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HEADLINE: LAWYER'S BOOKSHELF;
Pay Without Performance: The Unfulfilled Promise of Executive Compensation

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BODY:

In a thought-provoking book, "Pay Without Performance: The Unfulfilled Promise of Executive Compensation," Professors of Law Lucian Bebchuk of Harvard Law School and Jesse Fried of the University of California at Berkeley examine factors that can prevent executive pay from accurately reflecting performance. In this reviewer's experience, there is no more complete and carefully considered published work addressing the weaknesses in the current executive pay process in the United States. Anyone involved in executive compensation matters or in issues of corporate governance will find "Pay Without Performance" a worthwhile read and a valuable information source for future reference.

The authors ascribe the executive pay problem to a number of factors. First, they find a lack of arm's length bargaining between boards of directors and CEOs seeking to better their own pay. Second, and linked closely to the first point, in their view, the CEO possesses such power that, if he wishes to, he can exert inappropriate pressure on boards of directors to approve pay that is not coupled to true performance. Third, they point to various forms of "camouflaged" compensation, the cost of which is difficult or impossible for shareholders to determine from proxy statements.

The authors suggest solutions. These include expensing of stock options [which the Financial Accounting Standards Board proposes to make mandatory]. They propose putting a monetary value on forms of pay the costs of which are not currently reported in proxy statements in a way that identifies those costs in a clear way [if at all]. They cite the values of pensions, perquisites and post-retirement consulting contracts as examples. They suggest increasing the number of specific elements of compensation required to be approved by shareholders.

The authors conclude that a long-term, basic solution of the executive pay problem must include improvements in the corporate governance process going beyond the specifics of executive pay. They propose, among other things, broadening shareholder rights in the process of nominating and electing directors. [They note that current Securities and Exchange Commission proposals, while a step in the right direction, fall short of giving shareholders a real say as to board membership.] They also would broaden the rights of shareholders to include the right to vote on governance matters such as amending the corporate charter.

The statistic-minded reader may find "Pay Without Performance" somewhat lacking in systemic data on egregious executive pay. To be fair to the authors, gathering systemic,

statistical data to support all of their observations [e.g., that many CEOs exert inappropriate pressure on boards of directors regarding their own pay] would have been difficult, if not impossible. The authors do frequently discuss specific examples of egregious pay. Copious footnotes lead the reader to cases and authorities, many of the authorities being academics or journalists, to support the authors' points. The authors make numerous references to, and frequently incorporate into the text, findings of various studies based on substantial pay data, such as studies finding a correlation between poor governance and higher pay and lower pay-performance sensitivity.

In response to the thesis that much of executive pay is pay without performance, I think Bebchuk and Fried do not give us an explanation as to why our society, as a whole, tolerates executive pay as it is ---- tolerate meaning doing relatively little proactively to combat it. This tolerance exists despite the extraordinary criticism CEO pay receives in the media and from able commentators such as Bebchuk and Fried.

For example, I doubt critics would be so upset with executive pay if such pay was limited to current cash compensation, meaning salaries and annual bonuses at levels presently in effect. The critics' principal target is equity, primarily in the form of stock options. In a September 2002 report, the Conference Board indicated that approximately 80 percent of the increase of CEO pay over the period from 1992 through 2000 was attributable to the increased value of stock option grants. As the stock markets ballooned during this period, so did the value of stock option grants. A stock market boom like that in the 1990s is not likely to occur again very soon.

Frequently cited examples of high-pay levels are those of professional entertainers and professional athletes as to which criticisms hardly compare with those directed at CEO pay. To these comparisons might be added the pay of asset managers, who rarely are criticized for the levels of their pay.

Like CEOs, asset managers are responsible for the investments they manage, but, unlike CEOs, they do not have the job of running the businesses in which they make those investments. A typical fee for asset management is 1 percent of the assets under management. [Some asset managers charge less, especially for very large amounts; on the other hand, some asset managers, such as hedge funds, charge more.] CEO pay as a percentage of the market capitalization of the companies they run is far below 1 percent. The average pay of CEOs of public companies with market values of $2 billion or more for 2003 was approximately one-tenth of 1 percent.

Forces and pressures at work on executive pay go beyond the relationship between CEOs and boards of directors. Over decades, an ever-growing, more complex and faster moving economy has invested CEOs with a very high level of impact on the market values of the companies they run. Bebchuk and Fried, in my opinion, do not give sufficient weight to such factors in the setting of executive pay.

It may be that significant changes in our corporate governance system are required affecting not only executive pay but also other aspects of the businesses conducted by our major public enterprises. These changes, as suggested by the authors, may include greater disclosure to shareholders and more direct participation in the corporate governance process by shareholders.

What Bebchuk and Fried have done ---- and it is a very significant accomplishment ---- is to conduct a careful, sophisticated scrutiny of an important aspect of the governance of our major public companies. Their work shows without question there are real problems in the executive pay process and, hopefully, real solutions to the problems. At the heart of these problems are weaknesses recently exposed in some boards of directors by their failure to carry-out their fiduciary duties to shareholders. Boards of directors of public companies have long been

presumed to provide shareholders with a solution to the principal/agent problem: that is, the problem of conflicting interests between shareholders and management. This issue was discussed in "The Modern Corporation and Private Property" by Adolf A. Berle and Gardiner C. Means nearly 75 years ago. The board of directors as an institution "caught-in-the-middle" in today's fast-moving world of large and complex public corporations has not always lived up to the hopes of 75 years ago. That does not mean we should not be trying to find solutions within or outside the paradigm. Finding such solutions is the direction in which "Pay Without Performance" is pointing and it represents a very constructive step in that direction.

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