Review Essay

IS THE MARKET FOR CEOS RATIONAL?

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LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard 2004)

INTRODUCTION

Are the multimillion dollar CEO compensation packages that have become such a notable part of contemporary American business culture the product of rational arms-length bargaining in a relatively efficient market, or are they exorbitant "rents" extracted by CEOs with largely unfettered power over corporate boards? This question, once relegated to the more obscure corners of business and legal corporate scholarship,[1] has now become a central feature of the debates over corporate governance generated by recent corporate scandals. A few years ago, the fact that corporate CEOs were being paid at levels many hundreds of times greater than that of the average employee in their companies might have been condemned as unseemly, perhaps even potentially socially disruptive, and certainly not conducive to good labor relations. Yet these con-

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1. Nonetheless, the question is one that has been around for a rather long time. *See* George T. Washington, *The Corporate Executive's Living Wage*, 54 HARV. L. REV. 733 (1941) (arguing that some chief executives might be worth even as much as one million dollars, while also cautioning about the need for courts to guard against fraud and overreaching). For a recent history of attempts to regulate executive compensation, *See* Jerry W. Markham, *Regulating Excessive Executive Compensation – Why Bother?*, 2 J. BUS. & TECH L. 277 (2007).

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cerns were of little import to corporate governance, so long as high CEO pay appeared to be linked, as it was believed to be through most of the 1990s, to high stock prices and good corporate performance.

In the post-Enron era, however, as market bubbles burst, scandals broke and irrational exuberance gave way to criminal prosecutions and class actions for securities fraud, the continued rise of CEO compensation has come to be seen as a potentially serious problem of corporate governance. Although still a moderate expense to most public corporations relative to their total costs or total income, there has been increased concern that excessive levels of CEO compensation may actually be harmful to shareholders.[2]

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2. The total amounts of "megagrants" of stock options and other "incentive-based" compensation have grown so large in some companies that they represent a significant cost to the firms, particularly those that make extensive use of stock options as compensation. Justin Fox, *The Amazing Stock Option Sleight of Hand*, FORTUNE, June 25, 2001, at 86 (describing research which found that the cost of options to 496 large cap companies was 13% of operating earnings, 51% for tech companies). *See also Intel Reveals Cost of Options*, FIN. TIMES, Aug. 3, 2004, at 26 ("Intel would have posted a net profit almost 17% lower if it had expensed stock options in the June quarter . . . "); Calvin H. Johnson, *Stock Compensation: The Most Expensive Way to Pay Future Cash*, 52 SMU L. REV. 423, 424, 426 (1999). An even greater concern is that improperly designed incentive compensation schemes may give corporate executives added incentives to mislead or withhold information from investors, at least for a limited period of time. David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997). *See also* Iman Anabtawi, *Secret Compensation*, 82 N. CAR. L. REV. 835 (2004); Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83 (also discussing the legality of timing such disclosures); Kara Scannell, Charles Forelle & James Bandler, *Can Companies Issue Options, Then Good News?*, WALL ST. J., July 8, 2006, at A1. The rash of options backdating scandals that began to emerge in 2005 and 2006 have shown that these incentives for fraud are even stronger than academics and regulators previously supposed. *See* Gary Rivlin & Eric Dash, *Haunted by a Heady Past; Silicon Valley was Calming Down. Now, an Options Scandal*, N.Y. TIMES, July 22, 2006, at C1, C9 ("There have been clear cases of deliberate backdating, with executives fiddling with option grant dates to take advantage of a stock's lower price, to more murky cases when options were granted just before the release of positive news that was likely to cause a jump in a stock's price."); Jesse Eisinger, *Long & Short: What Backdating of Stock Options Means*, WALL ST. J., May 24, 2006, at C1.

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Yet there is perhaps an even deeper reason for the newly pervasive discomfort over CEO pay levels. For many, they represent blatant proof of managerial excess which investors remain unable to limit or control.[3] The 1990s were supposed to be the decade of investor activism. Shareholders, once disaggregated and powerless, were increasingly entering the market through pension funds, index funds and other large and active investors who supposedly had the interest, power and expertise to monitor managerial performance and take effective action against slacking or underperforming CEOs. One of the prime symbols of that new power was the enthusiastic support by institutional shareholders for incentive-based methods of CEO pay.[4]

There is a growing body of opinion, however, that pay for performance has been pretty much of a sham, simply an excuse for CEOs to engineer enormous pay hikes for themselves, and, as the recent corporate scandals suggest, leaving management and shareholder interests as misaligned as ever.[5]

No less an authority than Alan Greenspan has blamed the recent corporate scandals on "infectious greed" among managers, engendered largely by "poorly structured" options, which "perversely created incentives to inflate reported earnings in order to keep share prices high and rising. *Good Timing: CEO Stock Option Awards and Company News Announcements*, *supra* note 2; *Secret Compensation*, *supra* note 2; *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, *supra* note 2.

3. As William Bratton posed the question in a recent review of Bebchuk and Fried's book, "[w]hy should a boondoggle [executive compensation] persist in the teeth of the triumph of shareholder capitalism over the moribund managerialist model of the postwar period?" William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CALIF. L. REV. 1557, 1557 (2005).

4. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 226 (1990); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives - It's Not How Much You Pay, But How*, HARV. BUS. REV. May-June 1990, at 138; *see* Charles M. Yablon, *Bonus Questions - Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 279-80 (1999); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 715 (1995).

5. Even Jensen and Murphy, who are in many ways the founders of the pay for performance movement and have been among its strongest defenders, *see supra* note 4 and accompanying text, have suggested in some of their recent work that the current debate over CEO compensation "has more than the usual amount of energy and more than the usual amount of substance." Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them*

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Accordingly, the recent book by Professors Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation,*[6] has received substantial attention, and deservedly so, not just from business and legal academics, but from the wider investing public. Bebchuk and Fried forcefully argue that "pay for performance" in major American public companies has indeed been a sham. They cite extensive evidence to support their view, which they call the "managerial power" thesis, that CEO compensation is set unilaterally by the CEO at the highest amounts and with the lowest level of risk that the CEO thinks he or she can get away with.[7]

In support of this view, Bebchuk and Fried cite studies which show that executive compensation is higher when the board is weak and when there are no large shareholders and few institutional shareholders. They cite the prevalence of "stealth" compensation arrangements, which allow the company to hide the actual amounts of compensation being paid and "gratuitous goodbye payments" given even to CEOs who have been fired for poor performance. They conclude that "[i]n sum, the CEO's own compensation will almost always reflect managerial power. . . ".[8]

While these arguments have considerable strength, they have not by any means carried the day. In the years since Bebchuk and Fried first put forward their "managerial power" thesis, other academics and compensation professionals have generated a series of counter-arguments to show that the managerial power thesis is false and that serious arms-length bargaining does take place between CEOs and boards.[9] *Moreover,*

(Harvard NOM Working Paper No. 04-28, 2004), *available at* http://ssrn.com/abstract=561305.

6. Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004) (hereinafter "*PWP*").

7. Bebchuk and Fried assert that "managers may use their own influence not only to obtain more pay but also to structure that compensation in forms that are less performance sensitive," and "[t]he greater the CEO's power, the managerial power approach predicts, the larger the CEO's rents will tend to be." *Id.* at 63, 64.

8. *Id.* at 64.

9. *Brian J. Hall and Kevin J. Murphy, The Trouble with Stock Options,* 17 J. ECON. PERSP. 49 (2003); Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle,* 28 DEL. J. CORP. L. 129, 133 (2003); Randall S. Thomas, *Explaining The International CEO Pay Gap: Board Capture or Market Driven?,* 57 VAND.

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the continually increasing compensation of the top athletes, movie stars and investment bankers have led many to lump CEOs together with them as winners of "tournament markets" where the most talented are able to command an ever increasing share of total wealth.[10] Such arguments presume that CEO compensation is set through an arms-length bargaining process, the very presumption Bebchuk and Fried seek to refute.

So who has the better of this argument between Bebchuk and Fried's managerial power account of CEO compensation, and the still widespread belief that much CEO pay is set by arms-length bargaining between CEOs and compensation committees? Bebchuk and Fried's book makes some powerful points, buttressed by the continued growth of CEO pay during the market downturns of 2001 and options backdating scandals. From this reader's perspective, the managerial power

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L. REV. 1171, 1175 (2004). These authors note that CEO compensation levels have risen during the last decade even as boards have become increasingly independent and less subject to managerial control, *The Trouble with Stock Options*, at 65; *More Pieces of the CEO Compensation Puzzle*, at 141; and that options and other forms of "stealth compensation" have become relatively more transparent over time. *The Trouble with Stock Options*, at 65; *More Pieces of the CEO Compensation Puzzle*, at 141. Particularly troubling to the managerial power thesis is that newly hired "outside" CEOs are paid substantially more than incumbent CEOs, despite the latter's presumed greater power over the board. *The Trouble with Stock Options*, at 65; *Explaining The International CEO Pay Gap: Board Capture or Market Driven?*, at 6; *More Pieces of the CEO Compensation Puzzle*, at 142; Holman W. Jenkins, Jr., *Outrageous CEO Pay Revisited*, WALL ST. J. Oct. 2, 2002, at A17 ([W]hy did some of the richest pay deals go to executives who hadn't been hired yet and therefore didn't have hiring boards under their thumbs?"); Joann S. Lublin, *The Serial CEO — Experienced Chief Executives are in Demand as Companies Look Outside for Leadership*, WALL ST. J., Sept. 19, 2005, at B1 ("To attract a successful, incumbent CEO from another company, 'you've got to give him a good incentive'"). Bebchuk and Fried recognize this problem. Although they attempt to deal with it by observing that agency costs and managerial power might influence board members even when dealing with an outside, prospective CEO, they admit that "negotiations with new, outside CEOs might have been closer to the arm's length model than negotiations with incumbent CEOs." *PWP*, *supra* note 6 at 48-9.

10. *See* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?* (National Bureau of Economic Research, Working Paper No. 12,365, 2006); Robert B. Reich, *CEOs Deserve Their Pay*, WALL ST. J., Sept. 14, 2007, at A13 ("CEOs have become less like bureaucrats and more like Hollywood celebrities who get a share of the house").

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model is strongly ahead on points, but has not yet been able to score a knockout.

The problem is that Bebchuk and Fried's managerial power model accounts for many, but not all, of the salient characteristics of the market in which CEO pay is set. It does not explain why boards that have become increasingly independent (at least with respect to formal conflicts of interest) and have been increasingly willing to fire CEOs for poor performance are still presumptively under the thumb of the CEO when it comes to setting pay. It cannot explain why ever increasing disclosure of the details of CEO pay has not curbed its excesses, and it cannot explain why newly hired CEOs are paid more, comparatively, than incumbent CEOs in similar companies.

Bebchuk and Fried share with their adversaries the tools of standard economic analysis, including the assumption of rational, wealth-maximizing economic actors. If intelligent board members are facilitating the payment of exorbitant economic rents to CEOs, it must be the result of bribes, threats, or a combination thereof, i.e. "managerial power."[11] Recent work in behavioral theory as well as recent accounts of the board decisionmaking process cast doubt on this assumption of pervasive economic rationality, or at least requires us to consider a much wider range of director motivations that can lead to approving exorbitant CEO compensation.

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11. On this view, the central problem of corporate governance in the public corporation is agency cost, specifically, how to prevent CEOs from using corporate resources to benefit themselves personally rather than the company and its shareholders. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Incentive-based pay, by increasing the CEO's incentive to increase shareholder wealth, was seen as one partial solution to the problem. Bebchuk and Fried essentially share this analysis, but view the problem of agency costs as more pervasive, affecting board members at least as much as the CEOs they are supposed to monitor. On their view, board members are so fearful of personal loss of status or wealth as a result of incurring the wrath of a CEO whose pay has been cut (or insufficiently raised) that they acquiesce in whatever pay package the CEO desires, unless the package is so obviously excessive as to trigger the external criticism by investors and the financial press that Bebchuk and Fried label "outrage." On this account, the model is a purely rational one, with directors always acting in their own self-interest.

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Pay Without Performance reveals any number of phenomena regarding CEO compensation that can be better or more fully explained with reference to social pressures, cognitive bias and other aspects of behavioral theory than purely on the basis of rational choice.

First and foremost is the extraordinary growth in CEO pay since 1990.[12] Bebchuk and Fried use this to refute the presumption of arms-length bargaining arguing, correctly I think, that it is highly unlikely that the actual value of CEO performance to a company could have increased at anything approaching that rate. Yet it also seems doubtful that managerial power has been increasing at that same exponential rate. The really rapid change has been in public perceptions, the increasing investor focus on the CEO and the growth of the "cult of the CEO" encouraged both by an ever more pervasive business

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12. Precise measurements of that growth rate are difficult, however, given the different methodologies that can be used, problems of valuation with respect to certain types of compensation, and different data sets. There is little doubt that the amounts paid to CEOs grew enormously in the 1990's. Bebchuk and Grinstein, looking at the aggregate compensation of the top five executives in publicly traded companies found that it increased from about 5% of aggregate corporate earnings in 1993-1995 to 10% in 2001-2003. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL. 283, 283 (2005). Kevin Murphy, in his 1998 overview of executive compensation, found that from 1992 to 1996, median pay levels for CEOs had increased 55% for manufacturing companies, 53% for financial businesses and 34% for utilities. Kevin Murphy, *Executive Compensation*, HANDBOOK OF LABOR ECONOMICS 2485, 2493 (Orley Ashfelter & David Card eds., 1999). Hall and Murphy also note: "The average real pay for chief executive officers of S & P 500 firms skyrocketed during the 1990s, growing from $3.9 million in 1992 to $14.7 million in 2000." *The Trouble with Stock Options*, *supra* note 9, at 51.

