funds are invested and grow tax-free. Neither the firm nor the employee pays taxes on the income and capital gain generated in the account. Employees do not pay taxes on the contributions or the increase until they withdraw the funds. The employer, on the other hand, gets a deduction for both its contribution and the employee's contribution to the 401(k) plan. By placing current compensation in a 401(k) account, the employee gains the benefit of tax deferral without the employer's loss of a tax deduction.[96]

Firms could provide deferred compensation to executives through 401(k) plans. However, there are limits on how much money can be contributed annually to a 401(k) account. For the tax year 2004, employees covered by such a plan ordinarily cannot defer more than $13,000 of compensation.[97] In order to provide executives with amounts exceeding this limit, firms implement deferred-compensation arrangements outside the

---

96 To illustrate how the tax subsidy provided to a 401(k) operates, consider the following examples involving a hypothetical firm and employee. As in the SERP examples found in note 2 (examples 1 and 2), assume that both the firm and the employee face a 40 percent tax rate on all of their income. Assume also that both are able to earn, between the pre-retirement and retirement periods, a pre-tax return of 100 percent on their investments.

Example 4: The employee saves outside the 401(k) plan. Suppose the firm pays the employee $100 in the pre-retirement period. The firm deducts $100 from its taxable income, reducing its tax liability by $40. The employee pays $40 in taxes, and invests the after-tax income of $60 in an ordinary, non-qualified investment account. By the retirement period, the $60 grows to $120 – a gain of $60. The employee pays a tax of $24 on the gain (40 percent of $60), leading to an after-tax gain of $36. The employee is thus able to withdraw a total of $96 ($60 + $36).

Example 5: The employee saves under a 401(k) plan. Now suppose that the employee contributes $100 of compensation income to a 401(k) account. The firm again deducts $100 from its taxable income, reducing its tax liability by $40. The $100 grows to $200 by the time the employee withdraws the funds from the 401(k) account. The employee pays a tax of $80 (40 percent of $200), leaving the employee with $120 -- $24 more than in example 4, where the employee received $100 from the firm in the pre-retirement period and saved the money outside of the 401(k) plan. The $24 gain to the employee does not come at the expense of the employer.: In both example 4 and example 5, the employer pays the employee $100 in the pre-retirement period, thereby reducing its taxable income by $100 and its tax liability by $40.

97 Internal Revenue Code, section 402(g)(1)(B).

tax-advantaged framework of 401(k) plans. Executives' deferred compensation is therefore not based solely, or even primarily, on 401(k) plans.

Rather than contribute a portion of the executive's compensation o an account where the investment grows tax-free, the firm simply withholds part of the executive's pay and credits the executive each year with a pre-specified return on the money, allowing it to "grow" over time. The withheld compensation, along with the appreciation credited to it by the firm, is paid to the executive at a later date.

The company pays taxes on the income it must generate in order to pay the executive the promised buildup of the deferred compensation. If, on the other hand, the deferred compensation had been distributed when it was originally owed the executive, the executive would have invested the money and paid taxes on any income generated. Thus, as in the case of a SERP, the effect of executive deferred compensation is to shift some of the executive's tax burden to the firm.[98]

If the employee and the firm are subject to the same tax rate and are able to earn the same pre-tax rate of return on their investments, executive deferred compensation, like a SERP, cannot reduce the parties' joint tax burden. While every dollar of deferred compensation lowers the executive's taxes, it boosts the firm's taxes by one dollar. Like a SERP, and unlike qualified 401(k) and retirement plans, deferred compensation plans for executives provide no tax efficiency benefit.[99]

---

98 A firm can shelter from taxation investment income on funds set aside for financing executive pensions by investing these funds in life insurance policies on the lives of its executives and other employees, but this will impose other costs on the firm. See note 4.

99 To illustrate the effect of executive deferred compensation arrangements on the tax burdens of the parties, consider the following example and explanation, which refer to examples 4 and 5 provided in note 29.

Example 6: The firm offers the executive deferred compensation outside of a 401(k) plan. Assume, as in examples 4 and 5, that both the firm and the executive face a 40 percent tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pre-tax return of 100 percent on their investments.

Suppose a firm seeks to use deferred compensation to give an executive the same (100 percent) return the firm provides the employee in example 5 using a 401(k) plan. As in the case of the employee, the firm sets aside $100, which grows to $200 by the time the

As in the case of SERPs, of course, there will be many cases in which deferred compensation outside 401(k) plans can increase or reduce the total amount of value available to the executive and the firm.[100] Even if the firm and the executive are able to earn the same return, they may face different tax rates. If the firm faces a lower rate than the executive, it might well be efficient, from the perspective of both parties, for the firm to defer compensation and bear the (small) tax cost. Even if the firm and the executive face the same tax rate, the investment returns available to the firm may be higher than those available to the executive (although, as we noted in our discussion of SERPs, this is unlikely to be the case for companies with easy access to capital). If the firm does have better investment opportunities,

---

executive withdraws the deferred compensation and the buildup credited to the designated amount of deferred compensation. The $200 is distributed to the executive. Like the employee, the executive pays 40 percent tax on the retirement distribution – a tax of $80. This leaves the executive, like the employee in example 5, with $120, $24 more than the employee saving on his own ended up with in example 4.

