Out of Control?

Executive pay is often not linked to performance, says Lucian Bebchuk, who knows precisely what's needed to bring it into line.

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Another Harvard professor.
Another Harvard professor who's written another book.
Another Harvard professor who's written another book about CEO pay.

Not quite. *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* is the most comprehensive, closely argued, and devastating (although the author disputes that characterization) critique on the subject that has appeared in years.

The author is Lucian Bebchuk. He is professor of law, economics, and finance and director of the program on corporate governance at Harvard Law School, and he and his co-author, U.C. Berkeley law professor Jesse Fried, have produced a book that will be -- at least should be -- studied by those who believe that our corporate system, which currently looks out of control, still has a future.

What's remarkable about *Pay Without Performance*, and which may give it more impact than other books about executive pay, is that it is not an angry screed but, rather, a studied, scholarly analysis whose understated language gives it a cumulative effect that is overpowering. Moreover, it was not written by any of the "usual suspects" -- the critics who have a bone to pick with corporate America and its excesses, which makes Bebchuk and Fried's book more credible and more damning.

In person, Bebchuk sounds like the Polish-born, Israeli-educated academic he is. He is polite, diffident, careful to qualify what he says. He doesn't at all see himself as an "enemy" of business, and the idea that some of his views might make CEOs apoplectic seems to have never occurred to him. He doesn't sit on any boards.

Bebchuk, 50, flew down from Boston to talk to *Across the Board* editor A.J. Vogl at the magazine's offices in New York.

Your book takes issue with what you call the "official view" on executive compensation: that it is shaped by market forces and boards loyal to shareholders and their interests.

People have a basic assumption: that executive-pay arrangements are the result of arm's-length bargaining between executives trying to get the best deal for themselves and boards trying to get the best deal for shareholders. Those who believe in this "official view" think it's a good approximation of reality and that, as an outcome of such bargaining, directors design compensation arrangements that provide executives with incentives that increase shareholder

value. What we question in the book is the common belief that, putting aside a few "rotten apples," we are reasonably close to this desirable state of affairs.

Quite an indictment. Why has the official view prevailed?

Because it provides a neat and tractable model for looking at the executive-compensation landscape. Trying to understand the myriad factors that influence directors is much more difficult than assuming that boards seek to maximize shareholder interests. Furthermore, finding ways to make boards more accountable is not easy and confronts us with difficult issues, which are convenient to ignore.

Also relevant is the fact that the U.S. economy has done well over time and the stock market has done very well over the past decade, during which pay levels soared. American companies have been successful, and executives deserve a great deal of credit. The performance of the corporate sector facilitates the belief that we have no significant problems in corporate governance.

But such inferences are unwarranted. Corporate performance is a product of many factors other than the quality of governance arrangements in place. Recall that during the 1980s, when the U.S. economy was doing less well than the economies of Japan and Germany, many observers leaped to the conclusion that our corporate-governance system might be inferior to theirs. We now recognize that other factors were at work, and that our governance system should not have been blamed for the economy's weak performance during that period. Similarly, the economy's subsequent success should not make us complacent about our governance arrangements. There is significant room for improvements that could contribute substantially to shareholder value.

There's also something else hiding behind this official view, isn't there -- what you characterize as a "smoking gun."

Yes, the influence of executives on their own pay, and the use of compensation practices that obscure the numbers, that are insensitive to performance, and the practice of showering gratuitous benefits on departing executives.

But aren't there limits to what executives may seek and directors may grant?

Yes -- among them, what we call "outrage" costs. If the compensation arrangement is so favorable to managers that it causes outrage on the part of shareholders, it may lead to shareholder pressure that could embarrass directors and officers and hurt their reputations. The greater the prospects for outrage, the more hesitant managers will be to propose it and directors to approve it. That leads to something we call camouflage -- which means obscuring both the level of executive compensation and its insensitivity to performance. That, of course, allows executives to reap benefits at the expense of shareholders.

But even where there has been outrage over a CEO's pay, the corporate response has usually been, "That's the market at work. The CEO is a top performer, like a star athlete." Is that an apt analogy?

No. The market analogy is based on the premise of arm's-length bargaining. When the owner of a ballclub negotiates with a star player, the owner wants to get the best deal for his club and the player the best deal for himself. That's the real market at work and real arm's-length negotiation. Moreover, the owner has no incentive to camouflage the amount of pay or any of the other perks of the compensation package. And then, too, owners, when they get rid of a player, don't usually provide them with gratuitous payments beyond what they are contractually entitled.

