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THE DIMINISHING RETURNS OF INCENTIVE PAY IN EXECUTIVE COMPENSATION CONTRACTS

Andrew C.W. Lund* & Gregg D. Polsky**

For the past thirty years, the conventional wisdom has been that executive compensation packages should include very large proportions of incentive pay. This incentive pay orthodoxy has become so firmly entrenched that the current debates about executive compensation simply take it as a given. We argue, however, that in light of evolving corporate governance mechanisms, the marginal net benefit of incentive-laden pay packages is both smaller than appreciated and getting smaller over time. As a result, the assumption that higher proportions of incentive pay are beneficial is no longer warranted.

A number of corporate governance mechanisms have evolved to duplicate incentive pay's positive incentive effects, thereby reducing its marginal benefit. Most significantly, a newly robust CEO labor market has made incentive pay largely redundant in focusing CEO attention on stock prices. In addition, while the marginal benefit of incentive pay has been overstated, its costs are significant and often overlooked. As a result, we believe that the net overall effect of incentive pay on shareholder wealth is now either minimally positive or even negative. We also argue that, given the strength of the corporate governance mechanisms discussed in the Article, attempts to improve company performance by "fixing" incentive pay structures are unlikely to succeed.

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Nevertheless, the trend towards greater and greater incentive pay continues unabated. This resiliency, however, is not surprising even in a competitive market. In the past, the incentive pay orthodoxy was justified because corporate governance mechanisms were not as robust. Incentive-laden contracts therefore became a key marker for "good governance" in the compensation context. In addition to the stickiness of that status quo, incentive pay's staying power has been supported by the private interests of those who benefit from the conventional view of its efficacy. As a result of the incentive pay orthodoxy, executives receive greater pay, boards bear less responsibility for that pay, and compensation consultants and experts garner more attention. On the other hand, there is no constituency with a significant incentive to soberly assess the benefit of incentive pay that is not afflicted with informational disadvantages or collective action problems.

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INTRODUCTION

In the aftermath of the financial crisis, executive compensation has received an immense amount of attention. In January 2011, the Financial Crisis Inquiry Commission blamed the crisis, in part, on executive compensation.¹ That report capped two years of governmental, popular, and academic commentary that attributed some measure of the destruction in the financial sector to flawed pay practices.² This recent focus on executive compensation follows decades of attention paid to the topic by legal scholars, financial economists, politicians, regulators, and governance activists. Since the early 1980s, when attention to executive compensation design began in earnest, books and articles (in both the popular and academic press) have been written, shareholder campaigns have been waged, and laws and

1 See FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xix (2011), available at <http://www.gpoaccess.gov/fcic/fcic.pdf> ("Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.").

2 See, e.g., KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT (2010) (expressing the opinion of a group of fifteen of the United States' most distinguished financial economists); Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation*, 26 YALE J. ON REG. 359 (2009); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 Nw. U. L. REV. (forthcoming 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546229; Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks on *The Squam Lake Report* (June 16, 2010); Press Release, Kenneth R. Feinberg, The Special Master for TARP Executive Compensation Concludes the Review of Prior Payments (July 23, 2010), available at <http://www.treasury.gov/press-center/press-releases/pages/tg786.aspx>; Press Release, U.S. Dep't of the Treasury, Statement from Treasury Secretary Timothy Geithner on Compensation (June 10, 2009), available at <http://www.treasury.gov/press-center/press-releases/pages/tg163.aspx>.

regulations have been promulgated,³ all focused on how executives should be compensated.

Traditionally, the goal of pay reformers was to more closely link executive compensation with firm performance in order to reduce agency costs. More recent discussion, on the other hand, has focused on the role of executive pay structures in preventing future economic crises. Regardless of the goal—agency cost reduction or financial crisis prevention—the debate over executive compensation has settled on two related principles. First, the precise manner in which companies design executive pay contracts matters deeply.⁴ Second, the proper design necessarily includes a very large amount of incentive pay, such as stock options, stock grants and performance-based bonuses. While participants in the corporate governance field quibble over the details, the ability of incentive pay to substantially affect executive and firm performance is largely taken for granted. The result has been the proliferation of incentive-laden contracts, with incentive pay dwarfing fixed salary and benefits across contemporary CEO contracts.