Now let us consider the effect of the executive's deferred compensation arrangement on the firm. In examples 4 and 5, the firm reduces its tax liability by $40 in the pre-retirement period when it pays the worker $100 or contributes $100 to the worker's qualified pension plan. In example 6, the firm reduces its tax liability by $80 in the retirement period when it pays the executive $200. However, the firm must add to its taxable income in the retirement period the $100 generated to boost the executive's withdrawal payout from $100 to $200—which in turn increases the firm's tax liability by $40. The net effect of the $100 gain and the $200 payment to the executive is to reduce the firm's tax liability by $40 during the retirement period. The firm is thus worse off than in example 2, where it received the same reduction in its tax liability in the pre-retirement period.

Had the firm reduced its tax liability by $40 in the earlier period, it could have invested the $40 and earned a pre-tax return of $40 (100 percent) by the retirement period. The $40 would have been taxed at 40 percent, leaving the firm with $64. By reducing its tax liability in the retirement period, the firm has only an extra $40, $24 less. Thus, the $24 gain to the executive from the use of a deferred compensation arrangement designed to put the executive in the same position as an employee under a qualified 401(k) comes at the expense of the firm.

100 For an explanation of the tax effects of deferred compensation under various scenarios, see Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Mayview, and Terry Shevlin, *Taxes and Business Strategy: A Planning Approach,* 2nd edition (Upper Saddle River, N.J., Prentice Hall., 2002), pp. 181-85.

having it invest for the executive's retirement may yield a larger retirement pie, even if their tax rates are identical.

As we noted in our examination of SERPs, however, there is no reason to believe that, absent the tax subsidy provided by qualified plans, there is generally a benefit to the parties if the firm defers the executive's compensation. In many cases, the tax burden on the firm is greater than the tax benefit to the executive, thus increasing the total tax the two parties pay to the government. Consider, for example, the case in which an executive is promised a return that is linked to a stock index. If the executive invests the money in shares of a stock index fund, the gains will be taxed at the long-term federal capital gains rate, which in the highest bracket is 15 percent (as of 2003[101]). If, instead, the firm invests the money – in those shares, other investments, or its own business – the gains could be taxed at the highest marginal rate for firms, 35 percent.[102]

Yet 90 percent of firms provide such arrangements to their executives.[103] As in the case of SERPs, there are good reasons to think it inefficient for many of these firms to being do so. It is curious that firms offering nonqualified deferred compensation arrangements to executives do not offer such nonqualified plans to other employees. After all, if nonqualified deferred compensation is efficient for certain executives and firms because the firms have better investment opportunities than the executives, nonqualified deferred compensation should also be efficient for the non-executive employees of these firms, who supplement their 401(k) plans –

---

101 IRC. Sec. 1 (2003).

102 IRC. Sec. 11 (2003). As in the case of SERPs, a firm can reduce the tax cost of deferred compensation by using company-owned life insurance. Recall that under this strategy, the firm uses after-tax dollars to buy insurance on the lives of its executives and other employees. Part of the premium is invested, increasing the "cash value" of the policy. The policy is then cashed out when funds are needed to pay deferred compensation. The tax savings come from life insurance policies' capacity to shelter from taxes the buildup of the cash value. However, the use of a life insurance policy to avoid taxes gives rise to transaction costs. A 1996 study found that 70 percent of the 1,000 largest firms did not use insurance for funding deferred compensation, which suggests that these costs can be quite high. See Christopher Drew and David Cay Johnston, "Special Tax Breaks Enrich Savings of Many in the Ranks of Management," *New York Times*, 13 October 1996, sec. 1, p. 1.

103 Clark Bardes Consulting, "Executive Benefits: A Survey of Current Trends: 2001 Results."

which allow only a modest contribution annually -- with their own personal retirement savings. The fact that firms rarely if ever provide lower-level employees with the option of non-qualified deferred compensation arrangements in addition to their 401(k) plans suggests that there is a significant cost to firms in deferring executive compensation apart from 401(k) plans.

Camouflage Benefits

Although it is far from clear that deferred compensation arrangements provide efficient-contracting benefits, their camouflage value is substantial. Deferred compensation must be reported in the compensation tables in the year in which it would otherwise have been received. However, the substantial benefit conferred by deferred compensation – the tax-free and often above-market buildup over time -- is usually not salient.