So, then, the goal you advocate is genuine arm's-length negotiation that would lead to incentives for managers that are not simply excuses to give them more money.

Right. Incentives are crucial, not only for executives but for directors too. Directors generally do not have incentives, nor are there other forces operating on them that would lead them to focus solely on shareholder interests. Indeed, they have reverse incentives derived from the desire to be reelected to the board, and by the possibility of being rewarded by the officers of the company. But it goes beyond those narrow incentives. There are also other forces -- friendship, collegiality, loyalty, the desire to avoid conflict or haggling -- that operate on people when they set compensation for a colleague who is also the most important figure in the company.

Are you talking here about the old-boy network?

Doesn't have to be that. You have a situation where people are working together, and one of them is the leader of the company. It's hard psychologically for a director to change hats very quickly -- one moment deferring to the CEO as the leader, the next setting pay at arm's length and making decisions that the CEO doesn't like. You might say that this is unavoidable, but unfortunately there's no countervailing force that would balance or outweigh this inclination to go along with compensation arrangements that favor the CEO and other senior executives.

What would be a countervailing force?

Something powerful that would connect the directors to shareholder value. Most of the time, their own stake is such a small fraction of total stockholdings that the personal cost of making a decision that is socially or otherwise convenient is small or practically negligible, so one countervailing force would occur when a company has large shareholders who are serving on the board.

Would the presence of, say, a union or consumer representative, or an environmentalist, constitute a countervailing force?

We're after maximizing shareholder value. We are not after maximizing stakeholder interests. Without the pressure to increase shareholder value, the board might have more slack and so be more accommodating or give greater weight to stakeholder interests. So increasing stakeholder power would be contrary to the interests of shareholders.

If you had to classify my position, I'm within the mainstream view that companies should operate in the interests of shareholders, with long-term shareholder value being the major objective. This is not a cruel, disregarding view but, rather, one that works in the long run to the

benefit and efficiency of the economy. The interests of other stakeholders should be protected, either by contracts that they have with companies or by other forms of regulation.

If I understand you, you're arguing that it would be a poor idea to have, say, a unionist on the board -- not because he wouldn't be a member of the old-boy network but because he would be representing his constituency rather than seeking to increase shareholder value.

Right. To make directors more accountable to somebody on the outside would be a step in the wrong direction. We want to make them more accountable and attentive to the interests of shareholders. If a labor representative were doing his job well, he would be advancing the interests of labor, not shareholders.

Still, wouldn't somebody from outside the traditional pool of directors -- CEOs and other senior executives -- encourage a less accommodating, more arm's-length negotiating stance toward officers of the corporation?

I think this really would be going in the wrong direction. If you put a class-action lawyer like Mel Weiss on the board, the board would be very afraid of being sued. If you put a person from Slate magazine on the board, they'd be influenced. The question is: Would they be influenced in the right direction?

I can think of many reasons for not having a journalist on the board, but the least would be that he'd represent the interests of journalists.

It's possible he would represent the interests of shareholders, but it's also possible that he wouldn't.

But isn't that also possible with traditional directors? It might explain why they are so free with golden parachutes and retirement benefits-that they don't have enough incentives, economic or other, to adequately discharge their responsibilities to shareholders.

I believe that most directors are doing the right thing, for whatever reason; if they weren't, the U.S. economy might not be where it is today. What Jesse Fried and I advocate is supplementing the norms of doing the right thing with good economic incentives, and that's what we don't have enough of with respect to directors.

Golden parachutes and payoffs for executives on the way out are one of the major ways, under existing arrangements, in which the link between pay and performance is weakened. Departure payments are, to a substantial extent, independent both of an officer's performance in service and of the circumstances surrounding his departure.

You can think about such departure payments in two ways. One is the payments that follow from contractual arrangements; the other is payments beyond what's contractually provided. The contracts we see have soft-landing severance provisions that may be linked to directors willing to go along with arrangements that are less than optimal for shareholders.

Another force can also influence departure payments: when a failing executive has to be pushed out. Even though firing a CEO is more common today, it's still something very difficult for boards to do, so they may provide payments beyond what's contractually required -- either to alleviate the discomfort or to get some of the directors to go along with the dismissal.

Does having more independent directors make much of a difference?

Director independence, which recent reforms seek to strengthen, is beneficial but insufficient. While independence eliminates some "bad" incentives, it does not by itself provide affirmative incentives to serve shareholders.

Directors should be paid much of their fees in the form of restricted stock grants. Holding a significant stock position that cannot be unloaded for a reasonable period of time helps focus directors on shareholder interests. There is a limit, however, to what director-compensation schemes can accomplish. After all, there is no one external to the board who can set optimal incentive schemes for the directors.