We believe that the incentive pay orthodoxy is no longer warranted. New research suggests that the benefits generated by incentive pay have significantly diminished in recent years, and whatever benefits remain can be expected to only dwindle further. Unfortunately, this erosion has been overlooked by those who still see substantial promise in fixing performance by fixing executive compensation. Instead of being subjected to an ongoing, rigorous cost/benefit analysis, the conventional wisdom regarding incentive pay has become entrenched in the psyches of boards of directors, compensation consultants, governance experts, policymakers, the press, and the public at large.

In this Article, we argue that the benefits of incentive pay are lower than conventionally understood because its effects are largely redundant of incentive effects stemming from newly robust corporate governance mechanisms that discipline executives for poor stock performance. These mechanisms—the activism of institutional investors,

3 See, e.g., I.R.C. § 162(m) (2006) (denying public companies deductions for senior executive pay in excess of \$1 million, but exempting performance-based pay). For discussion of section 162(m), see generally Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877 (2007).

4 See Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 196 (2011) (concluding that current pay structures are flawed but noting: “[I]n the midst of [the recent controversy over executive compensation], one important aspect of executive compensation remains undisputed. Well-designed pay arrangements should incentivize managers to further shareholder interests . . .”).

the oversight by more demanding boards, and, most significantly, the related reduction in CEO job security—are not new, but were perhaps too weak historically to replicate the incentive effects of performance-based pay. But, in recent years, these mechanisms have substantially gained in strength, and they are likely to continue to do so. The marginal benefit of incentive pay must be evaluated in light of these existing and evolving mechanisms, and we believe that that benefit is both smaller than commonly appreciated and, as importantly, diminishing over time. Meanwhile, incentive-laden compensation arrangements increase firms' compensation costs in numerous ways and have the potential to distort managers' behavior in value-diminishing ways.

Nevertheless, the incentive pay orthodoxy persists and shows no signs of relenting. This resiliency is not surprising. The conventional view was probably justified before corporate governance mechanisms evolved to make incentive pay's effects largely redundant. Incentive-laden contracts therefore became a key marker for "good governance" in the compensation context. The bias in favor of the status quo is very strong in the executive compensation context; this makes it very difficult for firms to offer less incentive pay. At the same time, all of the influential voices in the executive compensation arena have incentives to overstate the benefits of incentive pay. For example, because of the emphasis on incentive pay, executives earn greater compensation, boards bear less responsibility over executive pay outcomes, and compensation consultants and experts enjoy greater demand for their services. Moreover, incentive pay has superficial appeal to the public because it appears to strengthen the relationship between CEO pay and CEO talent level, a result that comports with basic notions of fairness.

Our conclusion that incentive pay is now less effective than commonly believed has two key implications. First, individual boards should be more skeptical of incentive pay's purported benefits and more cognizant of its costs. Before using incentive-laden compensation arrangements, boards should consider the many firm- and executive-specific factors that are relevant to incentive pay's efficacy and take into account the alternative mechanisms that affect executive behavior. Second, policymakers should be dubious of claims that unrelated goals, such as financial industry risk regulation or better corporate performance, can be effectively accomplished by adjusting (through regulation or otherwise) the manner in which firms pay their senior executives.

Even though we offer these prescriptive remedies, we are not sanguine about their prospects in the face of prevailing sentiment. There is deep popular distrust of executives and boards; therefore, any pro-

positional to fundamentally alter pay practices will surely be met with suspicion. Moreover, Congress's recent enactment of Say on Pay⁵ is likely to further entrench existing pay practices. Under Say on Pay, the conventional view of incentive pay will cause boards to cling to incentive-laden structures in order to minimize the risk that their compensation arrangements will be criticized by newly empowered shareholders. Thus, a final tentative implication of our analysis is the somewhat counterintuitive one that the best results in pay design may be achieved by insulating boards from pressure exerted by shareholders.