Even assuming that the nominal rate of return used by a deferred compensation arrangement is no higher than the market rate, the effective interest rate earned by executives is higher than it appears because of the substantial tax benefits. Executives must pay taxes on investment income earned outside deferred compensation arrangements, but investing *within* such plans provides them, at the expense of the firm, with a tax-free build-up. Thus, as long as the rate of return in deferred compensation arrangements is above the after-tax rate of return, the executive makes substantial gains that do not show up in the compensation tables. The *New York Times* reported, for example, that CEO Roberto Goizueta of Coca-Cola was able to defer taxes on $1 billion of compensation and investment gains over a 17-year period.[104] Coca-Cola picked up the tab, paying taxes on the earnings needed to cover the returns credited to Goizueta's deferred compensation account.[105]

As also noted above, 401(k) plans offer lower-level workers returns equivalent to those available in the bond or stock markets, but many deferred compensation arrangements provide executives with substantially higher returns. These executives are thus receiving investment income that

104 See "Tax Deferred Pay for Executives," *New York Times*, 18 October 1996, p. A36.

105 According to Coca Cola's annual reports to shareholders, it paid taxes on its income in every year of Goizueta's tenure except 1992.

is not only tax free for them (at the expense of the firm) but also above-market. The benefits from these above-market returns, which may be quite large, can also be hidden to a significant extent.

The SEC requires firms to include in the compensation table for each executive only the above-market interest earned that year on deferred compensation. In the case of a guaranteed interest rate, "above-market" interest is defined as returns in excess of 120 percent of the applicable federal rate (AFR) used by the IRS at the time the guaranteed interest rate is set, multiplied by the amount of deferred compensation. As a result of the SEC's definition of "above-market rate," a firm can provide its executives with rates of return that may be higher than they could get on their own—and the firm need not include this benefit in the compensation tables.

The threshold used by firms for "market" long-term rates of return is especially generous because boards can reset interest rates whenever doing so benefits executives. If market interest rates and the AFR rise so that the current guaranteed rate is not especially attractive, the firm can simply adopt a new, higher, guaranteed rate. As long as the reset rate is lower than 120 percent of the new, higher AFR, the additional interest accruals need not be reported in the compensation tables. If, however, market interest rates and the AFR fall, the firm can continue to pay at the old guaranteed rate, which is now above market. And because the AFR used for the disclosure threshold is that prevailing when the guaranteed interest rate was initially set, no matter how low market rates drop, the above-market interest paid to the executive never appears in the compensation tables.

Finally, even benefits that come from rates of return exceeding the SEC's threshold are unlikely to be fully reflected in the compensation tables. The reporting requirement ends when the executive retires, but the executive often has the option to continue enjoying the above-market rates. Thus these extra earnings paid to retirees -- which can be quite substantial -- never appear in the firm's publicly filed compensation tables.

As in the case of SERPs, deferred compensation plans for executives are in one respect less advantageous to their beneficiaries than the 401(k) plans provided to lower-level employees. The 401(k) plans are backed by their assets, which cannot be seized by the firm's creditors. In contrast, deferred compensation is merely a promise by the firm to pay compensation in the future. The executives owed this compensation are thus unsecured creditors who may not be paid in full if the firm becomes insolvent. As with

SERPs, Congress is considering legislation that would make it difficult for firms to shelter executives from this risk.

To date, however, executives have faced much less risk than might appear. Again as with SERPs, many firms have taken the additional step of using "security devices," such as trusts, to ensure that funds will be available to the executives. In addition, executives are usually free to withdraw deferred compensation at any time – such as when inside information suggests a firm is about to fail. Shortly before Enron filed for bankruptcy, for example, its executives withdrew millions of dollars of deferred compensation. Thus, executives' risk of losing deferred compensation due to company insolvency has been minimal.

For executives and their friends on the board, SERPs and deferred compensation have thus provided a means for channeling large amounts of money to the executive in a way that, under current disclosure regulations, has been difficult for outsiders to understand. As one compensation analyst pointed out: "The disclosure of the myriad executive compensation plans – pension, supplemental executive retirement plans, deferred compensation, split dollar life insurance – is not adequate in answering a fundamental question: What is the projected value of these plans to the executive upon his retirement?"[106]

Perks in Retirement

Many compensation contracts promise executives a substantial stream of perks after retirement. For example, many executives receive a certain number of hours of corporate aircraft use annually for themselves, and sometimes for their families and guests as well. Some executives have even received unlimited lifetime use of corporate aircraft.[107] Other perks that often follow the executive into retirement are chauffeured cars, personal assistants, financial planning, home security systems, club memberships, sports tickets, office space, secretarial help, cell phone service, and access to company dining and fitness facilities.[108] Outgoing IBM CEO Lou Gerstner,

---

106 Gretchen Morgenson, "Executive Pay, Hiding Behind Small Print," *New York Times*, 8 February 2004, Section 3, p.1.

107 The Corporate Library, Special Report: "The Use of Company Aircraft" (October 2001).

108 See Joann S. Lublin, "Executive Pay under the Radar," *Wall St. Journal*, 11 April

for example, was given access to apartments, planes, cars, home security services, and financial planning. Terrence Murray, former CEO of FleetBoston, received 150 hours of company aircraft use, a chauffeured car, an office, office assistants, financial planning, and a home security system.