For this reason, it's important to make directors not only more independent of management but more dependent on shareholders. One main way of doing so would be to make board replacement by shareholders more viable, which means giving them access to the corporate ballot, subject to appropriate safeguards. Moreover, companies should not have staggered boards, which make control challenges all the more difficult. I should mention, too, that in a recent empirical study, a colleague and I found that staggered boards are correlated with an economically significant reduction in firm value.

Aren't you worried that making director removal easier would produce costly campaigns and distract boards from focusing on the long term?

No. Making director removal more viable does not mean that electoral challenges will become the norm. Most of the benefits of such a change would not require actual elections. Rather, there would be the systemwide benefit of making U.S. directors more attentive to shareholder interests, which is the case in the United Kingdom, where it is much easier for shareholders to remove directors.

I agree that it is important to provide boards with the ability to focus on the long run, but this does not mean that we should make removing directors practically impossible. If providing sufficiently long horizons is a concern, we could allow companies to adopt longer terms -- say, three years -- for directors, with removal between elections relatively more difficult. What's critical is that, when elections do arrive, shareholders have a meaningful opportunity to replace the directors. Having a viable possibility of replacing the board only every two or three years would be far superior to having a fictitious option of doing so every year.

What about SEC chairman William Donaldson's proposal to let shareholders propose their own candidates in certain situations?

This is a proposal that I support, and I testified to that effect at SEC hearings. The proposal has run into great resistance, even though it is a mild step in the direction of making directors more dependent on shareholders. In my testimony, I referred to an empirical study that looked at the incidence of electoral challenges to public companies over a seven-year period, from 1996 to 2002; it found that the incidence of electoral challenges was practically nonexistent. Among thousands of public companies, there were on average ten companies a year whose boards faced electoral challenges. Out of those ten, only two had a market cap that exceeded $200 million. That suggests that the power to replace directors, which is the foundation of the accepted view of the corporation, is right now largely a myth. Therefore, any step in that direction would be positive.

It's my understanding that, under the Combined Code in the United Kingdom, outside evaluation of directors is compulsory. They bring in consultants from the outside to evaluate the board. Would you favor this?

In our view, the most important thing is to have good incentives for directors and then, in turn, for company officers. If you have directors that are attentive to shareholder interests, then you can save a lot of formalities of evaluation.

But how can you make sure that directors will be attentive to shareholder interests if they're not evaluated in some way?

I always return to this, the Archimedean point: The best way to make directors attentive and accountable is to have them evaluated in a real way by the shareholders. And the only way to do this is by making shareholder power to remove directors more viable, and by empowering shareholders to make changes in corporate-governance arrangements. Everything else creates problems. You talk of external evaluation -- but who will choose the evaluators? How will we ensure that this evaluator will have the right incentives? Will we have to evaluate the evaluators? No, the best way, if you don't want to bring regulators and costs into the system -- which we don't -- and you want somebody whose money is on the line, then it is the shareholder who should be the ultimate judge of whether directors are performing well.

Wouldn't it get directors' attention if they were held personally liable for their lack of oversight? I'm thinking now of the ten former directors of Enron who agreed to pay $13 million out of their own pockets to settle a class-action suit stemming from the company's collapse, which cost stockholders some $60 billion.

I'm not at all sure that stiff monetary penalties are the answer, and I made this point in an op-ed piece that I wrote for *The New York Times*. In the Enron case, the directors were treated very gently -- indeed, so gently that directors of other companies can rest easy. These ten directors sold Enron shares worth more than $250 million while the company was misreporting its financial affairs. The settlement requires each of them to pay an amount equal to 10 percent of pretax profits, but they'll be able to keep the remaining 90 percent. Enron investors, of course, lost their shirts.

I argued against making this a precedent. Why? Because the liability system is basically a court-based system. Again, it involves an external party -- in this case, judges in Delaware -- passing judgment on issues afterward and imposing liability. But courts don't have the right knowledge, the right information, the right processes. Much better, as we say in the book, to have boards deal with such problems internally. Moreover, in the nature of things, a liability-based system focuses on the extremes, on cases that are truly bad. The most it can do is to provide incentives against the most egregious behavior.

Oddly enough, while discussing executive compensation, we haven't brought up the magnitude of their pay. CEOs now, as we all know, make more than 500 times the pay of an average worker. Do you have a problem with that?