Most observers believe the growth in CEO pay accelerated in the late 1990's, with 1996 being "the year the real run-up in executive pay began." *Special Report: Executive Pay*, BUS. WK., Apr. 21, 2003, at 86, 90. One compensation analyst estimated that executive pay grew at an annual rate of 38% in the late 1990's. *Id.* at 88. The data since 2001 is more equivocal, but CEO pay has continued to rise, but probably at a slower rate. A survey by Mercer Human Resource Consulting in 2006 revealed an annual 8.9% increase in total direct compensation in its study of 350 U.S. corporations. Joann S. Lublin, *CEO Compensation Survey (A Special Report) — The Pace of Pay Gains: A Survey Overview*, WALL ST. J., Apr. 9, 2007, at R1. However, a Forbes 2006 survey announced that CEOs of Fortune 500 companies saw an increase in pay of 38% during 2006 due in large part to exercised stock options. Scott DeCarlo, *Big Paychecks*, FORBES, May 21, 2007, at 112.

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press that has focused with greater intensity on charismatic CEOs, as well as the "ratcheting effect" whereby most directors mistakenly believe (or at least wish to signal) that their CEO's performance is in the top half or top quartile of CEOs of comparable companies.[13] Both the estimation of the CEO's potential contribution to total corporate returns and the CEO's actual and potential performance relative to his or her peers are examples of decision making under uncertainty and are therefore highly prone to the kind of cognitive errors familiar from behavioral theory.

Behavioral theory also helps explain the puzzling fact that newly hired CEOs can negotiate even richer compensation packages for themselves than incumbents, compensation with the very same questionable features, like "generous goodbye payments" and weak performance requirements. It is hard for most corporate lawyers or economists, trained to think of the primary theoretical problem of the firm as one of agency costs, to envisage a market in which contracting between the board and outside third parties can lead to less efficient, less optimal results than those obtained through bargaining by the board with existing managers. Yet other important recent scholarship, written from a behavioral and sociological as well as an economic perspective, argues that this is precisely the case.[14]

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13. This ratcheting effect was described in some detail by Graef Crystal as early as 1991. GRAEF CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991). *See also* Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups* (Working Paper, March 2007), *available at* http://ssrn.com/abstract=972197 ("Firms appear to select high paid peers as a mechanism to increase CEO compensation" and this effect is strongest among firms with weak corporate governance).

14. RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISTMATIC CEOs (Princeton 2002) (hereinafter "*Searching*"). Professor Rakesh Khurana provides an account of contemporary CEO selection and compensation processes which differs in substantial ways from the assumptions of both Bebchuk and Fried and their academic opponents. Khurana argues that the circumstances under which firms seek external CEOs are situations where the former CEO has been fired or resigned under pressure, and therefore constitute a different market from that for incumbents or internal successor CEOs. *Id.* at 161-67. He also reports that the market for external CEOs is far less efficient than most, characterized by small numbers of buyers and sellers, sparse and costly information, pressure both within the board and from outside investors to hire a "charis-

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This third account of a highly social and somewhat irrational bargaining process for CEO compensation does not fit easily under either the arms-length bargaining or managerial power theories of CEO compensation. It is best conceived as an alternative way of analyzing the problem of CEO compensation, one which relaxes the assumption of rational wealth maximizing individuals to include insights from sociology and behavioral theory, and which recognizes that groups of decisionmakers, particularly under conditions of fear and uncertainty, may make predictable errors in judgment. On this view, the very same increase in shareholder activism and greater board transparency has also created vastly greater pressures on boards to fire underperforming CEOs and to locate new corporate saviors who will meet with investor approval and thereby boost lagging stock prices. Accordingly, increases in board independence and additional disclosure may lead to greater overpayment, particularly in the market for external CEOs.[15]

This essay is in two parts. The first analyzes the debate Bebchuk and Fried set up between their managerial power model and what they call the alternative "arms length bargaining model." It then considers a third alternative, a model that includes consideration of social and psychological factors in its account of board behavior. The second section provides a fuller account of the executive search and compensation decisionmaking process, a process during which actors in complex social networks must make difficult decisions under conditions of stress and uncertainty. It is exactly under such conditions, behavioral theory tells us, that decisions are most prone to irrationality, distortion and cognitive error.

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matic" leader, known and highly thought of by investors and the financial press. He concludes that as a result of these internally and externally generated pressures, the choice of an outside CEO is often an irrational one in which boards focus too early on a single candidate, give far too much weight to marginally relevant factors like the prestige of the company the candidate came from, or the "vision" they project in a short personal interview with the board, and thereby give the chosen candidate enormous bargaining power to obtain ever more outrageous levels of compensation.

15. *Id.*

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I. MODELING THE CEO COMPENSATION PROCESS

A. *The Formal Structure of the Compensation-Setting Process*

Formally these days, CEO pay is set by the compensation committee of the board with the advice of professional compensation consultants.[16] Regulations promulgated by the Internal Revenue Service in connection with the deductibility of "performance-based compensation" (as well as potential liability concerns) tend to ensure that compensation committees for publicly traded companies are composed entirely of outside directors.[17]

Compensation consultants are usually hired by the board with input from management, although they are directly hired by management in a substantial minority of companies.[18] The

16. *See* DEL. CODE. ANN. tit. 8, § 141(a) (2004); *see also* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("To be sure, directors have the power, authority and wide discretion to make decisions on executive compensation. *See* 8 Del. C. § 122(5)"). *Id.* at 262 n.56.

17. Under current tax law, executive compensation above $1,000,000 is only deductible by the corporation if it is "performance-based," subject to performance goals determined by a committee of two or more independent directors. I.R.C. § 162(m)(4)(C)(i)(West 2006). The term "outside director" is defined in Treas. Reg. § 1.162-27(c)(3) (as amended in 1996).

18. Corporate Board Member and Towers Perrin, *Directors and Executive Compensation Study*, Oct. 10, 2003, responses to question 16, *available at* http://www.boardmember.com/network/cbm_execcomp.pdf (55% of compensation consultants retained by board, with management input, 10.3% by board alone and 25.1% by management alone). The consultants' advice on CEO compensation is provided to the compensation committee, although the same compensation consultants may give the CEO advice on other employee compensation issues. Accordingly, it is sometimes a little unclear precisely for whom the compensation consultants are working. Kelly K. Spors, *The Pay Police*, WALL ST. J. , June 21, 2004, at R7 ("Some consultants themselves are recognizing the conflict of interest inherent in advising a company's executives on compensation plans and serving the same role for the compensation committee – by refusing to take part in the long popular practice"). There have been calls in recent years to require that board compensation committees make all decisions regarding retention of compensation consultants. New York Stock Exchange Listing Requirements state that the compensation committee should have "sole authority" to retain and fire compensation consultants. Final NYSE Corporate Governance Rules, Commentary to Item 5 of References to Form 10-K (approved Nov. 4, 2003) (to be codified in the NYSE Listed Company Manual at §303A), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf. Additionally, the House Committee on Oversight and Governance Reform recently began examining

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pay package of the CEO and other top executives is then submitted in the proxy statement for a shareholder vote.[19] Accordingly, the basic structure of the CEO compensation process is designed to provide, at least formally, for arms-length bargaining between independent parties informed by the opinions of expert consultants.

B. *The "Arms-Length Bargaining" Model*

The "Arms-Length Bargaining" Model asserts that the CEO compensation process is working pretty much as intended, providing optimal aggregate value to both parties to the compensation contract.[20] The trend towards performance-based pay was initially the result of academic critiques of existing compensation practices.[21] It was picked up by the nas-

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the extent to which the largest compensation consultants have conflicts of interests within their respective practices. *See* Gretchen Morgenson, *Subpoena For Advisers on Salaries*, N.Y. TIMES, June 30, 2007, at C1.

19. CEO pay agreements involving publicly traded companies are virtually always disclosed in proxy statements, pursuant to SEC Regulations. *See* 17 C.F.R. §229.402 (2007). Moreover, at least the (generally vague) statements of performance goals that underlie options grants and other performance-based compensation must be submitted to shareholders for approval, both for tax reasons and to comply with various listing requirements. I.R.C. § 162(m) (West 2006); N.Y. Stock Exch. Listed Co. Manual § 303A.08 (2004), *available at* http://www.nyse.com/regulation/listed/1182508124422.html; Nat'l Ass'n Sec'y Dealers Manual § 4350(i)(2003). However, the clarity and detail required in the proxy statement disclosures had been the source of some criticism of the SEC, as was the existence of some rather obvious loopholes, like the failure to require disclosure of severance pay. In 2006, the SEC substantially revised the required proxy disclosures regarding executive compensation, closing loopholes, adding a required management discussion of compensation policies and requiring it all to be in plain English. SEC Press Release 2006-123, *SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters* (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm.

20. With respect to labor contracts generally, and CEO contracts in particular, the major theoretical problem is minimization of agency costs. One of the most effective ways to reduce such costs is to link pay to various performance criteria, such as accounting profits or stock price, thereby "incentivizing" CEOs to work more effectively to satisfy those criteria, increasing value to the corporation and thereby also increasing the compensation received by the CEO, an "optimal contract" for all concerned.

21. In their classic article in the Harvard Business Review, Professors Jensen and Murphy were highly critical of the failure of most large businesses to either reward or penalize managerial performance through the compensation process. *Performance Pay and Top-Management Incentives*, *supra* note 4.

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cent institutional shareholders' movement, who saw it as a means to focus managers more intensely on increasing shareholder value.[22] It was endorsed, in various ways, by new tax and disclosure rules that encouraged incentive pay, thereby enabling politicians to claim that they had achieved reform of the compensation system, but had done so in a way that was business-friendly.[23] Within a few years, the great majority of the pay received by CEOs of major American corporations was performance-based, primarily due to vastly increased grants of stock options.

Yet the advocates of the arms-length bargaining model do not claim that practice conforms perfectly to theory. They recognize that designing optimal performance incentives is very difficult and compensation committees can easily make mistakes. Yet on their view, such errors in structuring compensation decisions provide no evidence that the system is fundamentally flawed.[24]

They pointed out that CEO compensation was most closely tied to the total sales of firms, and were therefore more dependent on a firm's size than its profitability. They even went so far as to suggest, in an academic article published at about that time, that some of the "inefficient expenditures" made during the conglomerate merger activities of the late 1960s and 1970s were the result of CEOs seeking to expand firm size in an indirect attempt to justify higher pay levels for themselves. From this perspective, incentive pay for top executives appeared as a much more direct and effective way to maximize value for shareholders. Jensen and Murphy dismissed concerns that such performance based pay might result in major increases in compensation to the strongest performing CEOs. They cited statistical evidence to support the view that, as of 1990, CEO compensation was just beginning to approach, on an inflation adjusted basis, the levels of pay CEOs had received in the late 1920's and early 1930's. *Id.* at 143-44.

22. Brian J. Hall & Kevin J. Murphy, *The Trouble With Stock Options,* J. ECON. PERSP., Summer 2003, at 49,62 ("By the early 1990s, shareholder groups like the United Shareholders Association, the Council of Institutional Investors and several large state pension funds had become critical of existing pay practices that were largely independent of company performance.").

23. I.R.C. § 162(m) was enacted in 1994. The SEC's expanded disclosure regulations for executive pay, 17 C.F.R. § 229.402, took effect in 1992.

24. In his 1998 survey of academic work in the field of executive compensation, Professor Murphy provided his own observation of contemporary compensation practices as follows:

> Based on my own observation and extensive discussions with executives, board members, and compensation consultants, I tend to dismiss the cynical scenario of entrenched compensation committees

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Those who basically accept this model of the compensation-setting process usually ascribe recent prodigious increases in CEO compensation levels to globalization and increased competition for top managerial talent which has created a tournament market in which the top managers can command ever increasing amounts of executive compensation, and are nonetheless cheap at the price.[25]

> rubber-stamping increasingly lucrative pay programs with a wink and a nod. Although there are undoubtedly exceptions, outside board members approach their jobs with diligence, intelligence, and integrity, regardless of whether they have social or business ties with the CEO. However, judgment calls tend systematically to favor the CEO. Faced with a range of market data on competitive pay levels, committees tend to err on the high side. Faced with a choice between a sensible compensation plan and a slightly inferior plan favored by the CEO, the committee will defer to management. Similarly, faced with a discretionary choice on bonus-pool funding, the committee will tend to over- rather than under-fund.

Executive Compensation, *supra* note 12, at 2518.

25. *See* Xavier Gabaix & Augustin Landier, Why Has CEO Pay Increased So Much? (Nat'l Bureau Econ. Research, Working Paper No. 12365, 2006), *available at* http://www.nber.org/papers/w12365.pdf; Edward P. Lazear & Sherwin Rosen, *Rank-order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841, 863 (1981). One of the most coherent and popular forms of this argument is found in ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: HOW MORE AND MORE AMERICANS COMPETE FOR EVER FEWER AND BIGGER PRIZES, ENCOURAGING ECONOMIC WASTE, INCOME INEQUALITY, AND AN IMPOVERISHED CULTURAL LIFE (Martin Kessler Books 1995). Cook and Frank view the most important characteristics of these markets as "reward by relative performance" and "high concentration of rewards" *Id.* at 24. While not entirely happy about the development of such markets, which they see as a source of growing income inequality as well as a potential misallocation of human resources, Cook and Frank nonetheless argue that they are characteristic of more and more professions. The market for sports stars is seen as a paradigmatic example of such a market. As they state:

> "[A]lthough thousands of players compete each year in professional tennis, most of the industry's television and endorsement revenues can be attributed to the drawing power of just the top ten players." *Id.* at 2.

The Frank and Cook argument is not limited to sports stars, but on their view extends to top professionals in many fields, including corporate executives. Some have used Cook and Frank's theory to defend current CEO compensation practices, arguing that the growth in executive compensation is simply another example of an increasingly winner-take-all market, where the additional value that a top CEO can provide to a large corporate organization more than justifies their increasing compensation packages. *See* Robert B. Reich, Op-Ed, *CEOs Deserve Their Pay*, WALL ST. J., Sept. 14, 2007, at A13;

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C. *The "Managerial Power" Model*

In *Pay Without Performance,* Professors Bebchuk and Fried not only provide a powerful critique of the "arms-length bargaining" model, but offer what they consider to be a superior alternative. Their model makes the standard assumptions about rational utility-maximizing economic actors, and they believe that economic analysis provides the best method for understanding the problems of corporate law. They share the prevailing norm of shareholder wealth maximization as a guide to corporate governance.[26] Their critique consists primarily of the empirical demonstration that current compensation practices do not maximize shareholder wealth or align the interests of managers and shareholders. Their central claim is that the vast majority of compensation received by CEOs under the rubric of incentive pay is nothing more than a wealth transfer from shareholders achieved through managerial power over the compensation process.