Another common benefit is giving contributions to the retiring CEO's favorite charities. For example, FleetBoston gave $3.5 million in contributions to Murray's favorite charities he ability to direct the firm's charitable contributions. And Ford promised retiring CEO Jacques Nasser to endow a scholarship in his name at the educational institution of his choice (along with a new car each year, financial planning assistance, an office and an assistant). [109]

Most of these perks cost the company more than may be apparent at first glance. Consider retiree use of corporate jets, now a common perk. Although the marginal cost of allowing a retired executive to use the company jet may appear limited,[110] consider such an executive's flight from New York to California and then back several days later. Because the New York-based aircraft and flight crew will return to the East Coast after dropping the retired executive off, the actual charge to the company is two round trips: a total of eight takeoffs and landings and approximately 20 hours of flying time most likely costing -- for fuel, maintenance, landing fees, extra pilot and crew fees and incidentals, and depreciation (an aircraft's operating life is reduced for every hour it flies and, more importantly, for every takeoff and landing) –– at least $50,000.[111] Henry R. Silverman, CEO of Cendant, was promised lifetime use of the corporate aircraft or, if the plane were in use, an equivalent chartered plane at a direct cost of thousands of dollars per hour.[112]

2002, p.B7; Gary Strauss, "CEOs Cash In after Tenure," *USA Today*, Money Section, 25 April 2002, p1B.

109 See Joann S. Lublin, "Many Former Chief Executives Get Lush Perks and Fat Fees for Limited 'Consulting' Work," *Wall Street Journal*, 13 September 2002, p. B1.

110 This misperception led one compensation consultant to label jet use as "an efficient way of delivering something of value to the executive." Yale D. Tauber, quoted in Joann S. Lublin, "Executive Pay under the Radar," *Wall St. Journal*, 11 April 2002, p.B7.

111 We would like to thank Marc Abramowitz and Yitz Applbaum for useful discussion on the cost of operating corporate jets.

112 The Corporate Library, Special Report: "The Use of Company Aircraft" (October

Firms do not regularly provide post-retirement perks to lower-level employees. There is good economic logic to avoiding such in-kind compensation. Promising a retiring employee $10,000 a year for travel expenses is less efficient than providing $10,000 in cash. The reason is straightforward. If the retiree views travel as the best way to spend $10,000, the cash and the travel coverage will have identical utility. However, cash is superior if there are any possible circumstances in which the retiree would prefer spending some or all of the money on goods or services other than travel, because the retiree will receive greater utility at the same cost.

A retiree's needs and preferences are likely to change over time. Thus economic logic suggests that if in-kind retirement benefits are provided, they should not be provided for long periods. Yet such long-term, in-kind benefits are often provided to retired CEOs: for example, Louis Gerstner of IBM received use of a plane, cars, offices, and financial planning services for ten years.

Although post-retirement perks are unlikely to be an efficient form of compensation, they are an effective way to camouflage it. Non-monetary perks in particular enable the board to provide additional value to executives without ever including the expected benefits in compensation tables or even placing an explicit monetary value on them. The value of such perks is not reported when they are agreed to, and the firm incurs the expenses only after the executive has left, at which point any value provided is no longer included in the compensation tables—the records most salient to outsiders and, importantly, the basis for most studies and comparisons.

Consulting Contracts

Like perks, consulting contracts provide substantial value to retired executives. They usually offer the retiring CEO an annual fee for "being available" to advise the new CEO for a specified amount of time per year. Approximately 25 percent of CEOs negotiate a post-retirement "consulting" relationship with their old firm.[113] Such contracts often extend for the life of the retiring executive, or if not, then for a very long period of time.

2001).

113 Ira Kay, cited in Gary Strauss, "CEOs Cash In after Tenure," *USA Today*, Money Section, 25 April 2002, p 1B.

For example, AOL Time Warner is paying retired CEO Gerald M. Levin $1 million per year to serve as an adviser for up to five days per month.[114] In 2000, retiring Carter-Wallace CEO Henry Hoyt was promised annual payments of $831,000 for the same monthly obligation.[115] Verizon co-CEO Charles Lee negotiated a $6 million consulting contract for the first two years of retirement. Delta Airlines CEO Ronald Allen's 1997 retirement package provided him with a seven-year, $3.5 million consulting deal under which, according to Delta's public filings, he was "required to perform his consulting services at such times, and in such places, and for such periods as will result in the least inconvenience to him."[116] Allen or his heirs will be entitled to the annual fee of $500,000 even if he is totally disabled or dead.[117]

The evidence indicates that these consulting arrangements are largely a severance payment to the departing executive disguised as compensation for post-retirement work. For better or worse, new CEOs hesitate to contact previous CEOs for advice.[118] For example, Ronald Allen reportedly "rarely talks" with the new Delta chief executive, Leo Mullin. Even compensation consultants acknowledge that retired executives add little if any value to the firm under these arrangements. According to Frank Glassner, CEO of Compensation Design Group, most of these consulting contracts are merely a way of increasing the severance payment to the departing executive. According to another executive compensation expert, Alan Johnson, "most former CEOs are doing very little for what they're getting paid…. Usually, the demands [from new management] are miniscule."