This Article proceeds in four parts. Part I examines the traditional agency-cost case in favor of incentive pay and explains how certain corporate governance mechanisms have developed to do much of the work for which incentive pay structures were designed. This Part also describes more recent attempts to improve risk-taking decisions at financial firms through better executive pay structure, concluding that those measures are unlikely to have significant impact in light of the evolved governance mechanisms. Part II describes the costs imposed on firms when they adopt incentive-laden compensation structures. Part III suggests a number of explanations for the resilience of incentive pay despite its increasingly dubious utility. Part IV concludes with a discussion of the implications stemming from our thesis and some thoughts about what the future holds for incentive pay.

I. QUESTIONS ABOUT THE PURPORTED BENEFITS OF INCENTIVE PAY

It is widely believed that the benefits of providing incentive pay to senior management exceed its costs, perhaps by several orders of magnitude.⁶ These benefits, on the classical view, come in the form of agency cost reductions that occur when executives bond themselves to shareholder interests via their compensation structure.⁷ Nevertheless,

5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 83 Stat. 1376-2223 (2010).

6 See, e.g., 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, 140 (hypothesizing a properly functioning CEO who was able to increase shareholder value by \$100 million and who, under prevailing compensation structures, would have received a marginal compensation gain of only \$6,700 over two years).

7 See *id.* at 140 (hypothesizing a CEO who wastes \$10 million in firm value by purchasing executive aircraft or adding on to corporate headquarters); see also John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 27, 27 ("[W]e follow a traditional agency-theory framework and define an efficient [executive compensation] contract as one that maximizes the net expected economic value to shareholders after transaction costs

it remains an open question, despite decades of research into the subject, as to how significant this mitigation actually is.⁸ The conventional position in favor of high levels of incentive pay is supported more on theory and intuition than evidence.⁹ Given the thorny empirical issues involved,¹⁰ it is likely impossible to reach a precise answer. On the other hand, we think it is safe to conclude that (1) the marginal benefits of incentive pay are less than generally believed, (2) they have decreased since incentive pay first became prominently pegged as a solution to the agency problem some decades ago, and (3) they will continue to decrease as a shareholder-centered version of the public corporation becomes more entrenched.

Incentive pay, like many corporate law innovations, was intended as a solution to problems created by the separation of ownership and control in publicly-traded companies. This separation and its consequences have provided the basic tension animating corporate law theory since Berle and Means described it almost a century ago.¹¹ Having one group (dispersed and diversified shareholders) hold the residual

(such as contracting costs) and payments to employees. An equivalent way of saying this is that we assume that contracts minimize agency costs.”).

8 See Core et al., *supra* note 7, at 34 (describing conflicting studies regarding the relationship between equity compensation and firm performance while noting “[t]here is presently no theoretical or empirical consensus on how stock options and managerial equity ownership affect firm performance”); Igor Filatotchev & Deborah Allcock, *Corporate Governance and Executive Remuneration: A Contingency Framework*, ACAD. MGMT. PERSP., Feb. 2010, at 20, 21 (“Despite considerable research effort, the empirical findings on these causal linkages [between compensation-based incentives and firm performance] have been mixed and inconclusive. For example, empirical studies and meta-analyses of the effects of executive equity-related incentives on financial performance have failed to identify consistently significant effects [citing other research to that effect.]”); Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2539 (Orley C. Ashenfelter & David Card eds., 1999) (“Unfortunately, although there is a plethora of evidence on dysfunctional consequences of poorly designed pay programs, there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock-price performance.”).

9 See Dennis Wright Michaud & Yunwei Gai, *CEO Compensation and Firm Performance* 6–7 (Dec. 20, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531673 (“[M]ost of the normative contemporary CEO compensation schemes were developed during the 1990s under a broad paradigm that the greater the financial incentives for CEOs the greater the financial returns to corporate operations. What we find disturbing by [sic] this paradigm is that it was developed as a theoretical proposition rather than a fact confirmed by empirical evidence. In short, little ‘heavy lifting’ in empirical statistical research was undertaken.”).

10 See *infra* note 111 and accompanying text.

11 ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

claim to a firm's assets while another group (managers) holds day-to-day control over those assets results in a misalignment of interests and an opportunity for exploitation. While shareholders are interested in maximizing the value of the firm,¹² managers have personal preferences that are often inconsistent with this goal.¹³ Managers might shirk and devote less than appropriate effort, they might decide to invest some of the company's assets in unproductive pet projects, they might block valuable mergers, acquisitions, or takeovers, or they might provide themselves excessive perks and other compensation. In addition, managers might avoid risky but high value projects out of an abundance of caution because, unlike shareholders, managers have a large undiversified investment of human capital in the firm.