Their primary empirical support for this conclusion is an analysis of the form in which CEO compensation has been paid. For example, Bebchuk and Fried point out that many CEO compensation packages contain provisions for "generous goodbye packages" i.e., substantial severance pay. Paying lots of money to CEOs when they leave or are fired not only fails to provide them with any incentive to do a good job, but actually decreases such incentives by cushioning the downside risk of managerial failure. Similarly, they question why virtually all

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More Pieces of the CEO Compensation Puzzle, supra note 9, at 155. The notion that the relative managerial talent of current CEOs is so much greater than other executives and so much more valuable to shareholders that it justifies their enormous and increasing pay levels is hard to maintain in a post-Enron business environment and is thoroughly debunked by Khurana's account of CEO hiring. SEARCHING FOR A CORPORATE SAVIOR , *supra* note 14, at 50. It may not even be an accurate account of the market for sports talent. *See* discussion of *Moneyball, infra* note 68.

26. *PWP, supra* note 6, at 8. ("[W]e share the assumption of defenders of current pay arrangements that executives are influenced by financial incentives. We agree that paying generously to provide desirable incentives can be a good compensation strategy for shareholders. Indeed, the fact that executives (as well as directors) are influenced by financial incentives and have an interest in increasing their own pay actually plays an important role in our analysis. Our concern is simply that executives have partly taken over the compensation machine, leading to arrangements that fail to provide managers with desirable incentives.").

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executive stock options are issued at market price, when pricing the options 5 or 10% above market would create far stronger incentives to increase shareholder value, and why very few stock options are indexed to provide incentives to exceed general market increases, rather than simply profit from them.

Bebchuk and Fried argue that CEOs and board committees frequently fail to negotiate at arms length because their desire to maintain their board seats and avoid the wrath of the CEO is greater than their desire to carry out their fiduciary duties to bargain effectively. Bebchuk and Fried's model is at least as coherent, as a matter of economic theory, as the optimal contracting model. Indeed, it was never clear, in the arms-length bargaining model, why board members would bargain for CEO contracts that sought to maximize shareholder value rather than simply do whatever was most personally beneficial to them. Under the law, of course, they are fiduciaries with legal obligations to act in the best interests of the company and its shareholders, but for that matter, so is the CEO, and the optimal contracting model is based on the assumption that, absent appropriate incentives, the CEO will shirk those duties. Since, at least until very recently, it was equally clear that board members would suffer no legal consequences for acquiescing in CEO compensation demands[27], the Bebchuk and Fried assertion that directors will crumble in the face of managerial power appears to be a more consistent methodological assumption than that of their opponents. Since it also explains many aspects of current compensation practices that are not comprehensible under the assumption of arms-length contracting, it also seems to have greater empirical validation. In short, Bebchuk and Fried's managerial power model provides an account of the CEO compensation process that is superior to the arm-length bargaining model on both theoretical and empirical grounds.[28]

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27. *See* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1881-82 (1992) (noting that board determinations regarding executive pay "are not now restricted in any substantial way by corporate law rules").

28. In a relatively recent paper, (co-authored with Jensen and Wruck) Murphy, perhaps influenced by the arguments of Bebchuk and Fried, paints a substantially more negative picture of the compensation-setting process than he had previously offered (*see* note 24 *supra*):

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Being better than the prior model, however, does not necessarily mean it is wholly satisfactory. There are still plenty of aspects of the executive compensation process that the managerial power model fails to explain. Critics of the Bebchuk-Fried thesis have pointed to a number of facts about CEO compensation which appear inconsistent with or unexplained by the managerial power model. One is the dramatic increase in levels of CEO compensation in the recent past. During this period, boards have tended to become more independent and less subject to managerial control.[29] There are more outside directors on boards.[30] There are more boards that have a majority of outside directors.[31] There are more boards that are chaired by a director other than the CEO, more instances

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> Compensation committees, which typically meet only six to eight times a year, lack both the time and expertise to be involved in the minutia of performance evaluation and pay design. The fact that initial recommendations are made by company management and not by the compensation committee may be an efficient outcome given the time and resource constraints faced by the committee, but it calls into question the integrity of the compensation process. The fact that the committee only sees plans that have already been "blessed" by top managers creates an environment that invites abuse and bias. Put differently, although individual committee members are generally competent and well motivated, the governance system itself is corrupted and tilted in the direction of management in a way that will almost inevitably lead to excesses in executive pay levels.

Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *CEO Pay. . .and How to Fix it* 51 (Harvard Bus. Sch. NOM Research Paper No. 04-28, March 2005), *available at* http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Jensen_ExecPay3-9-05.pdf (last visited Jan. 23, 2008).

29. *The Trouble with Stock Options*, *supra* note 9, at 64-65.

30. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921 (1999).

31. NYSE Listing Requirements, *available at* http://www.nyse.com/regulation/listed/1022221392369.html (last visited Jan. 25, 2008); Final Corporate Governance Rules (November 2003) (codified as § 303A of the NYSE Listed Company Manual) (requiring that a majority of board members be independent), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf (last visited Jan. 24, 2008). *See also* Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64154, 64176 (Nov. 12, 2003). Bengt Holmstrom & Steven N. Kaplan, *Corporate Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121 (2001).

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where independent directors meet separately from the CEO,[32] and the definition of "independent director" has been tightened in recent years.[33] Furthermore, Bebchuk and Fried note that "[a] CEO is likely to be relatively more powerful as the size of the board increases."[34] Yet the evidence is clear that there has been a substantial decrease in board size.[35] In short, the trend has clearly been toward greater board independence and less CEO influence over boards and board members. If the managerial power thesis is correct, why has this not led to a decrease, rather than a massive rise in CEO compensation?

Similarly, while Bebchuk and Fried make much of the fact that some CEO compensation is in the form of "stealth payments" that are hard for shareholders and other interested observers to understand or find out about,[36] the trend again over the last 10 to 15 years has been toward much greater transparency, disclosure and publicity regarding the compensation of CEOs. Again, however, this has not led to any diminution in levels of pay over that same period, but to a huge increase.

One particularly strong and invariably cited argument against the Bebchuk-Fried thesis is that compensation levels paid to newly hired "outside" CEOs substantially exceed the amounts paid to incumbent CEOs. This is a problem for them, since incumbent CEOs presumably have more manage-

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32. Ellen Byron, *Managers: Keep Out*, WALL ST. J., June 21, 2004, at R4 (discussing the impact of new NYSE and NASD rules requiring regular meetings of non-management directors).

33. *See supra* note 23 (discussing Internal Revenue Code requirement that performance criteria be set by a committee of independent directors). *See also* Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1(m)(3) (Supp. IV 2000) (requiring each member of the audit committee of a listed company to be independent); NYSE Listed Company Manual Rule 303A, *available at* http://www.nyse.com/regulation/listed/1182508124422.html (last visited Jan. 25, 2008); *Qualitative Listing Requirements for Nasdaq National Market and Nasdaq Small Cap Market Issuers Except for Limited Partnerships*, NASD Manual (CCH) Rule 4350(c), at 5334 (Sept. 2005).

34. *PWP*, *supra* note 6, at 80.

35. Yi-Lin Wu, *The Impact of Public Opinion on Board Structure Changes, Director Career Progression, and CEO Turnover: Evidence from Calpers' Corporate Governance Program*, 10 J. CORP. FIN. 199, 206 (2004); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, June 15, 2000, at 15, *available at* http://www.ny.frb.org/research/epr/03v09n1/0304herm.pdf (last visited Feb. 15, 2008).

36. *PWP*, *supra* note 6, at 108, 109.

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rial power over their boards than newly hired outsiders.[37] Although Bebchuk and Fried recognize that many of the factors which give rise to managerial power may be present for prospective as well as incumbent CEOs,[38] they do not have a convincing explanation of how external CEO candidates appear to exercise substantially greater power over their pay than incumbents.[39]

A somewhat different set of arguments attack the reasonableness of Bebchuk and Fried's assumption that arms-length bargaining, properly conducted, should result in more risky performance incentives for CEOs. Opponents point out that any arms-length bargain involves some compromise between the desires of the bargaining parties, and CEOs might rationally seek to put less of their compensation at risk.[40] Bebchuk and Fried's response, I suspect, would be that an economically rational compensation committee members should always prefer to increase the amounts of compensation rather than reduce the risk.[41]

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37. *See supra* note 9.

38. *PWP, supra* note 6, at 80.

39. *Id.* at 84. Bebchuk and Fried also argue that "outside hires are often already CEOs of other firms, while inside candidates, by definition, are not. Outside candidates who are already CEOs are likely using their current positions to extract rents and firms hoping to hire such candidates must match these rents." *Id.* at 45. This argument, however, is a bit too simple. If the managerial power thesis is correct and incumbent CEOs are already being overpaid, why would an outside board, not subject (or at least less subject) to that managerial power, agree to pay an even larger amount? If outside board search committees were rational, they would reject CEOs with inflated pay packages in favor of non-CEO outsiders who offered greater value for their pay. As we shall see, however, board search committees are not, by and large, rational decisionmakers.

40. This is a central point for Snyder, *supra* note 9, at 152. He notes "the fact that one party has more bargaining power than the other does not necessarily compromise the transaction. The party with more bargaining power will likely get a better deal, but that is what is supposed to happen when transactions are voluntary and power is asymmetrical." The fact of CEO bargaining power is also important to Hall & Murphy, *supra* note 9, at 59, who note that "risk-averse executives" will disfavor indexed options since their likelihood of expiring worthless is far greater than that for options issues at market price.

41. I suspect Bebchuk and Fried view the position that low risk CEO contracts may simply reflect strong CEO bargaining power as theoretically incoherent. Bebchuk and Fried speak in many places in their book of certain *forms* of compensation, irrespective of amount, as being more or less effi-

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Bebchuk and Fried's managerial power model assumes not only a CEO with an insatiable appetite for compensation and a supine board, but two other critical concepts, "outrage," an external limit on the amounts of compensation that can be paid without generating highly negative responses from "interested outsiders" and "camouflage" or "stealth compensation," a method by which certain types of compensation can be kept hidden and thus reduce the likelihood and amount of "outrage." For Bebchuk and Fried, it is the varying efficacy of different forms of camouflage that explains the highly complex forms of CEO compensation that exist today.[42]

D. *The Importance of Social and Psychological Factors*

The managerial model is powerful in its simplicity, but we may well ask whether it is a little too simple to fully capture the salient features of the CEO compensation-setting process. The most implausible players in the drama are the board members, who are assumed to be both extremely cowed by the CEO (so they give him whatever compensation is desired) but also ex-

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cient than others. For example, deferred compensation outside of 401(k) plans is generally inefficient on this view, because it increases the total joint tax liability of the firm and the CEO. *PWP* at 103. Accordingly, it would be more efficient, irrespective of the amount paid to the CEO, to pay him in a different form that reduced joint tax liability. Bebchuk and Fried would argue, I believe, that current forms of CEO compensation are inefficient in much the same way.

42. Assume, for example, that a CEO wishes to receive $100 million in compensation, but recognizes that "outrage" costs will be considerable at any amount greater than $35 million in highly incentivized forms of pay. (In this hypothetical, $35 million represents the risk neutral value of some highly incentivized form of compensation, like indexed options.) Accordingly, in consultation with the board and compensation consultants, they develop a package which provides for $25 million in deferred compensation (which does not have to be disclosed to shareholders), $5 million in corporate perquisites like corporate jets (difficult to value and defensible as business costs) and change the terms of the incentive compensation (difficult to value), which make the performance criteria twice as likely to be met by the CEO (thereby increasing its value to the CEO from $35 to $70 million). I believe Bebchuk and Fried would say that a CEO whose value to the firm genuinely justified a $100 million pay award would not incur any outrage cost and would not have to engage in any such subterfuge. The fact that many pay packages are structured along the lines of our hypothetical is therefore itself a strong indicator that such pay is the result of managerial overreaching.

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tremely knowledgeable (so they understand and at least acquiesce in camouflaging the compensation). Even Bebchuk and Fried recognize that the board's motivation may sometimes be less venal and self-interested. They recognize that a variety of what they call "social and psychological factors"[43] may "encourage directors to go along with compensation arrangements that favor the company's CEO and other senior executives" irrespective of economic incentives.[44] According to Bebchuk and Fried, these social and psychological factors include the director's "sense of obligation and loyalty" to the CEO, social considerations of collegiality and desire to avoid "direct conflict and confrontation,"[45] deference to the CEO as an authority figure, and the cognitive biases of board members, many of whom are CEOs themselves, who "will tend to err on the positive side in assessing how well the company is doing relative to its industry peers, how qualified their CEO is relative to the CEO's peers, and so forth."[46] Similarly, in discussing whether "mistakes" or "misperceptions" may be the basis for directorial approval of inefficient pay agreements, Bebchuk and Fried express substantial ambivalence. On the one hand, they sometimes view the distinction between mistaken and self-serving actions by compensation committees as unimportant, stating:

> 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 have been at least to some extent willing to approve option arrangements that favor managers at the expense of shareholders.[47]

Yet they also argue, in the very next paragraph, that if "honest stupidity" were the only problem, overcompensation of CEOs could be solved by simply "educating directors or providing them with more accurate information." Since this has

43. *PWP* at 31.

44. *Id.* at 31.

45. *Id.* at 31-32 (quoting KHURANA, *supra* note 14, at 84).

46. *Id.* 33-34 (noting that about 20% of compensation committee members were current CEOs themselves).

47. *Id.* at 78.