Like post-retirement perks, the consulting payments to retired executives never find their way to the compensation tables because they occur when the executive is no longer an officer. However, these contracts enable boards to provide retired executives with something more valuable

---

114 Joann S. Lublin, "Many Former Chief Executives Get Lush Perks and Fat Fees for Limited 'Consulting' Work," *Wall Street Journal*, 13 September 2002, p. B1.

115 Gary Strauss, "CEOs Cash In after Tenure," *USA Today*, Money Section, 25 April 2002, p.1B.

116 *Ibid*.

117 Joann S. Lublin, "How CEOs Retire in Style," *Wall St. Journal*, 13 September 2002, p. B1.

118 The examples and quotations in this paragraph are taken from Joann S. Lublin, "How CEOs Retire in Style," *Wall St. Journal*, 13 September 2002, p. B1.

than in-kind perks: dollars.[119] Retirement consulting fees are essentially a cash severance payment, turned over in installments.

If these fees are just a form of cash severance, what is the advantage of packaging them as consulting agreements? Besides ensuring that the payments are kept out of the compensation tables, the consulting fees obscure the cost of the arrangement. Although the firm discloses the existence of the consulting arrangement, it does not disclose its total dollar value. Furthermore, the future expenditures appear legitimate to observers who believe the outgoing CEO will in fact provide advice to new management. Needless to say, these consulting agreements do not tie the retired executive's pay to any personal contribution to shareholder value either before or after retirement.

De-coupling Pay from Performance

Although succeeding chapters will discuss at length the insufficient correlation between pay and performance in executive compensation, it is worth pausing here to note that the retirement payments we have described in this chapter are largely insensitive to managerial performance. SERPs simply provide executives with some additional multiple of their cash compensation that is largely independent of performance. Deferred compensation provides value to executives through the tax-free income buildup at favorable rates that are not affected by managers' performance. Likewise, post-retirement perks and consulting fees are generally fixed in advance, rather than made contingent on future performance.

It could be argued that these retirement benefits reflect arm's length contracting because they provide performance-insensitive compensation in a more tax-efficient way. According to section 162(m) of the Internal Revenue Code, firms cannot deduct more than $1 million in non-performance-based pay for any given executive. However, firms can circumvent this problem by paying performance-decoupled compensation *after* the executive retires, when the rule does not apply. If for some reason it were efficient to provide

---

119 Of course, there are cases where even these outlays are hidden by the provision of in-kind value rather than cash. For departing CEO Hugh McColl's continuing "advice and counsel," Bank of America is providing him or members of his family with 150 hours of flying time on corporate aircraft. See Gary Strauss, "CEOs Cash In after Tenure," *USA Today*, Money Section, p. B1. This perk has a value of $500,000 or more.

executives with large amounts of performance-insensitive compensation, there would indeed be tax advantages to doing so though retirement benefits rather than through additional cash salary. The channeling of value through retirement benefits not only keeps the compensation out of shareholders' sight but also beyond the reach of section 162(m).

It is doubtful, however, that the tax advantages of these retirement benefits justify their use. Providing incentives to improve performance is offered as a primary justification for large executive compensation packages. Thus, there are reasons to doubt that efficient, arm's length contracting would de-couple so much of an executive's pay from actual performance.

CHAPTER 9: EXECUTIVE LOANS

"As of December 31, 1997, the outstanding principal balances of the … loans to [officers and directors] … which are guaranteed by Conseco were as follows: Mr Hilbert, $81,644,353; Ms Cuneo, $21,489,945, Mr. Dick, $42,657,845; Mr. Gongaware, $16,998,753….."

Conseco's 1999 Proxy Statement

Executive loans were once widely used to provide managers with a substantial amount of performance-independent pay in a way that escaped outsider attention. As with retirement benefits, the considerable value provided by loans was largely not reflected in the compensation figures used by the media, corporate governance reformers, and financial economists studying compensation.

The Use of Loans

In the past, firms could camouflage non-option pay by granting loans, or guaranteeing third-party loans, to the CEO and other top executives on very favorable terms.[120] Most of these loans were unsecured or secured only by the firm's stock. In addition, most of the loans carried below-market interest and a substantial number were interest-free. Finally, many of these loans were ultimately forgiven.

When WorldCom, Kmart, and other firms that had made large loans to executives filed for bankruptcy in 2002, the loans received a significant amount of negative public attention. This led Congress to include in the Sarbanes-Oxley Act of 2002 a prohibition against company loans to directors and officers, with narrow exceptions.[121] Existing loans, however, were exempted from the prohibition. As a result, directors and executives continue to reap the benefits from billions of dollars in existing loans.[122]

---

120 Gary Strauss, "Execs Reap Benefits of Cushy Loans," *USA Today*, 24 December 2002, p. 1B.

121 See 15 U.S.C. 78m (k); David S. Hilzenrath and Helen Dewar, "Senate Votes to Curb Insider Lending," *Washington Post,* 13 July 2002, p. A13.

122 Paul Hodgson, "My Big Fat Corporate Loan," study by The Corporate Library, December 2002, p.1.

Our goal is to understand the forces that have shaped executive compensation. Thus, it is quite helpful to reflect on the past use of loans, even though new executive loans have, for now, been taken off the compensation menu. Their past ubiquity can teach us how boards and managers selected from among available compensation devices those that provide significant camouflage, even when these arrangements were unlikely to be efficient.