I don't object to it per se. I know some people take a very strong line against magnitude, saying, Nobody should be paid more than X -- either on the grounds of fairness or of ethics. Or they might object to it on the grounds of human motivation, saying, You don't need to pay CEOs that much, because you can count on their professional pride and desire to succeed.

Here, we are pragmatists who look at this issue from an economic point of view. If maximizing shareholder value required doubling the compensation of top executives, then I say we should do it. That's quite a different view from that of the populist critics. The reforms we talk about in the book have to do not with magnitude of compensation but with incentives that increase shareholder value, and we conclude that, on this measure, existing arrangements are not scoring as well as one would want.

There are two levels of reform that we talk about in *Pay Without Performance*. One is our proposals for changing pay arrangements and practices, and most of these fall in the range of what people are discussing today -- heightening the link between pay and performance, filtering out gains that are connected to marketwide or sectorwide movement of options, amending severance provisions to make executives' retirement payoffs more sensitive to performance. These are all things that I would classify under "internal critique."

We also believe in greater transparency. There has been much attention paid to the expensing debate -- that is, whether the costs of options appear only in the footnotes or as a charge to earnings. But there are other substantial forms of compensation whose value does not now appear at all. A substantial amount of compensation is given through retirement benefits of various kinds, and most of this value is never included in the summary compensation tables in the firm's proxy filing. Companies should place a monetary value on all forms of compensation to which an executive becomes entitled and report this value to investors.

Then, we advocate substantial reforms -- we want to allocate more power to the shareholder. Some people might see that as revolutionary. To me, that shows only how attached many people have become to a very particularized allocation of power, which is neither entailed by the basic principles of the modern corporation nor necessarily one that we have in other countries-in the United Kingdom, for instance. Indeed, in some respects the United Kingdom gives even more power to shareholders than we propose in our book. We advocate making it easier to replace the

board at various points in time, but in the United Kingdom, replacement is possible anytime that shareholders choose to do so.

A final question. You present your views in a very nuanced way, but I'm not sure everybody perceives them that way: to wit, here's Tyler Cowen writing in *The Wall Street Journal*: "The authors" -- and here's he referring to you and Fried -- "believe that the fundamental practices of American business are rotten to the core."

That's not a good description of our work. Certainly there is the view that the system is morally corrupt, but this is a view that neither my co-author nor I share.

Even with all the examples of corporate corruption and executive self-aggrandizement that we read about almost every day in the *Journal* and elsewhere?

Here is the way I think about it: By and large, directors and officers of public companies are hardworking, caring, devoted--

Overpaid?

--a second -- individuals who probably do a good job. But we think that if you have a system that does not have good incentives, even if you have a lot of people who are decent, honest, and working by the rules, it will not produce good outcomes.

It seems likely that others who give your book a fair reading might conclude that executives have manipulated the system to their own ends, the primary end being self-aggrandizement.

It's a question of terminology. I wouldn't use the term *manipulation*. If at some point before your salary review you work harder to impress your boss, I wouldn't call it manipulation. I would say it's working within the rules of the system.

But if I were apple-polishing my boss -- giving him false smiles, running little errands for him, and the like -- wouldn't you characterize that as manipulation?

It's a question of degree. When we examined the links between directors and officers, we actually tried to stay away from the extreme cases, the Enrons or Tycos. The reasons are that those are a small minority and, second, those are instances that we could easily fix by obeying rules that we already have in place.

But to speak to your question about self-aggrandizement -- though I don't like that word -- we believe that incentives are important, which by definition means we are not content to rely on the executive doing the right thing for shareholders out of a sense of professionalism or dedication.

Forget about dedication -- let's say you give the CEO a $3 million salary, or $6 million, or $10 million. Are you saying that for those numbers he *still* wouldn't do the right thing?

This is an idea that is contestable. The argument goes that professors don't need incentive pay because they write papers in order to satisfy their vanity, for instance, or convince other professors, and you might argue that, if you give executives fixed pay, they'd have enough pride to make their company successful.

More than pride -- to keep their bloody jobs. If their company doesn't prosper, they take the fall.

But if you go there, you already go to the land of incentives. The fear of being fired is in itself an incentive, and, alternatively, so is the hope of being elevated to a position in a larger company. Actually, even today there exists the possibility of being fired, but it is not enough. Why? Because that possibility is extremely small. Today, it's not enough to be merely average or even mediocre in performance. Failure needs to be substantial, which means that if we care about providing incentives in the range between spectacular performance and performance that is just a notch above what is necessary for the board to push a CEO out, we need to bring something else to the table, which is why we believe that incentives are essential to both executive and director compensation.