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not occurred, they conclude that managerial power, not misperception, is the more likely cause.[48]

But Bebchuk and Fried's solution to the problem of cognitive error is one that only works when the question presented to the board has a relatively clear right answer that can be discerned with "accurate information."[49] When the question is one of judgment under uncertainty, such as determining the present value of the CEO's likely future contribution to shareholder wealth, there are no clear answers or dispositive information.

Consider the following three directors on the hypothetical board of XYZ Corp.:

Director A has known the CEO for 20 years. A considers him the most brilliant and knowledgeable person in the industry. Director A made a great deal of money investing in XYZ in the mid-1980's, shortly after the CEO took office and increased profits by 50% in 3 years. A recognizes that income growth since that time has been unspectacular, but is convinced that the CEO's current plans for XYZ are very likely to succeed. A's main fear is that the CEO, who has his detractors, will get fed up and resign before his new plans are completed. Accordingly, Director A wholeheartedly supports all of the CEO's compensation demands.

Director B is an experienced businesswoman who has recently come on the board. She thinks the CEO's talents are somewhat overrated and his compensation demands too high. Nonetheless, he is an important symbol of XYZ's prior success, and, she believes, still likely to do a better job in the next few years than anyone else the board is likely to hire to replace him. Given that fact, she thinks that objecting to his pay would be counterproductive, in that it might not succeed, and even if it did, would create dissension among the board, resentment by the CEO, and adverse publicity for the company. On balance, she votes to approve the compensation package.

Director C thinks the CEO is an egotistical fraud who should be fired as soon as possible. Unfortunately, he knows that no one else on the board feels as strongly as he does, but

48. *Id.*

49. Such as the question Bebchuk and Fried are discussing in this portion of their book, the costs to shareholders of conventional option plans. *Id.* at 77.

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that some others are beginning to have doubts. He thinks the CEO's requested pay package is outrageous but he votes to approve it because (a) he does not want to risk being thrown off the board before he can gather sufficient support to fire the CEO, and (b) he thinks that the contrast of exorbitant pay and lackluster results for XYZ, which he expects to continue, will make it easier to get rid of the CEO in the near future.

All of these directors vote to approve CEO compensation that is very likely inefficient based on motivations in which managerial power plays some, but by no means the sole or even the dominant role. Director A displays classic cognitive bias. He ascribes too high a probability to the repetition of a vivid event from the recent past. Director B shows signs of status quo bias and path dependency, as well as possible group polarization. Director C's actions are irrational given his personal beliefs and preferences, but quite rational given the social setting in which he must act. All three also illustrate the way questions of CEO compensation necessarily overlap with questions of CEO hiring, retention and succession.

I suspect Bebchuk and Fried would accept these hypotheticals as at least possible scenarios to explain some inefficient CEO pay agreements. They might well then respond that, given these inefficiencies, the motivation does not matter all that much. I think it matters quite a lot. First, recognizing the psychological and social bases for much CEO overcompensation removes the moral disapproval inherent in the pure agency cost model. To be sure, moral disapproval has its place in corporate law, particularly when dealing with breaches of fiduciary duty, which are, legally speaking, what agency costs represent.[50] But such moral opprobrium really does not attach in the same way if, as I have been suggesting, cognitive biases or social context may be the source of much inefficiency in compensation contracts rather than purely self-serving behavior by directors. Moreover, whereas most directors are likely to reject a pure agency cost theory of their compensation-set-

50. This is, of course, an oversimplification. Breaches of fiduciary duties are only those self-regarding actions by agents (like stealing corporate assets), which the law prohibits and for which it potentially offers a recovery. From an economic point of view, there may be many actions by corporate agents which constitute agency costs (like spending every Wednesday at the golf course) but for which the law provides no remedy.

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ting behavior, in part because it does not comport with their internally perceived motivations, they are more likely to listen and perhaps even change their behavior if presented with a theory that explains why paying too much to CEOs may seem like the right thing to do, even when it's not.[51]

More generally, different motivations for inefficient compensation contracts imply different potential policy solutions. Cognitive biases may be partially overcome by increasing awareness of them. Problems of group or social interaction can be ameliorated by changes in meeting practices or information exchanges. More generally, a variety of motivations, or a complex mix of motivations in setting CEO pay may be more susceptible to broad oversight or review than solution by a single ameliorating rule.

Finally, recognizing the psychological and social components of CEO pay would enable Bebchuk and Fried to answer some of the more salient criticisms that have been leveled at their theory. For example, Bebchuk and Fried's response to the growth of board independence in recent years is to argue that this does not mean that managerial power over board members has been eradicated, and that such managerial power may still therefore have a substantial impact on CEO compensation practices.[52] But this is a relatively weak response that does not explain the rise in CEO pay in recent years. A richer social and psychological account might begin by pointing out that on the managerial power model, CEO compensation is not constrained by a CEO's actual value to the company, but by the soft variable called "outrage" and outrage itself seems to be dependent on both the actual amount of compensation received (or at least disclosed) and the perceived (not actual) value of the CEO receiving it.[53] This em-

51. There are some suggestions in the behavioral theory literature that simply explaining cognitive biases to potential decision-makers can reduce the effect of such biases. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1527 (1998). *See* Russell Korobkin & Chris Guthrie, *Psychology, Economics, and Settlement: A New Look at the Role of the Lawyer*, 76 TEX. L. REV. 77, 115-16, 119 (1997). *C.f.*, Linda Babcock et al., *Creating Convergence: Debiasing Biased Litigants*, 23 LAW & SOC. INQUIRY 913, 921 (1998).

52. *PWP*, *supra* note 6, at 25.

53. Bebchuk and Fried expressly note that it is only compensation perceived as "unjustified" that triggers the outrage constraint. *Id.* at 65.

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phasis on perception means that the managerial power model can potentially explain much of the increase in CEO pay in recent years by looking at changes in the perception of the investing public as to the value of the CEO. As we shall see more fully in the next section, there is strong evidence that the 1990s saw the rise of the "cult of the CEO,"[54] in the business media and among investors, creating a powerful perceived need to have a strong, charismatic person as both the CEO and the public face of most major corporations. As the perceived value of CEOs increased during this period, the amount of compensation needed to trigger "outrage" also increased.

A similar change in perceptions at the level of each individual corporate CEO can be seen through the operation of the "ratcheting" effect.[55] The ratcheting effect occurs when compensation consultants, in gathering data on the current compensation of the CEO relative to his or her "peers" manages to show, as they almost always do, that the current level of CEO compensation puts her in the bottom 50% of comparable CEOs. Since most boards believe their CEO is at least "above-average" and probably should be paid in the top quartile of comparable corporate CEOs, this leads to a consistent "ratcheting up" of the compensation paid to the same group of CEOs. It should be noted that this "ratcheting effect"[56] is itself based on a cognitive error. If we assume that corporate CEOs can be ranked in terms of their relative abilities, than 75% of boards are simply mistaken when they believe that their CEO ranks in the top quartile in terms of ability. It is

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54. SEARCHING, *supra* note 14, at 74. In a recent study, Bebchuk and others refer to this phenomenon, (Khurana's concept of the "corporate savior") to help explain their finding that the percentage of pay received by the CEO relative to the pay of the top five executives (what they call the "CEO's pay slice") has increased substantially in recent years. Lucian Bebchuk, Martijn Cremers & Urs Peyer, *Pay Distribution in the Top Executive Team* 19 (Harvard Law and Economics Discussion Paper No. 574, Feb. 2007), *available* at http://ssrn.com/abstract=954609.

55. For discussions of the ratcheting effect, *see* Crystal, *supra* note 13 at 220-21; *see* Charles M. Elson, *The Answer to Excessive Compensation is Risk, Not the Market*, 2 J. BUS. & TECH. L. 403, 405-06 (2007); John M. Bizjak, Michael L. Lemmon & Lalitha Naveen, *Does the Use of Peer Groups Contribute to Higher Pay and Less Compensation?*, at 7-8 (working paper, Mar. 2007) *available at* http://ssrn.com/abstract=252544; *PWP*, *supra* note 6, at 71-72.

56. Bebchuck and Fried describe and accept the ratcheting effect phenomenon. *Id.*

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very similar to the cognitive error made by virtually all about-to-be-married couples, who, while they know that approximately 50% of all marriages will end in divorce, confidently predict that their own will not.[57] Because these are decisions made under uncertainty, strongly influenced by such heuristics as optimism and availability, it is almost as unlikely that board members can provide an accurate assessment of their CEO's relative abilities as a newlywed can give an accurate assessment of his or her likelihood of divorce.[58]

This emphasis on changing societal and investor perceptions of the CEO also helps answer the second major critique of the managerial power model, its failure to explain why greater disclosure and media coverage did not curb "stealth compensation" and other inefficient compensation arrangements. Bebchuk and Fried merely point out that there were loopholes in the disclosure requirements, particularly regarding severance pay, that could be exploited.[59] But a broader perspective on media coverage of CEO compensation in recent years can explain how increased disclosure actually exacerbated the problem of excessive compensation

First, increased reporting of high levels of executive pay probably increased demand by showing CEOs what they could ask for without triggering unacceptable levels of "outrage."[60] Second, the extended coverage given to certain highly publicized instances of excessive pay could give shelter (i.e. protect from "outrage") other CEOs with only slightly less exorbitant demands. Moreover, much of the reporting on high CEO

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57. Lynn A. Baker & Robert E. Emery, *When Every Relationship is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW & HUM. BEHAV. 439, 443 (1993).

58. For a general discussion of the policy issues raised by this phenomenon, *see* Charles M. Yablon, *The Meaning of Probability Judgments: An Essay on the Use and Misuse of Behavioral Economics*, 2004 U. ILL. L. REV. 899 (2004).

59. *PWP*, *supra* note 6, at 95-96, 100-01. For a comparative analysis of recent attempts to tighten disclosure rules for executive compensation in light of international corporate scandals *see* Jennifer Hill, *Regulating Executive Remuneration: International Developments in the Post-Scandal Era* (Vanderbilt Law & Econ. Research Paper No. 06-15, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=922299.

60. For example, in 1992, only 8.1% of the companies in Yermack's study disclosed use of corporate jets as an executive perk; by 2003, the figure had risen to over 35%. David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 223.

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compensation, particularly for individual CEOs, associated it with superior performance by such executives.[61] This gave boards of companies that had experienced good performance both a justification for increasing CEO pay and a vindication of such pay packages as a compensation strategy. Finally, it was the expanded disclosure of CEO compensation required under the SEC proxy rules which made possible the detailed comparisons of CEO pay levels and thereby exacerbated the "ratcheting effect."

Considerations of board dynamics and social perceptions can also provide Bebchuk and Fried with a potentially strong answer to perhaps the most powerful criticism of all, the claim that managerial power cannot be the basis of most CEO pay because newly hired outside CEOs are consistently paid more, on average, than incumbent CEOs. This argument only has substance, however, if we assume that incumbent and outside CEOs are part of the same market, a market for CEOs, and that market is a rational one in which outside CEOs are hired through competitive arms-length bargaining and whose prices can therefore be used as a check on the compensation levels of incumbent CEOs. Since the cost of outside newly hired CEOs is higher than that of incumbents, the pay of incumbent CEOs cannot be excessive.

Suppose, however, that there is no single rational market in CEOs. Suppose there are two markets, each with its own distortions and irrationalities. The first is the market in which compensation for incumbent and insider CEOs is set.[62] This is a market in which the relationship between the incumbent CEO and the board members looms large and, as Bebchuk and Fried suggest, the opportunities for the exercise of mana-

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61. *E.g.* Daniel Kadlec, *'94 was a lucrative year for GE's Welch*, USA TODAY, Mar. 14, 1995, at 3B ("Welch is known as a management visionary who has done fabulously for shareholders."); Ronald Grover & Michael Oneal, *Room for Two Lion Kings?*, BUS. WK., Aug. 26, 1995, at 28 ("insiders say, the seven-year deal [Michael Ovitz] got from Disney – even loaded with stock options – is far less than the reported $250 million that Bronfman was set to offer him. That makes him a bargain for Disney's board.").

62. By "insider" I mean a process whereby an existing employee of the firm is promoted to CEO, usually as a result of the planned retirement of the incumbent. As Khurana notes, the incumbent CEO often has substantial power over the choice of successors and substantial interest in having a favored candidate selected. SEARCHING, *supra* note 14.

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gerial power, as well as other less rational ways for powerful CEOs to affect the compensation-setting process, may all play a significant role and skew pay above optimal levels.

But the second market, the market in which outsider CEOs are hired and compensated, is one where such decisions are made under conditions of great urgency and uncertainty. First, the events precipitating the need for a new CEO are likely to have been traumatic. Either the CEO has been fired, resigned unexpectedly or died suddenly, all events likely to create a sense of crisis and a felt need to reassure shareholders and the investing public by placing a new confidence-inspiring CEO in place relatively quickly. Second, the fact that the new CEO is being sought outside the firm often indicates that there is some perceived problem with existing management, as when the incumbent CEO is fired or resigns under the cloud of scandal. Boards may then be under intense pressure to bring in outsiders.[63] Hiring from within remains the dominant mode of CEO succession in American corporations, but outside hiring has become increasingly frequent, accounting for almost one-third of new CEO hires in recent years.[64] During the same period, the frequency of CEO firings has substantially increased.[65] The result is that most compensation deci-

63. *The Siren Song of the Outsider*, THE ECONOMIST, Mar. 6, 2004, at 55 ("Boards have traditionally turned to outsiders when their companies have been in trouble").

64. SEARCHING, *supra* note 14, at 47, n.54. In a study of all CEO turnovers in the 500 largest public companies in the United States during 1997 and 1998, Professor Margarethe Wiersema found that outsiders were brought in 36% of the time, and when the prior CEO had been dismissed rather than retired, the hiring of outsiders rose to 61%. Margarethe Wiersema, *Holes at the Top: Why CEO Firings Backfire*, HARV. BUS. REV., Dec. 2002, at 70, 72. *See also*, Scott Thurm, *Directors Now Prefer Insiders in Search for CEOs*, WALL ST. J., May 2, 2007, at A2 (referring to a study by executive recruiting firm, Spencer Stuart, which found that 40% of the CEOs hired by S&P 500 companies in 2005 were outsiders. This same study found that this figure dropped to 15% in 2006 with signs of continuing the downward trend for 2007).

65. Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs* (Nat'l Bureau of Econ. Research, Working Paper No. 12465, 2006) (empirical study finding that in the period 1998 – 2004, CEO turnover increased to 16.5%, implying an average CEO tenure of just over 6 years); Barbara Rose, *CEO Chair Becomes Hotter Seat; Boards Impatient with Performance*, CHI. TRIB. (Jan. 28, 2004) §3, at 1 (reporting on a study by Khurana that CEO tenure had decreased on average by one year between 1980 and 2000 and that a

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sions regarding newly hired outside CEOs are made by boards urgently seeking to recruit a new CEO who can restore investor confidence and lead the company in different directions from the perceived failures of the old regime.[66] In such circumstances, it would not be surprising if the board was focused primarily on finding the "best" person for the job, and only very secondarily on how much that person was asking to be paid.[67]

CEO was three times more likely to be fired for the same level of performance at the end of the 20-year period than at the beginning. "Boards are more willing to pull the trigger now; they'll do it sooner than they used to," said Charles H. King, managing director and head of global board services of Korn/Ferry International in New York. "They are feeling a lot more exposed than they used to."); *see also* Wiersema, *supra* note 64, at 72 (if "early retirement" is taken as a euphemism for forced removal, as many as 71% of CEO departures in 1997-98 can be considered involuntary); Brooke A. Masters, *Job Security Wanes in Executive Suites*, WASH. POST, May 18, 2006, at D1 (quoting a study by Booz Allen & Hamilton finding a turnover rate of 15.3% in the CEO office at the world's largest 2,500 companies in 2005 – the highest rate in the decade that the firm has conducted the study); Eric Dash, *Boards More Likely to Oust Underperforming Chief Executives, a Study Finds*, N.Y. TIMES, May 22, 2007, at C6 (quoting the 2007 edition of the Booz Allen & Hamilton study, finding that the same turnover measure declined to 14.3% in 2006. The study also found that 4.6% of the CEOs who left their companies in 2006 were forced out, a slight decline from the same figure in 2005, but still a dramatic increase from 1.7% measured a decade earlier).

66. The idea that boards of poorly performing companies will engage in different practices with regard to monitoring, compensating and firing CEOs than more successful ones is implicit in the model developed by Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998).

67. Such newly hired CEOs may be overpaid, but they are not "entrenched," and may have considerable concerns about job security. This could explain the results found by Antonio Falato in his recent study of executive pay and corporate acquisitions. *Superstars or Superlemons? Top CEO Pay and Corporate Acquisitions* (October 2006) (unpublished manuscript, on file with the Federal Reserve Board). Falato found that CEOs who received "excess compensation" (relative to their peers) were less likely to engage in inefficient value-destroying acquisitions, contrary to the predictions of many economic models that entrenched management is more likely to pursue unprofitable acquisitions. If CEOs are not entrenched, however, but are overpaid due to cognitive errors by the board, they have little to gain and much to fear from engaging in unprofitable mergers. Interestingly, Falato found his strongest results among CEOs with excess pay who had recently switched firms, exactly the category that is most likely to be paid as a result of imperfections in the market for CEOs rather than pure exercises of managerial power. Compare, however, the recent study by Bebchuk, Cremers & Peyer,

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Board willingness to pay exorbitant amounts of relatively riskless compensation to outside CEO candidates is exacerbated by the process through which the CEO search is conducted. Khurana's book provides an extensive description of that process and analyzes its deficiencies. He describes the external CEO search process as characterized by lack of information, lack of transparency, time pressure, cognitive bias, group polarization and other inefficiencies, all of which lead boards to prematurely fix on a single "corporate savior" as the "best" candidate to rescue the company from its crisis. The CEO candidate, in turn, recognizes both her bargaining power in connection with this hiring decision and the very substantial uncertainty that she can actually live up to the expectations of the board. Accordingly, it is in her interest to demand and receive initial pay packages very much along the lines Bebchuk and Fried describe, which provide enormous compensation for little actual risk.[68] In short, Khurana's description of the irrationality of the outside CEO selection process gives Bebchuk

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supra note 54, which found that companies with a high "CEO Pay Slice" tended to engage in a disproportionate number of bad corporate acquisitions.

68. SEARCHING, *supra* note 14, at 190-93. While the notion of a market in which ostensible attempts at arms-length bargaining frequently lead to predictably non-optimal results may seem strange to those used to classical economic models, it is consistent with much current social and behavioral theory. Indeed, the external CEO market Khurana describes has some interesting similarities to the market for major league baseball prospects described in the book *Moneyball.* MICHAEL LEWIS, MONEYBALL: THE ART OF WINNING AN UNFAIR GAME (2003).

It is hard to imagine that the market for CEOs can be any more efficient than that for baseball players, and is likely to be substantially less so. After all, unlike vague and hard to define CEO qualities of "dynamism" or "leadership potential," the ability to play baseball is relatively easy to ascertain and is objectively measurable. The richest teams pay the most for the best players, which in turn enables them to win the most games. *Moneyball* tells the story of the Oakland Athletics, a team with one of the lowest payrolls in major league baseball. Yet it has also been one of the most successful teams by exploiting the predictable cognitive errors of other participants in the market for baseball players, such as a tendency to overvalue players who look or act a certain way, to undervalue historical performance statistics and to overvalue both success and failure in crucial games. It is increasingly accepted that behavioral heuristics can, under certain circumstances, lead to predictable but suboptimal decisionmaking. Khurana's thick description of the external CEO market reveals a decision making process distorted by many factors: cognitive errors, group norms, agency costs, and lack of information.

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and Fried a powerful way to refute the argument that the high pay of outside CEOs shows that incumbent CEO pay is not out of line. Bad as the incumbent CEO compensation setting process may be, the compensation setting process for outside CEOs is even worse.[69]

In short, managerial power involves more than just a sleazy *quid pro quo* in which spineless directors acquiesce in excessive pay demands in exchange for keeping their board positions. It potentially describes a highly complex set of relationships between the board members and the CEO in which the CEO not only implicitly threatens but simultaneously convinces the board, through control of information, personal dynamism, exploitation of cognitive biases, social norms and fear of disruption of the status quo, that he or she is indeed the best person to lead the company. A board that has such a view of their CEO will generally see little need for arms-length bargaining over compensation.

Moreover, compensation decisions, particularly with respect to underperforming CEOs, are frequently tied to questions of retention and firing. Perhaps the most important role of the board is recognizing when a CEO should be fired and then actually doing the firing. Yet this role is also frequently incompatible with arms-length bargaining over salary.[70] In the following section, we will consider how the psychological and social aspects of the board member's perception of incumbent

69. *See also* Eric Dash, *Hire by the Contract Now, Risk a Big Regret Later*, N.Y. Times, Jan. 12, 2007, at C1 (noting recent CEO firings in which the former execs walked away with enormous exit packages. "Employment contracts, agreed upon when a new leader arrives, have been blamed for virtually guaranteeing such huge payouts even when that executive fails . . . . Among the 16 chief executives of the top 100 companies who were recruited from outside in the last three years, 13 had an employment contract or severance contract; among the 10 executives who were promoted, 6 had a contract.") (internal citations omitted).

70. Imagine, in connection with the ratcheting effect, a board that learned that the CEO was being compensated in the bottom quartile of his or her peers, and concluded that such pay accurately reflected the CEO's relative level of abilities and achievements. Would the board simply accept that, and conclude that the CEO did not deserve a raise, or would the fact that their CEO was in the bottom quartile of his peers itself create serious doubts as to whether the CEO should be retained at all? As CEO turnover increases and firings become more frequent, the CEO's need to retain board confidence becomes not just a matter of maximizing one's salary, but of corporate survival.

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and potential CEO's can affect their compensation decisions, as well as decisions regarding hiring and firing.

II.
CEO Pay in Social and Pyschological Context

A. *The Complexities of the Board – CEO Relationship*

Consider the case of Douglas Daft, former CEO of Coca Cola. Mr. Daft makes a brief appearance in *Pay Without Performance* when Bebchuk and Fried recount how the terms of his performance-based bonus were initially set in late 2000, six months after he became CEO, to provide him with shares worth at least $30 million if average annual earnings growth for the next five years was 15% or greater. By April 2001, however, Daft announced that the 15% growth target would not be met. Daft's bonus plan was then revised to provide him with the same compensation for meeting the more modest goal of 11% growth.[71] Based on these facts alone, it is hard to imagine a clearer illustration of the title of Bebchuk and Fried's book.

But if we take a broader view of Daft and the problems of Coca-Cola during this period, the motives and decisions of the parties involved become considerably more complex. Mr. Daft had recently replaced Douglas Ivestor at Coca-Cola, who resigned suddenly after only two years in the CEO position, amid disappointing earnings, product liability issues and a racial discrimination lawsuit.[72] Although he was promoted internally, Daft was not Ivestor's chosen candidate (indeed, Ivestor resigned without ever choosing a second-in-command).[73] Daft was seen as having a different and more congenial management style than Ivestor and had begun initiating significant changes in management strategy. Accordingly, the question of what to do when Daft announced, only four months into his formal term as Coca-Cola CEO that the company would not meet its earnings goal (and his bonus benchmark) of 15%, would not have appeared so clear cut to board members. On

71. *PWP, supra* note 6, at 127. David Leonhardt, *Coke Rewrote Rules, Aiding Its Boss,* N.Y. Times, Apr. 7, 2002, at B6.

72. Constance L. Hays, *Transition in the Chief Executive Post at Coca-Cola Comes Early,* N.Y. Times, Feb. 18, 2000, at C9.

73. David Leonhardt, *A Well-Known Brand Changes Its Public Face,* N.Y. Times, Dec. 7, 1999, at C2.

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the one hand, Daft (and probably the board as well) had certainly erred in announcing (and pegging Daft's bonus to) an ambitious earnings target that, only a few months later, it was clear the company would be unable to meet. Yet the underlying problems could not be ascribed primarily to Daft but had obviously been inherited from his predecessor. Moreover, the board, as well as most of the financial analysts, still had high hopes for Daft. To simply leave Daft's unreachable bonus contract in place would mean he had no effective incentives to achieve even the 11 or 12% growth that they still believed was potentially attainable.[74] On yet another hand, once the board showed a willingness to revise performance goals downward, it would diminish the incentive effect of all subsequent bonus plans.

It should also be noted that even if the board was disappointed in Daft, firing him at that time was not a realistic possibility. His predecessor had resigned under a cloud after only two years in office, probably at the board's instigation,[75] and another CEO turnover so soon would have generated serious negative publicity for the company as well as the board. Another interesting feature of the story is that Coca Cola's board was about as blue chip as a board can get, including as outside directors such luminaries as Warren Buffett, Robert Nardelli (Home Depot), Barry Diller (Interactivecorp), Herbert Allen (Allen & Co.), Cathleen Black (Hearst Corp.), Ronald Allen (Delta Airlines) and James Robinson III.[76]

Even though most if not all of these directors would agree with the general proposition that bonus incentive plans should not have their goals revised downward in response to bad performance,[77] applying that general rule in response to the spe-

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74. "[O]ptions that are likely to expire worthless provide weak incentives for risk-averse executives . . . . " *The Trouble with Stock Options, supra* note 9, at 59.

75. Insider accounts reveal that Ivestor was fired at the instigation of two of the most powerful shareholder representatives on the Coke board: Warren Buffett and Herbert Allen. SEARCHING, *supra* note 14, at 59.

76. Allison Fass, *It's the Real Thing*, FORBES, June 7, 2004, at 64.

77. Warren Buffett has been outspoken on the subject of executive pay. ("There is no question in my mind that mediocre CEOs are getting incredibly overpaid. And the way it's being done is through stock options."). Shawn Tully, *Raising the Bar*, FORTUNE, June 8, 1998, at 272. *See also*, Warren E. Buffett, *1998 Letter to Berkshire Hathaway Shareholders*, at 14, *available at* http://www.berkshirehathaway.com/letters/1998pdf.pdf ("Though options, if

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cific business problem at hand turned out to be very difficult. Under Coke's particular circumstances in 2001, lowering the goals on Daft's bonus plan likely appeared as the best of a small number of bad choices. Given that Daft was going to stay on as CEO, was it better to keep the bonus goals as set, thereby essentially deeming an 11% average earnings increase a failure unworthy of additional recompense, or to revise the goals downward in the hopes it would be perceived as a vote of confidence in Daft's new plans and hope for the future? Coke's board, faced with that decision, chose the latter option.

This too is a form of managerial power. Although Bebchuk and Fried don't emphasize it as such, preferring to rely on traditional notions of carrots and sticks, it has long been recognized that parties in relational contracts (and it is hard to imagine a more relational contract than that between CEO and board) each exert substantial power over the other.[78] But it is even more important to note that any attempt to look at board-CEO relationships solely in terms of an employment contract is a fundamental violation of the principles of relational contract theory.[79] The relationship between boards and CEOs is far more complex than simply employer-employee or monitor-monitored. It is a relationship in which CEOs and directors are each effectively responsible for hiring and retaining one another, the CEO through control of the board nomination process, the board through its hiring and firing power. It is a relationship in which each side invests a considerable amount of time and energy seeking to satisfy the

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properly structured can be an appropriate, and even ideal, way to compensate and motivate managers, they are more often wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders.").

78. A classic example is the potential power of the debtor over creditors in relational credit arrangements. *See, e.g.*, Robert Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 900, 964-69 (1986).

79. As set forth by Ian McNeil, the four "core propositions" of relational contract theory are: (1) every transaction is embedded in complex relations; (2) understanding any transaction requires understanding all essential elements of its enveloping relations; (3) effective analysis of any transaction requires recognition and consideration of all essential elements of its enveloping relations that might affect the transaction significantly; and (4) combined contextual analysis of relations and transactions is more efficient than a non-contextual analysis. Ian R. MacNeil, *Relational Contract Theory: Challenges and Queries*, 94 Nw. U. L. Rev. 877, 881 (2000).