Among the most notorious executive loans are those that were granted to WorldCom CEO Bernard Ebbers.[123] Between September 2000 and the beginning of 2002, WorldCom directly or indirectly extended hundreds of millions of dollars—approximately 20 percent of the cash on the firm's balance sheet—in unsecured loans to Ebbers to help him pay off margin debt in his personal brokerage account. . In exchange, Ebbers promised not to sell his WorldCom shares. The loans were made at floating interest rates that hovered between 2.15 percent and 2.35 percent. These rates were well below the prevailing rates for large-margin accounts – even though, unlike margin loans, the loans made to Ebbers were unsecured.

When Ebbers left WorldCom, he still owed the firm $408 million. He promised to satisfy these remaining obligations and, under the terms of his severance arrangement, he had until 2008 to do so. Much of that $408 million will probably never be recovered. With WorldCom in bankruptcy, the company shares that Ebbers agreed to hold are now almost worthless. WorldCom reported in May 2003 that he had failed to make the first payment due under the terms of the arrangement.[124] Had Ebbers taken out a regular, higher-interest, secured margin loan from a broker, the lender would not have suffered such a fate. The shares would have been sold to cover the loan when the stock price was still high enough to make this possible**.**

Other firms have extended or guaranteed large loans to executives. For example, in 1999, Conseco guaranteed loans of $175 million to its CEO and $375 million to other executives to buy company stock. When the stock

123 Amy Borrus, Mike McNamee, and Susan Zegel, "Corporate Probes: A Scorecard," *Business Week,* 10 June 2002; Andrew Backover, "Questions on Ebbers Loans May Aid Probes," *USA Today*, 6 November 2002, Money Section, p. 3B.

124 Dana Cimilluca, "Former Worldcom CEO Ebbers Misses Loan Payment," *Toronto Star*, 17 May 2003, p. C4.

later lost most of its value,[125] Conseco lent the executives millions of dollars to pay interest on the loans.[126] The total amount of the loans exceeded Conseco's 1997 net earnings of $567 million.[127] Hundreds of millions of dollars of these loans had not been paid back by the end of 2002. Similarly, Comdisco guaranteed more than $100 million to its executives to buy Comdisco shares whose price subsequently plummeted.[128] Tyco lent its CEO $62 million for "relocation costs."

Although most executive loans were smaller than those granted by WorldCom, Conseco, Comdisco, and Tyco, the practice was widespread. According to a study by The Corporate Library, more than 30 percent of the 1,500 largest U.S. firms disclosed cash loans to executives in their 2002 regulatory filings.[129] The average size of the cash loans was about $11 million. The total amount of insider indebtedness under the loans was $4.5 billion. Although many cash loans were stock-purchase related, many were for home improvements, investments, or other purposes apparently unrelated to employment. For example, manufacturer Flextronics lent executives money to invest in technology startups.[130] More than 25 percent of the firms reporting executive loans did not bother to report their purpose.[131]

Arm's Length Contracting?

Most employees who need loans turn to banks, not to their employers. Clearly, if it were more efficient for firms to act as their employees' banks, they would do so across the board, not only for executives. Presumably, firms do not regularly operate as their employees'

---

125 The loans made by this company are described by Gary Strauss, "Don't Bother Paying Us Back, Many Boards Tell CEOs," *USA Today*, 13 November 2001, p. 1B.

126 Debra Sparks, "The Mother of All Stock Option Plans," *Business Week*, 23 November 1998, p. 158.

127 *Ibid.*.

128 Sandra Jones, "Comdisco in Face-Off over Loans, Trying to Get Execs off Hook with Bank One," *Crain's Chicago Business*, 27 May 2002.

129 Paul Hodgson, "My Big Fat Corporate Loan," Study by The Corporate Library, December 2002.

130 Flextronics 2002 proxy statement.

131 Paul Hodgson, "My Big Fat Corporate Loan," Study by The Corporate Library, December 2002, p. 3.

banks because they lack a comparative advantage over outside banks in providing banking services. Because executives have at least as much access to banks as other employees, one certainly would not expect firms, acting at arm's length, to extend loans to executives but not to other employees. Indeed, Kathleen Kahle and Kuldeep Shastri have concluded that most firms that lend to executives have higher lending costs than do conventional lenders.[132]

Approximately 40 percent of loans are provided to enable executives to purchase more stock in their firms.[133] It is often argued that lending money to executives at favorable rates for that purpose benefits shareholders by aligning executives' interests with their own. However, even if it were desirable to give managers a financial incentive to borrow money to purchase shares, the loan does not have to be extended by the firm.

Suppose, for example, that a firm wishes to encourage an executive to take out a $1 million loan to purchase shares. It may do so by offering to lend him money directly at a rate that is (say) 2 percent below market. Alternatively, the firm can promise a manager that, after she takes out a bank loan at the market rate, the company will pay her 2 percent of the outstanding balance each year until the loan is repaid. As we will discuss below, the direct loan, which was commonly used in the past, is far less transparent than the latter method.