Alongside other mechanisms—monitoring by boards, the shareholder franchise, judicial enforcement of fiduciary duties, and related pressures exerted by capital markets, labor markets, and the market for corporate control—incentive pay is believed to be an effective device for minimizing agency costs. Depending on the perspective one takes as to the baseline level of compensation, incentive pay does this by increasing the personal cost to managers of shirking, expropriation, and inefficient decision making or by increasing the additional personal wealth generated by diligence, fidelity, and efficient decision making. In any event, the amount of a firm's incentive pay and the specific design of incentive pay components have been perceived to be exceptionally relevant indicia of the quality of a firm's corporate governance over at least the past twenty years.¹⁴

12 The appropriate end of managers' behavior is, of course, subject to enormous debate. Nevertheless, the plurality position, and, more importantly, the position advanced by many of the most prominent proponents of incentive pay, is that managers should act to maximize long-term firm value. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 8 (2004); Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 15–18 (European Corporate Governance Inst., Working Paper No. 44, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305. We therefore assume in this Article that that is the appropriate managerial objective.

13 On agency costs in firms, see generally Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

14 See BEBCHUK & FRIED, *supra* note 12; Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 763–64 (2002). For responses to the Bebchuk/Fried/Walker thesis, see generally Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004)); William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CALIF. L. REV. 1557 (2005) (same); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (same); Kevin J. Murphy, *Explain-*

Current academic discussions of incentive pay often focus on the extent to which it operates in a less-than-idealized fashion. The participants in these debates ask whether incentive pay delivers on its promise, and, if not, how to improve incentive pay structures to allow it to do so. Reform advocates, for instance, often observe that incentive pay design is currently too compromised by executive power over boards to maximize its potential as an agency cost reducer.¹⁵ Alternatively, (sometimes the same) reformers note that existing incentive pay arrangements provided incentives for short-term share price maximization that may have contributed to the recent financial crisis.¹⁶ Skeptics counter that incentive pay as currently practiced functions reasonably well, especially in light of the costs that reform might carry.¹⁷ We agree with these skeptics that the pursuit of an idealized form of incentive pay is largely a quixotic one. We question, however, the underlying premise that even an idealized version of incentive pay could deliver much marginal benefit given the current state of corporate governance. Specifically, such an idealized version would add less in the way of additional agency cost reduction than is commonly thought, primarily because the effects of incentive pay are largely duplicative of those stemming from other governance mechanisms that have become increasingly robust. We do not mean to say that the problem of agency costs in the public corporation has been solved by such alternative, non-pay-related mechanisms. Rather, we argue that the governance landscape has recently shifted such that (1) incentive pay is unlikely to reduce agency costs significantly further than they already have been by those mechanisms, and that (2) any potential for incentive pay to do so is diminishing over time.

Before we proceed any further, one important caveat is in order. Throughout this Article, we focus exclusively on compensation arrangements for the most senior executives at a firm and most particularly on those involving the CEO. We do this for two reasons. First, much of the literature advocating incentive pay likewise focuses exclusively on the senior management team—it is this literature to which

ing *Executive Compensation: Managerial Power Versns* [sic] *the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

15 See, e.g., BEBCHUK & FRIED, *supra* note 12.

16 See, e.g., Bebchuk & Fried, *supra* note 2; Bebchuk & Spamann, *supra* note 2; Bhagat & Romano, *supra* note 2; Tung, *supra* note 2. For discussion of several specific reform proposals, see *infra* Part I.A.2.

