Whom Do Corporate Boards Represent?

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In my previous two posts, I explored what insights might be had from economists on the compensation of American corporate executives. I concluded "not many," besides theoretical demand-and-supply models based on questionable assumptions.

The decision makers on the demand side of these models are corporate boards elected, in theory, by shareholders. Economists tacitly assume that in their decisions the boards act as faithful representatives of the shareholders. Thus, they are assumed to bargain on behalf of shareholders with management over the compensation of the C.E.O. and other top executives, and to do so in genuinely arms-length negotiations.

In these negotiations, the boards are assumed to structure the compensation of executives so that the economic incentives facing management will be aligned with those of shareholders — an ideal called "optimal contracting" between the principal (shareholders, as represented by the board) and the agent (the executives hired to manage the shareholders' firm) in this vision of corporate governance.

The question is how well this felicitous principal-agent model of corporate governance conforms to reality.

In their well-researched and cogently argued "Pay Without Performance: The Unfulfilled Promise of Executive Compensation" (Harvard University Press, 2004), Lucian A. Bebchuk and Jesse M. Fried, Harvard and Berkeley law professors, respectively, and experts on corporate governance, take straight aim at the economists' model. Anyone interested in this topic could not do better than reading this widely praised book, along with the economist Michael S. Weisbach's thoughtful review of it, published in the Journal of Economic Literature.

With persuasive empirical research, Professors Bebchuk and Fried argue that corporate governance in America is more realistically described by a "managerial power" model in which C.E.O.'s have sufficient power over their boards to dictate their own compensation, subject only to what the authors call an "outrage" constraint.

This outrage constraint is thought to be rooted in the shareholders', the media's and the public's reaction to what they might learn about executive compensation. It had been largely nonbinding until 2007. Since then, the financial crisis has activated it with a vengeance — to the point that Professor Bebchuk now warns in The Wall Street Journal that the "outrage constraint" has led Congress to impose downright punitive and inefficient controls on executive behavior.

One way to neutralize the outrage constraint, Professors Bebchuk and Fried argue, is to camouflage what executives are actually paid. Corporate boards and executives had for years done so by breaking total compensation into many components not easily summarized in a single figure — e.g., salary, cash bonus, call options on the firm's stock, restricted stock, deferred compensation with guaranteed rates of return, pensions and perks during and after the C.E.O.'s tenure at the company. Until the Securities and Exchange Commission forced corporations to disclose more detail on their executives' compensation, these details were by and large hidden from public view. Indeed, one wonders how many board members not serving on the boards' executive-compensation committees ever completely understood the economic implications of the compensation arrangements recommended to them by the compensation committee.

Under the optimal contracting assumed by economists, shareholders should reward executives only for performance that is actually attributable to the executives' behavior. Practically, this means that any performance reward should be based on performance relative to a benchmark (e.g., the performance of similar firms in the industry). That idea, however, has never been popular among American executives and their boards, to this very day.

Instead, as Professors Bebchuk and Fried point out, compensation with stock options and restricted stock typically rewards executives simply for upward movements in the raw price of the company's stock, a good part of which may be totally beyond the executives' control. (I tried to illustrate this phenomenon with G.E. stock in last week's post.) Boards tend to shrug off this inconsistency with optimal contracting with the argument that shareholders who enjoy growing wealth when stock prices rise are unlikely to object if Joe, the C.E.O., shares in the good fortune. Boards feel safe in calling these rewards "performance compensation."

On the other hand, in periods when the company's stock price falls and the exercise prices of options in the hands of executives dive deeply "underwater" (are far above the prevailing stock price), boards frequently worry about retaining the executives and reprice these options, or make the executives whole by other "retention awards," lest they fly the coop. These awards are then called "retention bonuses" and defended as being in the shareholders' interest.

It must be noted that Professors Bebchuk and Fried are not motivated by social envy, nor over the social, economic and political consequences of growing income inequality and the concentration of national wealth in the bank accounts of a few. As experts in corporate governance, their sole concern is over the deviation of actual compensation practice from optimal incentive contracts. In that spirit, they devote several chapters to changes that would move executive compensation closer to genuinely optimal incentive contracts written in the interest of shareholders.

In his review of their book, Professor Weisbach agrees with the authors' description of current board culture, but he doubts that we shall ever get executive compensation right. Resigned to that fate, he suggests that even our current, flawed practice of corporate governance has served our society by and large very well and, therefore, that we simply put up with imperfection in this regard, holding our noses as we do so.

Of course, he counseled us thus in 2007, before it became apparent that the highly flawed compensation of banking executives may have contributed significantly to their reckless and utterly destructive style of management.