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concerns of the other, and in which board members frequently have a great deal of reputational and even financial capital dependent on the success of the CEO.[80]

But it is not an equal relationship. The CEO generally controls information flows to the board and much of its agenda, and has other advantages derived from his or her preexisting relationships to board members, the board members' own cognitive biases and group interactions and the prevailing belief among board members that the CEO's strong and dynamic leadership is crucial to successful corporate performance. The board, however, also has the power and obligation, which it is increasingly willing to exercise, to fire and replace the CEO when such actions are perceived as necessary.

To attempt to isolate the CEO pay decision from these other ongoing aspects of the CEO-board relationship is necessarily to paint a distorted and incomplete picture of the factors that go into setting CEO pay. In that sense, Bebchuk and Fried are even more right than they know in attacking the "arms-length bargaining" model of CEO compensation. Not only is the compensation contract not "arms-length", but it is not the product of a discrete and isolated "bargain." Rather, the board's compensation decision is embedded in a web of preexisting relationships and responsibilities, the most serious of which is the board's power to fire and replace the CEO. In this section, we will try to analyze how these other aspects of the CEO-board relationship affect the compensation decisions of the board, effectively (if sometimes temporarily) augmenting CEO power over the board, and making a strict pay for performance regime extremely difficult if not impossible to achieve.[81]

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80. Hermalin and Weisbach seek to capture some of this relationship in their formal model of the CEO selection process. Hermalin & Weisbach, *supra* note 66. As they state in the introduction to their survey article:

> The major conflict of interest *within* the boardroom is between the CEO and the directors. The CEO has incentives to "capture" the board, so as to ensure that he can keep his job and increase his flow of rents. Directors have at least some incentives to monitor the CEO and to replace him if his performance is poor.

Hermalin & Weisbach, *supra* note 35, at 1. (emphasis in original).

81. As it turned out, Daft's new management program was not particularly successful. Coca- Cola continued to struggle with earnings growth and with other legal and regulatory problems. In February 2004, Daft announced

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B. *The Relationship Between CEO Pay and Hiring, Firing and Retention Decisions*

Are CEOs more powerful today than they were 20 years ago? Students of executive pay, looking at the massive wealth transfers CEOs have received from shareholders during that period, are likely to answer affirmatively. Those who look at the shortened tenure and increased rate of firings of CEOs during that same period, however, are likely to reach the opposite conclusion. Taken together, the two trends form a paradox. If current boards are sufficiently strong and independent of managerial influence to fire and replace underperforming CEOs on an increasingly regular basis, how can they also be so subject to managerial influence that they almost invariably agree to the exorbitant pay demands of newly hired or incumbent CEOs?

The paradox disappears when we recognize that both trends primarily reflect changes in the way investors, and therefore boards, view CEOs and the relationship between CEO abilities and corporate performance. The 1990s gave rise to the so-called "cult of the CEO."[82] While American CEOs have always wielded a great deal of power, the 1990s gave rise to an increasingly prevalent belief that the personal qualities and efforts of the CEO in providing leadership and direction was a primary determinant of corporate success or failure. Accordingly, Lee Iacocca was personally hailed for having turned around Chrysler Corporation.[83] Jack Welch was widely praised as the cause of GE's spectacular earnings growth.[84] The right CEO was seen as having the capacity to transform an entire

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his intention to retire at the end of the year, amid some speculation that he had been pressured to step down. Sherri Day, *Coke's Chief Set to Retire at End of 2004*, N.Y. TIMES, Feb. 20, 2004, at C1. Daft later resigned as of June 1, 2004, 7 months earlier than expected. *Chief Executive to Leave Coca-Cola Earlier than Expected*, N.Y. TIMES, May 29, 2004, at C4. Coca-Cola announced that it had hired a head-hunter firm to "carefully consider external candidates" as well as the sole internal candidate, who had only joined the company in 2001. *Siren Song of the Outsider*, *supra* note 63.

82. *See* Jerry Useem, *Tyrants, Statesmen, and Destroyers (a Brief History of the CEO)*, FORTUNE, Nov. 18, 2002, at 82; *Fallen Idols*, THE ECONOMIST, May 4, 2002; SEARCHING, *supra* note 14, at 51-80.

83. Constance L. Hays, *For Lee Iacocca, a New Game of Chicken*, N.Y. TIMES, Apr. 5, 1998, at BU5.

84. Craig, *supra* note 61.

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organization, and to do so not through a better business plan so much as through leadership skills and force of personality.[85]

Khurana attributes much of this new emphasis on charismatic leadership to changes in the business press and investment analysts, changes which were themselves brought about by the vastly larger number of individuals investing in the stock market, primarily through pension funds and mutual funds. As he states:

> With an eye to a national audience, the business media focus not on the complexities of organizations or on rapid changes in the business environment, but rather on the actors involved. This approach personifies the corporation, making much of winners and losers, of who is up and who is down, of who is a good CEO and who is not. The press has thereby turned CEOs – once as unknown to the American public as their secretaries, chauffeurs and shoe-shiners–into a new category of American celebrity.[86]

Khurana further notes that "analysts, bowing to the media's bias as to what makes interesting reading or viewing, have increasingly replaced technical analysis of a company with focus on the person running it."[87] Robert Shiller points out that such views become conventional wisdom, both for investment analysts and the investing public and conventional wisdom moves markets, at least in the short term.[88]

How did this new cult of the CEO impact hiring, firing and CEO pay? If a company is doing poorly, and the board is being criticized for not doing anything to boost stock prices, one of the easiest ways to signal change and at least tempora-

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85. Symposium, The Evolving Legal and Ethical Role of the Corporate Attorney after the Sarbanes-Oxley Act of 2002: Panel 1: The Collapse of the Corporate Model, 52 AM. U. L. REV. 579, 581-82 (2002) (Comments of James L. Gunderson, "The United States is an extreme example of the model in which, basically, the Chief Executive Officer ("CEO") runs the company. That's the American model. We look to the CEO for the vision. We look to the CEO for the leadership.") (footnotes omitted).

86. SEARCHING, *supra* note 14, at 74.

87. *Id.* at 77.

88. Robert J. Shiller, *Bubbles, Human Judgment and Expert Opinion*, (Cowles Foundation Discussion Paper No. 1303, 2001), *available at* www.papers.ssrn.com/abstract_id=275515.

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rily raise stock prices in a CEO-obsessed market environment is to change CEOs. Khurana notes that in the 1990s, boards of underperforming companies came under increasing pressure from investors to change CEOs and management teams.[89]

Khurana logically associates this greater board willingness to fire CEOs with a relative increase in shareholder power and a decrease in that of managers. But why should such a relative diminution in managerial power be accompanied by a tremendous increase in CEO compensation? It only makes sense once we recognize that in the board-CEO relational contract, price, that is, the compensation actually paid to the CEO for services, is of relatively little importance. The greater the perceived value of the superstar CEO to the market and shareholders, the less important the amount of his or her actual compensation will be to the board.

Consider the case of a CEO who the board perceives to have failed. If the incumbent CEO then agrees to a pay cut of 50%, or 75%, or even down to a nominal $1, would he or she be likely to keep her job? The answer, I think, is quite obviously no, and the reason lies in the board's perception that the opportunity costs lost if a "necessary" change is foregone are far greater than the amounts saved by a drastic cut in CEO pay. The perceived difference between an old failed CEO and

89. SEARCHING, *supra* note 14, at 67-68. Khurana identifies this change with what he calls the transition from "managerial" to "investor capitalism." It was the increasing assertiveness of institutional investors in blaming CEOs for poor stock performance that led, Khurana believes, to a greater willingness not just to fire the CEO, but to do so publicly and take credit for it. While this article was being edited, what appears to be a prominent example of the phenomenon described above by Khurana arose in the form of the departure of Citigroup CEO, Charles O. Prince. Days after Prince's resignation, Citigroup's largest single investor, Prince Alwaleed bin Talal Abdul Aziz al Saud gave an interview in which revealed the extent of his unhappiness with Prince's leadership and that he had made it clear to the ousted CEO in the days before his resignation that he no longer had his support. Andy Serwer and Barney Gimble, *Prince Alwaleed: Why Chuck Had to Go,* November 9, 2007, *available at* http://money.cnn.com/2007/11/08/news/companies/citigroup_alwaleed.fortune/ ("Fortune has learned that Prince Alwaleed and other major shareholders agreed last week that, if Chuck Prince didn't offer his resignation after the news of the additional $8 billion to $11 billion write-downs, they would publicly call for his ouster.").

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a new promising one, in short, is vastly more than any compensation actually paid.[90]

By the same token, when a new CEO is being selected, the price at which they are willing to take the job is again virtually irrelevant. Directors feel it is essential to get their first choice candidate and are willing to pay whatever it takes to get that person. The result, as Bebchuk and Fried and Khurana agree, is a massive wealth transfer from shareholders to CEOs with no economic justification, but which may give rise to a (likely temporary) jump in the company's stock price.[91]

But what of those incumbent and internally promoted CEOs who still form the bulk of all CEOs, and whose pay has been rising almost as fast as outsiders? The key to understanding their managerial power over compensation is to recognize that in an environment where CEOs are frequently fired and new ones hired from outside the organization, every decision to retain an incumbent or promote from within will be viewed as an implicit hiring decision and therefore governed by the

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90. In recent years, as stock prices declined, some CEOs agreed to work for little or no salary, usually issuing highly public announcements to that effect. *See, e.g.*, Reuters News Agency, *Apple Chief Jobs Takes $1 Salary for 2003*, THE TORONTO STAR, Mar. 12, 2004, at C04. Such actions are more representative of the currently popular charismatic style of leadership than they are of any serious attempt to negotiate with boards over pay. Some CEOs, like Apple's Steve Jobs, took these salary cuts while also receiving large amounts in other forms of compensation. (For Jobs, it was $72 million in restricted stock.) Others seem genuinely to be trying to show solidarity with and provide assurance to investors who have suffered serious financial losses in their company's stock. *See, e.g.*, George Anders, *After Rejecting Pay, Some CEOs Find Less Can Be More*, WALL ST. J. , Mar. 12, 2007, at B1 (detailing various recent instances in which CEOs have cut or foregone their pay as a show of solidarity or commitment to turn around troubled companies). I am unaware, however, of any CEO whom a board has sought to remove for unsatisfactory managerial performance who has been able to retain their job by lowering their compensation requirements.

91. Khurana describes the way directors, responding to pressure to fire the incumbent CEO, then feel under enormous time pressure, investor pressure and peer group pressure to agree on one of a small number of candidates as the "best." Such a person must come from the right background, from a firm of equal or higher status and must impress the board in a short interview as having the charismatic personal qualities associated these days with leadership ability. SEARCHING, *supra* note 14, at 103-14, 175-80. *But see, Siren Song of the Outsider, supra* note 63 (quoting an executive head hunter who describes Khurana's description of the CEO search process as "bollocks").

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same rule as outside CEOs—do not hire the cheapest, or most cost effective CEO, hire the best person for the job. Accordingly, the CEOs retained or promoted from within will be those who have convinced the board, by whatever means, that they not only have been, but still are, the best leaders available for the company. It is with that belief, very likely encouraged by the CEO, that the board approaches the compensation negotiation.

C. *Making CEOs Happy: The Compensation Decision in Relational Context*

We have seen that in the current business climate, every retention decision is, in effect, a hiring decision. Boards must be convinced that the benefit to the company of hiring a new CEO are either non-existent or so small and speculative as not to be worth the disruption and adverse publicity that a change in CEO will likely entail. For companies that are doing well, it is usually easy or unnecessary for CEOs to make such a case. For the poorest performing companies, it may be impossible. But within the broad middle range of performance, CEOs can do much to affect the cognitive frame with which boards view both the hiring and compensation decisions. The threats and bribes Bebchuk and Fried envision may play a role, but CEOs have much subtler and more effective psychological tools at their disposal.

First and foremost, as Bebchuk, Fried and many others recognize, is the fact of leadership itself. CEOs, especially in today's business world, are likely to be dynamic and charismatic people and directors are inclined to like them.[92] Board meetings provide CEOs with the perfect opportunity to charm and impress any directors who may be harboring doubts. As Donald Langevoort notes, board members may rationally prefer confidence and optimism in their leaders, even when it verges on overconfidence and over-optimism, since such attributes can be viewed as inspiring trust and cooperation among other members of the firm.[93] CEOs also have substantial control over the information that is provided to the board,

92. *PWP, supra* note 6, at 31-32.

93. Donald C. Langevoort, Resetting the Corporate Thermostat: Lessons from Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls, 93 GEO. L.J. 285, 301-02 (2004-2005).

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enabling them to portray many half empty glasses as just about to be full.[94] Moreover, the fact that CEOs have substantial influence over who serves on the board means not only that CEOs can threaten board members with expulsion for failure to acquiesce in their pay demands, but that CEOs can choose to add board members who are likely to be impressed by the style, manner and personal qualities of the current CEO.[95]

From the board members' point of view, reaching a correct judgment about the CEO's ability (relative to those of potential replacements) is a complex decision made under a fair amount of uncertainty. Accordingly, it will be subject to the cognitive biases that characterize such decisionmaking. If the prior performance of the company has been good, directors may overestimate the likelihood such good times will continue, disregarding or undervaluing contrary evidence.[96] If performance has not been so good, board members may overestimate the likelihood of improvement, exhibiting the behav-

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94. Carol J. Loomis, *This Stuff Is Wrong*, FORTUNE, June 25, 2001, at 72 (quoting a CEO who stated, "On my own board we have very sophisticated people, and we expose the full board to what's going on about compensation. Even so, since I know more than they do about this subject . . . ").

95. Bebchuk and Fried cite studies showing that CEO pay is higher, and the CEO is more likely to get a golden parachute, when more outside directors have been appointed under the current CEO. *PWP*, *supra* note 6, at 81. *See also* John E. Core, Robert W. Holthausen, & David F. Larcker, *Corporate Governance, Chief Executive Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372-73 (1999); Richard M. Cyert, Sok-Hyon Kang & Praveen Kumar, *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453 (2002).