Interestingly, firms extending loans to executives to buy company stock take few if any steps to prevent managers from simultaneously selling shares they already own. As a result, loans enabling managers to buy 100 shares of company stock increase managerial ownership by an average of only 8 shares.[134] This pattern makes it difficult to justify loans as an efficient device for increasing executive share ownership.

---

132 Kathleen M. Kahle and Kuldeep Shastri, "Executive Loans." *Journal of Financial and Quantitative Analysis*, forthcoming. Kahle and Shastri estimate that the average stock loan, which typically is offered to executives at a below-market interest rate, has historically cost a firm borrowing in the corporate debt markets $2 in interest for every $1 in interest savings made available to the executives. The authors of the study assume that the firm borrows at the prime rate and that the executive is able to borrow against the shares at the broker's call rate.

133 *Ibid*, p.9.

134 *Ibid*, p.5.

Camouflaging Subsidized Rates

An important way in which executive loans benefit executives is through their favorable interest rates. An executive who borrows money at an arm's length basis from a bank is required to pay the market interest rate on the loan. But about 50 percent of companies granting executive loans charge no interest, and the remaining companies charge rates that are on average significantly below market rates. The difference between the market interest rate and the reduced rate charged by the firm represents a form of ongoing compensation for as long as the loan remains outstanding.

Bernard Ebbers, for example, was able to borrow money from WorldCom at an interest rate of about 2.15 percent at a time when Charles Schwab was charging 5.75 percent on large margin loans.[135] Because 5.75 percent presumably reflected the going market rate for margin loans, WorldCom allowed Ebbers to save more than $3.6 million per year in interest costs for every $100 million he borrowed from the company. Thus, borrowing $400 million from WorldCom at 2.15 percent would thus have saved Ebbers about $14 million annually. The interest savings for Ebbers came at a cost to WorldCom. Instead of lending the money to Ebbers at 2.15 percent, WorldCom could have lent it to others buying stock on margin (or to any borrower with a similar risk profile) and charged an interest rate of 5.75 percent. Thus, the millions of dollars in benefits accrued by Ebbers imposed an approximately equal cost to WorldCom.[136]

Notably, if Ebbers had borrowed $400 million from a bank at 5.75 percent and WorldCom had paid him $14 million each year to cover the difference between the 5.75 percent and 2.15 percent interest rates, WorldCom would have had to report the $14 million as compensation in the

---

135 Christopher Byron, "Bernie's Bad Idea," *Red Herring*, May 2002, p.92.

136 Kathleen Kahle and Kuldeep Shastri report that the average size of loans given to executives (including both CEOs and junior managers) for purchasing stock was $2.5 million. The average interest rate was 2.3 percent below the prime rate and 1.1 percent below broker's call. See Kathleen M. Kahle and Kuldeep Shastri, "Executive Loans." *Journal of Financial and Quantitative Analysis*, forthcoming. On the assumption that the firm borrowed at prime and that the executive could obtain a margin loan at broker's call, they estimate that the average loan cost the company $63,000 per year, or 9 percent of the executive's total compensation, but provided a benefit of only $28,000 to the executive.

firm's publicly filed compensation tables. Providing this value through subsidized loan arrangements, however, enabled WorldCom to exclude the benefit from its compensation tables completely.

As we explained in chapter eight, firms are required to include in their annual public filings compensation tables indicating the dollar value of different types of executive pay. The numbers in these tables are the most visible indications of executive compensation. In the category of "other annual compensation," firms are required to disclose the difference between the actual interest paid on executive loans and the "market rate." However, the SEC has not clearly defined the term "market rate" and firms have often used the ambiguity to exclude – in whole or in part – the interest subsidy from the compensation tables. WorldCom, for example, excluded from its compensation tables the implicit income given to Ebbers via the loans, despite the fact that the rates were far below the prevailing rates on margin loans. WorldCom later explained that it had (conveniently) interpreted the low floating loan rates to be "market rates" because these were the rates at which WorldCom itself was borrowing under one of its credit facilities. This "trick" enabled the company to exclude from its compensation tables a benefit to Ebbers worth millions of dollars each year.

Note that, for tax purposes, Ebbers was required to report as income the difference between the rate he was charged and the Internal Revenue Service's "applicable federal rate" (AFR) for the loan. Thus, Ebbers should have reported that he was receiving, with respect to each new loan from WorldCom, imputed annualized income equal to the difference between the rate on the WorldCom loan and the AFR at the time the loan was granted, multiplied by the amount of the loan. During the period in which these loans were extended, the AFR was always higher than 2.15 percent, and it was above 6 percent when Ebbers first started borrowing from WorldCom in September 2000. Thus, Ebbers was required to report on his federal income tax returns millions of dollars of compensation income resulting from these "market rate" executive loans.