17 See, e.g., Core et al., *supra* note 7, at 27–28.

we are responding.¹⁸ Second, and more importantly, the alternative disciplinary mechanisms that we discuss are most forceful as they relate to the CEO and, to a somewhat lesser extent, her cohort of senior managers. Because these newly powerful mechanisms are less relevant to secondary managers, the cost/benefit analysis of their incentive pay is far different than the one that applies to senior management pay.¹⁹

A. Complementarity and Its Limits

The agency-cost-reducing mechanisms that exist in the corporate governance arena, including incentive pay, are thought to be complementary.²⁰ For instance, popular corporate governance indices intended to measure the quality of firms' governance usually aggregate answers to a group of corporate governance-related questions,²¹ while institutional investors and proxy advisory firms promulgate governance guidelines that provide a laundry list of expected behaviors or terms with little apparent concern for interaction effects.²² These indices and guidelines imply that the sheer number of pro-shareholder practices or pro-management practices is an important factor to consider in assessing a firm's corporate governance.²³ It should be obvious, however, that simply summing pro-management or pro-

18 For an exception to the CEO-centered focus in compensation discussions, see generally Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary Management Agency Costs*, 26 YALE J. ON REG. 457 (2009).

19 Other considerations make the cost/benefit analyses of incentive pay in these contexts distinct from each other. Most obviously, secondary managers are more easily monitored because their supervisors are full-time employees of the firm, while senior managers report to the board of directors. *But see id.* at 460 (discussing the difficulty of senior managers in monitoring subordinates where there is significant complexity).

20 See, e.g., Core et al., *supra* note 7, at 27–28.

21 See, e.g., Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1819–26 (2008); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 112–116 (2003) (using a list of over twenty aspects of a firm's governance profile, most of which have to do with takeover defenses). These governance indices are intended to provide simple-to-interpret views of whether a firm is properly governed.

22 See, e.g., Adam O. Emmerich, *Understanding RiskMetrics Compensation "GRID,"* HARV. LAW SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 1, 2010, 9:31 AM), <http://blogs.law.harvard.edu/corpgov/2010/06/01/understanding-riskmetrics-compensation-grid> (providing a spreadsheet mimicking RiskMetrics compensation review and arriving at a "score").

23 For criticism of the accuracy of corporate governance guidelines more generally, see Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 907–16 (2007).

shareholder answers is a highly dubious exercise,²⁴ insofar as it assumes two highly controversial premises. First, summing assumes that each mechanism has an equal effect on agency costs. More importantly for our purposes, summing assumes that the variables are complementary to, and not redundant of, one other.²⁵ If two or more mechanisms provide overlapping incentives, summing poses a risk of overestimating a mechanism's impact by counting a factor that has little marginal effect given the status quo *ex ante*.²⁶

Extreme redundancy can be demonstrated by substitutability, i.e., mechanism X is completely unnecessary given mechanism Y, like belts and suspenders. Consider, for example, board independence and the market for corporate control, both of which are thought to constrain self-interested management behavior. Researchers have recently found that board independence and a firm's G-index, which reflects a company's insulation from takeovers,²⁷ are *positively* correlated.²⁸ Thus, independent (and presumably less obsequious) boards appear to be substitutes for the market for corporate control.²⁹ The same researchers hypothesize that the choice between powerful boards and reliance on the corporate control market is driven by firm heterogeneity with respect to "institutional ownership, growth opportunities, firm age, recent stock market performance, the firm's valuation in the marketplace, firm size, leverage and the amount of information

24 Gompers et al. admit as much:

While this simple index does not accurately reflect the relative impacts of different provisions, it has the advantage of being transparent and easily reproducible. The index does not require any judgments about the efficacy or wealth effects of any of these provisions; we only consider the impact on the balance of power.

Gompers et al., *supra* note 21, at 114.

25 Summing also assumes that there are no synergies created by combining one mechanism with another.

26 Of course, the overestimation only leads to inefficient governance decisions if there are independent costs to adopting the marginal mechanism. For more on the costs of incentive pay, see *infra* Part II. Economy-wide, redundancy may lead to inappropriate investment decisions if those decisions assume an index properly rates governance quality across firms. See Bhagat et al., *supra* note 21, at 1858–61.

27 The G-index is an index created by Gompers et al. that sums the number of takeover barriers imposed by a particular firm. See Gompers et al., *supra* note 21, at 112. Thus, the higher the number of the index (which ranges from 0 to 24), the greater the apparent resistance to takeovers.

28 Stuart L. Gillan et al., Tradeoffs in Corporate Governance: Evidence from Board Structures and Charter Provisions 12–14 (June 2006) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917544.