They also cite a study showing compensation chairs appointed by the current CEO tend to award higher amounts of compensation. *PWP*, *supra* note 6, at 82. *See also* Brian G. M. Main, Charles A. O'Reilly III, and James Wade, *The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives*, 4 INDUST. & CORP. CHANGE 293, 302-03 (1995). Bebchuk and Fried assume the higher pay is awarded in reciprocation for the committee appointment, *PWP*, *supra* note 6, at 25-27, but it is at least as likely that CEOs can judge who on the board is most likely to be generous with shareholders' money.

96. This is generally ascribed to both the representativeness heuristic, which causes people to believe the future will be like the recent past, ignoring longer term perspectives, and conservatism, the failure of most people to revise probability judgments sufficiently in light of new evidence. *See* Shiller, *supra* note 88, at 4.

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ioral heuristic known as the "optimism bias."[97] Such overly optimistic predictions are particularly likely when the judgment involves a team or other association, (i.e. a corporation) with which one identifies and supports.[98]

Then there is status quo bias, or path dependency.[99] The decision that a new CEO will be better than the incumbent is pretty clear cut when the company is enmeshed in an accounting scandal or other catastrophic failure, or where the market and investors clearly perceive that the CEO has failed to turn the company around. In situations where the evidence is more equivocal, however, the perceived benefits of sticking with a known CEO are likely to be seen as outweighing the potential benefits of a new CEO.[100]

In addition to cognitive biases of individuals are unique behavioral characteristics that emerge when people act or make decisions in groups. Khurana recognizes the significance of these phenomena when he talks of how directors decide "not as autonomous individuals but rather as members of groups that are in turn firmly embedded in larger social networks."[101] Probably the most important social phenomenon in the board context is conformity. Bebchuk and Fried point out that a director's reluctance to express dissenting views at board meetings may be a purely rational strategy to avoid being re-

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97. Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163, 206 n.199 (2000) (describing an "optimism" and "overconfidence" bias as closely related, and defining both as "the belief that good things are more likely than average to happen to us and bad things are less likely than average to happen to us." (quoting Russell B. Korbkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091 (2000))).

98. Shiller calls this "wishful thinking bias." Shiller, *supra* note 88, at 6.

99. For a discussion of path dependency and its application to other corporate law issues, *see* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

100. Joann S. Lublin, *For Boards, Firing or Keeping a CEO Can Be Tough Call*, WALL. ST. J., October 22, 2007 at B1 ("Even these days, directors often act reluctantly. Board members feel uncomfortable pushing aside a chief executive whom they chose and like, says Jeffrey Sonnenfeld, a senior associate dean at Yale University School of Management. 'The devil we know is better than the unknown,' many tell Mr. Sonnenfeld.").

101. SEARCHING, *supra* note 14, at 91.

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moved from the board,[102] but recognize that it may also reflect a social norm of collegiality.[103] Studies of other group decision-making processes have found that group members are reluctant to challenge the consensus position because they believe they will lose status in the group if they do so.[104] Shiller describes a related phenomenon, the reluctance of group members to express or act on intuitive disagreements with the conventional wisdom of the group, unless they have a salient argument to present. He states:

> One does not easily stand up and have impact in challenging conventional wisdom because one's intuitive assessment of probabilities is a little different. One needs a striking argument that is trenchant and on target, otherwise one is likely to have little prospect of impact. When one senses that there is little prospect of having an impact, one tends to hold one's silence, or make only perfunctory objections.[105]

Finally, there is the social phenomenon known as "group polarization" which has been described as the tendency of members of a deliberating group to move to a more extreme point in whatever direction is indicated by the members' predeliberation tendency.[106] Accordingly, a board with some members strongly opposed to the CEO and others who are wavering and uncertain are likely to conclude, after hearing each others arguments and reports, that the CEO had to go. By the same token, however, a board most of whose members are well disposed to the current CEO are likely easily to quell any doubts by waverers and convince one another that the CEO should get a strong vote of confidence. These dynamics of conformity, consensus and group polarization, in short, will tend to underscore our earlier observation that boards who do not decide to fire their CEOs will, in most instances, be inclined to

102. *PWP*, *supra* note 6, at 25-27. *See also* Elson, *supra* note 55, at 406 ("[T]here was no easier way to get fired from a board then by acting independently.").

103. *Id.* at 31. *See also* SEARCHING, *supra* note 14, at 83.

104. *See* IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 5 (1982); Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025 (2007).

105. Shiller, *supra* note 88, at 14.

106. Cass Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71 (2000); Group Dynamics, supra note 104, at 2042-52.

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ignore any doubts and give the CEO a strong vote of confidence (generally in the form of a pay increase).

These social and psychological factors provide a fuller and more satisfactory explanation why incumbent CEOs are able to exercise enormous power over their own compensation.[107] They may also explain why most empirical studies find no difference between the levels of CEO compensation paid by compensation committees which contain directors with strong financial ties to management and those consisting primarily or solely of independent outsiders.[108] One can easily imagine a board discussing, as a theoretical matter, the best form of compensation for their CEO, and even concluding, perhaps after reading *Pay Without Performance*, to utilize only highly incentivized performance based plans which filter out gains based on general market movements. But that is not the choice most boards face. Rather, for most boards, given their pre-existing relationship with a particular CEO whom they have already decided to retain, the question is simpler and starker. Do we give the CEO what she wants, or not?

D. *Rational Reasons for Paying Unreasonable Compensation*

As we have seen, the close connection between retention and compensation makes the compensation decision about more than just money. It becomes viewed by all concerned as

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107. Jensen, Murphy and Wruck ascribe much of the excess compensation awarded to the fact that CEOs hire skilled and experienced contract agents to negotiate on their behalf, whereas compensation committees rarely use outside negotiators, creating a "mismatch" where the CEO always wins. *Remuneration, supra* note 5, at 52. But even skilled negotiators, like skilled lawyers, need to have strong arguments on their side. Contract negotiators are successful precisely because they understand and are able to exploit all the presumptions and advantages, both of power and psychology, that CEOs have in such negotiations.

108. *See* Ronald C. Anderson & John M. Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay*, 27 J. BANKING & FIN. 1323, 1346 (2003) (CEO pay/performance sensitivity not significantly affected by percentage of outsiders on compensation committee); Catherine M. Daily et al., *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 ACAD. MGMT. J. 209 (1998) (finding "no evidence that 'captured' directors led to greater levels of, or changes in, CEO compensation"). *See also* Harry A. Newman & Haim A. Mozes, *Does the Composition of the Compensation Committee Influence CEO Compensation Practices?*, 28 FIN. MGMT. 41 (1999) (reaching similar conclusions).

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a vote of confidence or no-confidence in the incumbent CEO. We have seen that CEOs have many means of instilling and fostering such confidence among the board members who set their salaries. But even a compensation committee who feels that the current CEO's performance is no better than adequate, and generally favors lowered, more stringently incentivized pay for CEOs, may still have numerous reasons, both good and bad, but all quite rational from their perspective, for giving the CEO what he or she wants.

First, as we have seen, lowering or refusing to give the CEO the compensation he or she seeks is likely to be viewed by the CEO as a vote of no-confidence.[109] The effect on the CEO of such a rejection is uncertain. Some CEOs might take it as a useful wake-up call and redouble their efforts, but many will react with anger, disappointment and feelings of being underappreciated. Such defensive responses might trigger reduced rather than greater efforts by the CEO. They might also cause the CEO to resign in situations where the board feels that would not be in the company's interest.[110]

Moreover, the CEO is likely to bear a grudge. For most CEOs, like most Americans, pay is a very private and personal

109. CEOs' arguments for higher pay, as we have seen, are usually based on a claim about their performance relative to their peers. No matter how nicely the compensation committee phrases it the rejection of such arguments will generally be viewed, probably correctly, as a statement by the board that the CEO's performance has been below par. Even if the committee believes that to be the case, they might not want to send such a message to the CEO.

110. As this piece was being edited, the corporate management of the New York Yankees, after what they perceived to be a mediocre season, offered manager Joe Torre a contract which only guaranteed one year, with a salary of $5 million, down from $7.5 million that Torre earned under the third and final year of his previous contract. The contract offer carried the potential for Torre to earn an additional $3 million if he were to lead the Yankees to the 2008 World Series. This was viewed by the sports press, probably correctly, as tantamount to a decision to fire Torre, who did not accept the contract, finding the incentive structure and the framework in which the offer was made to be insulting and indicative of a lack of trust and commitment. Murray Chass, *It Wasn't the Money, but What It Signified*, N.Y. TIMES, Oct. 20, 2007, at D3; Tyler Kepner, *Torre Rejects Contract Offer from Yankees: End of a 12-Year Era of Playoff Baseball*, N.Y. TIMES, Oct. 19, 2007, at A1. CEOs whose pay is reduced for mediocre performance are likely to have similar reactions.

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thing.[111] Unlike most other Americans, however, details of the CEO's pay are available to colleagues, competitors, and the investing public. As Bebchuk and Fried's managerial power model suggests, board members who cause the CEO such pain and embarrassment are unlikely to be greeted warmly at the next board meeting. In additional to the personal antipathy of the CEO, such board members also have to worry about reputational risk (nobody wants to be known as a troublemaker), loss of access to information and rapport with other top executives, and, of course, not being renominated as a director.[112] Note also that all these risks are suffered by the board members personally, while the money they are being asked to shell out to the CEO is not their own.

Then there is the question of market impact. Any cost savings resulting from a reduced pay package are unlikely to impress the market or investing public, who are more concerned with the CEO's dynamism and leadership than how much he or she is paid.[113] Indeed, the board may well expect that its willingness to pay a great deal in compensation to the CEO will be viewed not primarily as a cost but as a signal to the market that the board has high expectations, perhaps based

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111. This is apparently even more the case in Germany, where voluntary corporate governance codes requiring disclosure of executive compensation were generally ignored, and proposals to mandate such disclosure by statute were condemned as a violation of privacy rights and passed despite strong opposition from many of the companies that would be affected by the law. *See* Ralph Atkins, *Disclosure Threat for German Executive Remuneration*, FIN. TIMES, Aug. 9, 2004, at 23; Ralph Atkins, Bertrand Benoit, Patrick Jenkins and Hugh Williamson, *Law to End German Executives' Secrecy over Pay*, FIN. TIMES, May 19, 2005, at 11; Paul Betts, *European Executives Put on Alert over Pay*, FIN. TIMES, July 8, 2005 at 17.

112. The power of the CEO to cause difficulties for an antagonistic board member is a major theme of Bebchuk and Fried's managerial power thesis. *See, e.g., PWP, supra* note 6, at 28-31.

113. This assertion may well be tested if so-called "say on pay" legislation is enacted, which would provide shareholders with an annual advisory vote on the actual contents of top management's pay. A bill providing for such voting rights, the "Shareholder Vote on Executive Compensation Act", was passed by the House of Representatives on April 20, 2007. H.R. 1257, 110th Cong. (2007). It is modeled on similar laws that have recently been enacted in the United Kingdom and Australia, and which appear to have had some effect on restraining executive pay, at least in some relatively poorly performing companies. For a general discussion of those laws and their effects, *see* Hill, *supra* note 59, at 16-20.

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on private knowledge, as to the future performance of the firm under the management of the current CEO. Indeed, reports of high CEO pay for individual companies are frequently reported as positive news, associated as they usually are with strong corporate performance.[114] Reports of CEOs taking pay cuts, on the other hand, are almost always associated with reports of bad to catastrophic corporate results.[115] Board members might decide that it is better for the stock price to pay the CEO more rather than less, particularly if the pay can be structured in a somewhat incentivized form, like restricted stock, and characterized as an investment by the CEO in the future of the company.

E. *Why do CEOs Care So Much about Compensation?*

This brings us to the question why CEOs care so much about the amounts of compensation they receive. Although there may be an occasional CEO who is truly uninterested in

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114. *See, e.g.*, *Apple Chief Jobs Takes $1 salary for 2003*, *supra* note 90 (reporting that Apple CEO Jobs got $74.75 million in restricted stock in exchange for stock options, but failing to disclose that the exchanged stock options were "under water" at the time. Also noting the company "recently had success with its Ipod digital music Player."); *Worldcom's Ebbers Gets $17m Bonus*, N.Y. POST, Apr. 24, 1998, at 31 ("WorldCom has expanded at a furious pace, making a string of high-profile acquisitions"); Richard J. Dalton, Jr. & Pradnya Joshi, *Company Jackpot / 3 Computer Associates Split $1.1 Billion of Stock*, NEWSDAY, May 22, 1998, at A3 ("Several Wall Street analysts and compensation experts said the award seemed reasonable given the company's spectacular growth in revenues, earnings and share price."). *See also*, Michael S. Weisbach, *Optimal Executive Compensation Versus Managerial Power: A Review of Lucian Bebchuk and Jesse Fried's Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 45 J. ECON. LIT. 419, 426 (calling for more research on the way "public opinion" relates to the "outrage" constraint).

News stories about general trends in CEO compensation, in contrast, almost invariably have a negative connotation. *See, e.g.*, *Loomis*, *supra* note 94; *Fox*, *supra* note 2; Jerry Useem, *Have They No Shame ?*, FORTUNE, Apr. 28, 2003, at 57; Matthew Boyle, *When Will They Stop?*, FORTUNE, May 3, 2004, at 123.

115. *See, e.g.*, Michael Ellis, *Wagoner's Total Pay Cut in Half*, DETROIT FREE PRESS, Apr. 29, 2006, at 1B ("General Motors Corp. cut Chief Executive Officer Rick Wagoner's pay by 46% to $5.48 million for his work last year, which he said was one of the most difficult in the 98-year history of the automaker."); Donna Goodison, *Top Execs Take Pay Cuts*, THE BOSTON HERALD, Mar. 9, 2006, at 33; Russell Grantham, *Executive Pay Reflects Hard Times at Delta*, ATLANTA J. & CONST., May 13, 2006, at A8.