To be sure, the existence and terms of loans to executives were usually reported by firms as part of their disclosure of related-party transactions in SEC filings. However, the information reported in this section does not include the implicit income generated by the low-rate loans. The existence and magnitude of this implicit income would be apparent only to a careful reader. One would have to obtain information about market rates, calculate the implicit income, and add it to the information in the compensation tables. Providing executives with benefits that are not included in the compensation tables has a considerable camouflage effect. It is likely to hide or reduce the salience of a potentially significant element of compensation.

Loan Forgiveness

The practice of loan forgiveness enhanced the camouflage benefits of executive loans.[137] An executive who borrowed money from a bank would be required to pay the money back with interest or face the prospect of the bank seizing his or her property. Not surprisingly, firms that lent money to their own executives were much more lenient. More than 25 percent of the firms whose public filings revealed whether repayment was required indicated that they had forgiven or were forgiving loans.[138] It has been estimated that as much as $1 billion of the loans extended before Sarbanes-Oxley will eventually be forgiven.[139] Firms often “gross up” the forgiven loans: they make a large cash payment to the executive to cover income taxes arising from the forgiveness, as well as the additional tax liability associated with the cash payment.[140]

In a substantial number of cases, the loans (or the interest payments owed on them) were eventually forgiven either while the executive was still at the company or when he or she left. In many cases, the firm explicitly committed at the outset to full or partial loan forgiveness if certain conditions were met, such as the executive remaining employed for a specified period. The value provided by these “retention loans” was almost

---

137 Kathleen M. Kahle and Kuldeep Shastri report that in the period 1996-2000, 12.6 percent of executive loans in their sample were forgiven, and the interest was forgiven in another 10.2 percent of the cases. See Kathleen M. Kahle and Kuldeep Shastri, “Executive Loans.” *Journal of Financial and Quantitative Analysis*, forthcoming. However, most of this activity took place before NASDAQ crashed. The rate of forgiveness in the period 2000-2002 is likely to have been much higher.

138 Paul Hodgson, “My Big Fat Corporate Loan,” study by The Corporate Library, December 2002, p. 2.

139 Ralph King, “Insider Loans: Everyone Was Doing It,” *Business 2.0,* November 2002, p.82.

140 Paul Hodgson, “My Big Fat Corporate Loan,” study by The Corporate Library, December 2002, p. 2.

completely performance-insensitive; all the executive had to do was remain at the firm. In addition, these loans offered camouflage benefits as compared with regular salary arrangements. In particular, the large amount of cash provided up front was not reported in the compensation tables; the firm was required to report income to the executive only when it forgave the loan. In addition, the firm reported the income not as "salary," which is transparently not performance-sensitive, but rather as "other annual compensation," which may or may not be performance-sensitive.

When loans were made for the purpose of purchasing stock, there was probably an implicit understanding that if the price of the stock fell substantially, the firm would forgive the loan or at least not demand repayment while the price remained down. Such an arrangement would have been similar to, but usually less tax efficient than, granting the executive an option to buy shares at a price equal to the amount owed on the loan. From a camouflage perspective, an important difference was that an option grant had to be reported as long-term compensation in the executive compensation tables, while a loan to buy stock did not. Thus, the firm could provide the executive with something economically similar to an option without reporting its value in the publicly filed, highly visible compensation summary tables at the time the loan was extended.

Down the road, if the stock price went up, the executive repaid the loan, and any profit made on the shares did not have to be reported as compensation. If the stock price remained below the amount owed, and the loan was actually forgiven, the resulting compensation was reported in the compensation tables only in the year the forgiveness took place. Because such forgiveness often took place when the executive left the company, the amount forgiven was included in the compensation tables at a time when the executive was much less concerned about shareholder outrage.

Camouflaging the Sale of Shares

Yet another way in which loans facilitated camouflage was by hiding from investors the magnitude of managers' stock sales. Each year, hundreds of executives used to make swaps under which loans were repaid with company stock.[141]

141 See David Leonhardt, "It's Called a 'Loan,' But It's Far Sweeter," *New York Times*, 3

Before the Sarbanes-Oxley Act of 2002 took effect, executives selling stock in the open market had to report the sale by the tenth day of the following month. But when executives gave stock to the company to repay loans, they had to report such transactions only within 45 days after the end of the fiscal year in which the transaction occurred. Thus, the loans enabled insiders to hide their stock sales for up to a year.[142]

For example, in 2001, Tyco's CEO, Dennis Kozlowski, returned $70 million worth of stock to the company, partly to repay loans, even as he continued to say publicly, to preserve investor confidence, that he rarely sold his Tyco shares.[143] The transaction was disclosed to the SEC only much later, after the stock price had fallen substantially.

February 2002, p. 1.

142 We discuss further the relative lack of restrictions on insider trading in chapter fourteen.

143 David Leonhardt, "It's Called A 'Loan,' But It's Far Sweeter," *New York Times*, 3 February 2002, p. 1; Joann S. Lublin, "Under the Radar: As CEO's Reported Salaries and Bonuses Get Pinched, Many Chiefs are Finding Hidden Ways to Increase Their Compensation," *Wall St. Journal*, 11 April 2002, p. B7.