29 See *id.* at 14.

uncertainty.”³⁰ Whatever the variables, once firms have one of the two mechanisms (board independence or openness to takeovers) in place, they appear to adjust their cost/benefit analysis regarding the adoption of the other because the benefit of doing so is reduced.³¹

Redundancy has been most fully examined with respect to the takeover market. The ability of managers to insulate themselves from the market for corporate control, particularly through the adoption of poison pills, caused great alarm and spawned dozens of law review articles during the 1980s and 1990s. The consternation over poison pills has largely diminished in recent years, however, with the recognition that other mechanisms have worked to push managerial behavior closer to shareholder-preferred courses of action.³² Kahan and Rock observed that boards became more independent and focused on enhancing shareholder value, while the evolution of golden parachute provisions and equity pay made takeovers more palatable to executives.³³ Holmstrom and Kaplan described similar phenomena and concluded that shareholder consolidation, board independence and equity-based incentive pay served to focus managers on shareholder value, making the takeover market largely unnecessary.³⁴ More recent work by Bratton and Wachter has similarly pointed to equity-based incentive pay, as well as the rise of private equity buyouts and hedge fund activism as substitutes for the classically conceived takeover market.³⁵

This “dynamic”³⁶ aspect of the corporate governance system remains somewhat underappreciated.³⁷ As described above, the idea

30 *Id.*

31 Admittedly, this presumes a benign view of board intentions—that they are trying to maximize firm value. Even if not always the case, however, it is hard to see why board independence and takeover vulnerability should be negatively correlated absent an explicit or implicit decision by shareholders that one of these devices is sufficient.

32 See Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); see also Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the U.S.: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121 (2001).

33 See Kahan & Rock, *supra* note 32, at 896–97.

34 See Holmstrom & Kaplan, *supra* note 32, at 136–41.

35 See William W. Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 679–85 (2010).

36 See *id.* at 676.

37 See Filatotchev & Allcock, *supra* note 8, at 27 (“One of the central weaknesses in most executive compensation studies is the assumption that incentives and other types of corporate governance influencing performance are conceptualized and operationalized as independent and that each governance factor will have its own unique ability to influence the firm’s strategies and performance. This supposition presumes

of evolving and substitutable corporate governance mechanisms has usually been invoked in the context of takeover markets. The dynamic approach has therefore been applied only to adaptations or substitutions that seem to have occurred in relation to that particular mechanism. Commentators are surely correct that incentive pay was among the many mechanisms used in the hopes of revitalizing, or at least mimicking, the incentives created by the takeover market. But the positive accounts of incentive pay's substitution in place of hostile takeovers leave open how necessary or valuable incentive pay was as an element of the package of substitutes. More importantly, those accounts do not provide much help in determining its value today, holding constant the new baseline of alternative disciplinary devices.³⁸ The remainder of this Part argues that the governance benefits of incentive pay are now largely redundant given other current constraints on management behavior.

The focus of this section is on the ability of newly powerful mechanisms (primarily the managerial labor market) to constrain managerial behavior over the set of actions that incentive pay's proponents believe pay structure can help shape. But first, we should set aside the set of problems which are not readily solvable through resort to executive pay structure.

First, there is the question of optimal managerial effort. In typical agency relationships, slothfulness is usually the most significant concern. On the other hand, even the most strident incentive pay proponents do not suppose that, absent incentive pay, there would be large-scale loafing going on in corner offices.³⁹ This indicates that alternative mechanisms operate (or are believed to operate) suffi-

that governance factors are both linear and additive to the extent that the effect of an internal or external governance attribute is the same regardless of the levels and combinations of other organizational attributes, or even the institutional conditions surrounding the company.").

38 Bratton and Wachter are an exception on this score. Part of their project is making the case that share price is not a true indication of firm value and therefore distorts the behavior of managers and shareholders. See Bratton & Wachter, *supra* note 35, at 689–716. Accordingly, equity-based incentive pay is problematic on their account for similar reasons. See *id.* at 714–15. While we agree with their diagnosis of a problem for equity-based incentive pay, we offer in Part II a broader indictment of incentive pay which cannot be solved by the reforms Bratton and Wachter suggest. See *id.* at 725–26.