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what he is paid,[116] the evidence seems clear that the vast majority care deeply, and make their views on the subject known to the board and the compensation committee.[117] It is equally clear that what they want is what they have been getting – mildly incentivized pay in ever-increasing quantities.[118] Indeed, it is hard to understand current American CEO compensation practices without concluding, as Bebchuk and Fried do, that CEO demand for compensation is effectively infinite, and is limited only, if at all, by constraints of "outrage."[119]

Yet all CEOs are wealthy, and many give large amounts of their fortunes away. Nonetheless, there are a number of reasons why contemporary CEOs may have an even greater interest in being highly paid than CEOs of earlier eras. First, as we have seen, the average number of years people serve as CEOs is getting progressively shorter. The risks of being fired, formally or informally, are greater than ever before, and the likelihood of obtaining another CEO position once you have been let go is extremely small.[120] Accordingly, CEOs may well con-

116. Most such CEOs, of course, are founders of companies who retain sizeable equity stakes in their own firms. For example, Warren Buffett and Richard Kinder of Kinder Morgan, receive little in the way of salary or stock options. *See* Lavelle, *supra* note 12, at 88-89.

117. *See* Loomis, *supra* note 94, at 84.

118. *PWP, supra* note 6, at 62-63, 72-75 ("Managers, like most people, generally prefer to have more money rather than less."). Most economic models, of course, simply assume that each individual (CEO or not) will seek to maximize his or her individual wealth. But many models of personal utility also assume that as people get richer, the marginal value to them of each additional dollar earned becomes less, and they will "pay" less (in time, effort, energy, and/or reputational risk) to obtain it. Since most CEOs keep pushing for the extra pay, we must assume that it is either relatively easy for them to attain, or that they continue to place substantial value on the marginal increase in compensation, or both.

119. Many believe outrage does not limit executive pay to any great degree. *See* Roe, *Can Culture Constrain the Economic Model of Corporate Law,* 69 U. CHI. L. REV. 1251,1258 (2002) ("[The] outrage constraint is staggeringly high in the United States").

120. C. Edward Fee & Charles J. Hadlock, *Management Turnover Across the Corporate Hierarchy* 41 (Working Paper, 2003) (finding that new positions obtained by executives after a management turnover, are, on average, inferior to their old positions, and that "executives who appear forced from office are less likely than some other executives to secure new employment."). A notable exception to this observation recently arose in the case of Robert Nardelli: after being ousted at Home Depot in January of 2007 and walking away with a "golden parachute" worth over $200 million (consisting of de-

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clude that they have only a short time to enjoy the perquisites of CEO compensation, and should therefore attempt to make the most of them.[121]

A more important reason is likely to be competitiveness and concerns about relative rather than absolute wealth.[122] With the increased disclosure of CEO compensation that began in the early 1990s, and the media-reinforced "cult of the CEO" that emerged shortly thereafter, CEOs today are far more acutely aware than they were in previous decades of what other CEOs at competitor firms are earning. Psychologists and economists have postulated that it is relative pay, as an indicator of relative status, which is the primary motivation for people in business or other organizational settings,[123] not the absolute amounts they are paid.[124]

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ferred equity awards and stock options, 401(k), pension, and a severance payment), he had earned the ire of investors and became the poster boy for pay without performance in the business press. Nonetheless, in August, Cerberus Capital Management chose him to be the CEO of the now privately owned automaker, Chrysler LLC. *See* Micheline Maynard, *Once Tainted, Now Handed Chrysler Keys*, N.Y. TIMES, Aug. 7, 2007, at A1.

121. Rose, *supra* note 65, at 4 (quoting a study by management consulting firm Booz Allen & Hamilton that "[t]he grace period for a new CEO is becoming shorter and shorter . . . ").

122. Robert H. Frank, a Cornell economist, has written a number of books describing how relative rather than absolute wealth is the prime motivation for productive activity (and human happiness). *See, e.g.*, ROBERT H. FRANK, LUXURY FEVER: MONEY AND HAPPINESS IN AN ERA OF EXCESS (1999); *see also* THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY OF INSTITUTIONS (1912).

123. *See* Vai-Lam Mui, *The Economics of Envy*, 26 J. ECON. BEHAV. & ORG. 311(1995); George F. Loewenstein, Leigh Thompson & Max H. Bazerman, *Social Utility and Decision Making in Interpersonal Contexts*, 57 J. PERSONALITY & SOC. PSYCHOL. 426 (1989); Edward P. Lazear, *Pay Equality and Industrial Politics*, 97 J. POL. ECON. 561 (1989).

124. It might be possible, in theory, for CEOs to measure their relative merit by something other than the total dollar amount of the compensation they receive – for example, by rankings based on who provided the most value to shareholders for each dollar of CEO pay. Accordingly, it is probably a good thing that some of the annual surveys of CEO compensation these days look not just at who is being paid the most, but who is providing, on various measures, the most performance for their pay. *See, e.g.*, Lavelle, *supra* note 12, at 88. Yet any such major change in CEO sensibilities is clearly a long way away. *See also* Yablon, *supra* note 4, at 303-05 (proposing a cap on deductibility of incentive pay, computed on a risk-discounted basis and arguing that there would be closer alignment of managerial and shareholder interests "if the *Forbes* and *Business Week* surveys focused not merely on which

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F. *Can Managerial Power Be Curbed?*

Recognizing the powerful incentives board members have to agree to the CEO's compensation demands leads to a somewhat more complicated understanding of the "outrage" constraint, and a more pessimistic assessment of the likelihood that the problem of managerial power in compensation decisions can be substantially ameliorated. External criticism of the CEO's pay package may indeed restrain some board committees from giving the CEO whatever he or she asks for, and restrain some CEOs from asking for too much. Yet it can also trigger or reinforce internal misgivings on the part of directors themselves that the amounts the CEO is requesting are too high. In such cases, *describing* their concerns as worries about potential outrage by investors can be a useful tool of board members in avoiding confrontation and deflecting potential CEO anger. Instead of telling the CEO that they believe his pay request is excessive, they can instead describe their fears of a likely adverse investor reaction without making an explicit statement of their own views. They may even leave the CEO with the impression that, but for likely investor outrage, they would be happy to agree to the CEO's request. Of course, investor reaction is likely to be more adverse when the company is doing poorly than when it is doing well, so boards feel freer to give big pay increases when times are good, smaller ones when times are bad, which seems to be the pattern that has emerged as the good times of the 1990's were replaced by the financial scandals and earnings restatements of more recent years.[125]

Boards and CEOs recognize that investors are not uniformly opposed to high pay for CEOs, especially if it can be (1) justified by good corporate performance and/or (2) hidden where they don't notice it. Board committees and their compensation consultants generally use a combination of both methods to give the CEO what he or she wants. The CEO-board committee negotiation therefore frequently resembles not a bargaining session so much as a public relations campaign, with the CEO, board members and compensation con-

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CEOs made the most, but on which CEOs realized the most total value from securities with [the same deductible] risk-discounted present value").

125. *See supra* note 12 (describing a decrease in the rate of growth of median CEO pay in the post-2000 period).

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sultants all focused on whether a given pay arrangement can be sufficiently justified to investors in light of the amount of the compensation, the company's recent performance, the stature of the CEO in the business community, the way in which the compensation package is presented and similar factors. Again, Bebchuk and Fried have the basic story right. This is not arms-length bargaining, even if it is occasionally effective in reducing or limiting the CEO's compensation demands.

However, Bebchuk and Fried may well be over-optimistic about the possibilities for change. As we have seen, the pay arrangement is an integral part of the CEO's relationship with the board – the vote of confidence that shows the board still has faith in the CEO's abilities. Bebchuk and Fried write at times as if all the board has to do to solve the problem is change the form of the compensation paid to CEOs. They assume, and are correct, at least in theory, that there is some level of pay in an "efficient" form that a CEO should be willing to accept as equivalent to the inefficient pay now on offer.[126]

For example, a CEO who has been offered a $2 million bonus based on performance criteria she is virtually assured of meeting should agree to accept instead, say, a $5 million dollar bonus based on performance criteria which she has only a 50% chance of achieving. (The extra million is to compensate for risk aversion). If carefully drafted and strictly enforced, such a contract would indeed be more efficient to all than the current one. It would give the company greater value (in the form of increased incentive effects) while giving the CEO no less than she already has.

The problem, of course, comes with that "careful drafting and strict enforcement". In many ways, Bebchuk and Fried's call for true "pay for performance" echoes the call of Jensen and Murphy 17 years ago.[127] The problem then, as now, was implementation in light of the complex relationship of CEOs and boards. One can easily imagine another CEO, learning of

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126. This seems to be true both as a matter of financial theory, where non-diversifiable risk can be valued in terms of certainty equivalents, although individual risk aversion must also be considered, and by Bebchuk and Fried's statements that they are not concerned with the quantity of compensation CEOs are paid, but primarily with its form. *PWP, supra* note 6, at 9.

127. *See Performance Pay, supra* note 4; *CEO Incentives, supra* note 4.

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the $5 million bonus offered in our prior hypothetical, asking his board for the same deal, but with slightly less risky performance criteria. Such requests will be hard to refuse, given the difficulty of measuring such risks, the CEO's control over much of the information relevant to those risks, and the board's desire to give the CEO what he wants. There is also substantial evidence that CEOs can, and do, lessen the risk and increase the value of compensation like stock options by their control over the timing of corporate disclosures or by outright fraud.[128] There is also the not inconsiderable possibility that if the CEO comes close, but fails to meet the goal, the board will decide to give him some or all or the bonus anyway, or lower the performance criteria for the next year. Accordingly, it is easy to see how a highly incentivized $5 million pay package might eventually lead to nothing more than further increases in the amounts of not-very-incentivized compensation CEOs currently receive.

Moreover, to offer CEOs truly risky pay-for-performance deals without lowering current amounts of pay, and also compensating them for risk aversion, would require offering CEOs truly stratospheric levels of compensation, perhaps similar to the amounts Computer Associates paid to their top executives when the company's stock price briefly rose from $22 to $55 per share.[129]

128. By June 2007, 140 companies were facing federal investigations into their options granting practices at the hands of both the SEC and the DOJ. Charles Forell and Kara Scannell, *SEC Steps up Backdating Pursuit*, WALL ST. J., June 1, 2007, at A4. The U.S. government scored a victory in its first criminal trial based on allegations of options backdating in August 2007 when former Brocade Communications CEO, Gregory Reyes was found guilty on 10 counts of conspiracy and fraud. Eric Dash and Matt Richtel, *Backdating Conviction, a Big First*, N.Y. TIMES, Aug. 8, 2007, at C1; *see* U.S. v. Reyes, No. C 06-00556-1 CRB, 2007 U.S. Dist. LEXIS 66074 at *2 (N.D. Cal. Aug. 29, 2007) (denying Reyes' motions for a new trial and to dismiss the indictment).

129. *See* Dalton and Joshi, *supra* note 114. It would later come out that the spectacular earnings growth CA experienced in the 1990s was at least in part a fraudulent mirage. In 2006, Sanjay Kumar, the former CEO of CA who had received a $330 million bonus in 1998 alone, pled guilty to eight counts of securities fraud and obstruction of justice. At the time of Kumar's plea, four other CA executives had already pled guilty and the company had paid over $200 million to an investor restitution fund. Alex Berenson, *Software Chief Admits to Guilt in Fraud Case*, N.Y. TIMES, Apr. 25, 2006, at A1.

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Even if such compensation deals could be properly designed and enforced, other problems would undoubtedly emerge in their administration. Once a tough performance goal is reached, for example, and the enormous payoff becomes not a remote possibility but a fact, it may not seem, in hindsight, to have been all that difficult. Announcement of the enormous payout may trigger exactly the same investor outrage boards and CEOs normally seek to avoid.[130] Finally, recent years have taught us that such strong incentives, particularly if poorly designed, may lead to accounting fraud and stock manipulation rather than truly improved corporate performance.[131]

Bebchuk and Fried's proposed response to the problem of managerial power is to increase the power of shareholders in corporate governance, particularly by giving them direct electoral power to remove directors and adopt changes in the corporate charter.[132] While such proposals have substantial merit as general reforms of the corporate governance process, it is unlikely that they will lead to any improvement in current CEO compensation practices. As we have seen, it is increased shareholder activism that has contributed to many of the

130. These would be instances of yet another cognitive heuristic, the hindsight bias, the tendency of most people to view the likelihood of the occurrence of past events to have been greater than appeared from an *ex ante* perspective. Baruch Fischhoff, *Hindsight? Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXP. PSYCHOL. 288, 304-12 (1975); *see also* Jay J.J. Christensen-Szalanski and Cynthia Fobian Willham, *The Hindsight Bias: A Meta-analysis*, 48 ORG'L. BEH. & HUM. DECISION PROCESSES 147, 147-48 (1991); Scott A. Hawkins and Reid Hastie, *Hindsight: Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311, 312 (1990).

131. Such fraud may well extend even beyond the manipulation and backdating of options. A recent study, Narayanan Subramanian, Atreya Chakraborty & Shahbaz Ali Sheikh, *Performance Incentives, Performance Pressure and Executive Turnover* (Working Paper Series, 2002) *available at* http://ssrn.com/abstract=322860, which found a positive correlation between both the amount and the return sensitivity of performance-based compensation and the incidence of forced CEO turnovers. They conclude that "CEOs with greater incentives also face greater performance pressures and have less secure jobs." They also agree with Alan Greenspan, *supra* note 2, that such compensation may have been "a factor contributing to the accounting scandals and distorted earnings reports of late 1990s," although they stress the job insecurity associated with such compensation rather than the potentially distorted incentives.

132. *PWP*, *supra* note 6, at 207, 212.

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problems of the current system, by favoring and approving incentive pay schemes without paying much attention to the all-important details, by favoring the hiring of charismatic CEOs regardless of their firm-specific knowledge and abilities, and by failing to express "outrage" over fairly outrageous compensation practices, at least when corporate results are, or appear to be, good.

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