39 See, e.g., Murphy, *supra* note 8, at 2521 ("Although the CEO's 'action space' is typically defined as unidimensional effort, it is widely acknowledged that the fundamental shareholder-manager agency problem is not getting the CEO to work harder, but rather getting him to choose actions that increase rather than decrease shareholder value.").

ciently to deter loafing.⁴⁰ First, executives have been forced to exhibit extreme diligence throughout their career in order to achieve their esteemed position. Individuals who are averse to hard work are weeded out by the competitive promotion process well before they arrive at the executive suite.⁴¹ Second, effort may be proxied by high levels of presence on site or availability off site, measures that are readily observable by both subordinates and boards.

Similarly, fiduciary duty law covers most of the terrain with respect to explicit self-dealing by managers. The duty of loyalty prohibits most forms of misappropriation and performs reasonably well at that task.⁴² Much of this is due to the misbehavior's observability, which is heightened by disclosure rules.⁴³ That observability makes legal sanctions more likely and diminishes the need for deterrence through incentive pay.⁴⁴ On the other extreme, incentives to engage in less observable self-dealing would not be significantly affected by

40 See, e.g., Radhakrishnan Gopalan et al., *Strategic Flexibility and the Optimality of Pay for Sector Performance*, 23 REV. FIN. STUD. 2060, 2061 (2010) ("The long-standing modeling choice in the literature considers a standard agency setup, wherein expected firm performance is assumed to depend on the CEO's (personally) costly effort and some random factors over which she has no control. The optimal contract incentivizes the CEO to exert effort to maximize firm value Our contention is that the board of directors is not primarily concerned with how hard the CEO is actually working, but whether she has the vision to choose the right strategy for deploying the firm's assets." (emphasis omitted)).

41 See, e.g., Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L. J. 1557, 1592 (2005) ("[CEOs] have survived multiple rounds of weeding out of individuals with any appreciable taste for slack and have self-selected or become acculturated to hard work.")

42 See, e.g., Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1661–63 (2001).

43 See 17 C.F.R. § 229.404 (2011) (regarding related-party transaction disclosure); 17 C.F.R. § 229.402(b)(2)(iii)(C) (2010) (regarding perquisite disclosure). For more on securities law functioning as a check on agency costs, see John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 683 (1999).

44 In any event, incentive pay, which forces managers to internalize part of the cost of self-dealing by reducing the value of the incentive pay, may not provide strong enough incentives by itself in that context. Any gains to the executive realized via self-dealing will always dominate the consequent reduction in incentive pay values unless the manager either holds the entire residual claim (at which point the trade-off is still merely neutral) or the incentive pay structure is nonlinear (such that the manager might forego a big payoff by narrowly missing a performance hurdle due to self-dealing). See Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 658 (1998) ("For many other decisions a small sharing rate will not be sufficient to induce value-maximizing decisions: with a sharing rate of 0.01, a CEO can purchase a corporate jet at a 99 percent discount (absent effective monitoring)"). For more on the irrelevance of incentive pay for disloyalty-type agency costs, see Alex

incentive pay. The tendencies of executives to expropriate value subtly from the firm—e.g., by consuming excessive perks or investing in pet projects—will not be deterred unless the incentive pay provides the executive with a much larger stake in the company than is practical. It is well established that the relevant measure for incentives in such expropriation contexts is the executive's percentage holding in the firm.⁴⁵ For example, an executive with a one percent equity stake in the company would prefer consuming a perk so long as the executive places a value on the perk at least equal to 1 percent of its cost to the company.⁴⁶ Thus, incentive pay will be helpful in deterring subtle expropriation only in cases involving extraordinarily high CEO ownership positions.⁴⁷ Incentive pay therefore will not be useful in deterring self-dealing, whether explicit or subtle, in the vast majority of cases.

Still, there will surely be agency costs in the modern public corporation where it is relatively difficult to observe managers' behavior,⁴⁸ where shareholders do not have the skills or motivations necessary to determine the proper cause of action,⁴⁹ and where executive deci-

Edmans et al., *A Multiplicative Model of Optimal CEO Incentives in Market Equilibrium*, 22 REV. FIN. STUD. 4881 (2009).

45 See George P. Baker & Brian J. Hall, *CEO Incentives and Firm Size*, 22 J. LABOR ECON., 767, 769 (2004).

46 For example, assume an executive with a one percent equity stake in the company. Assuming no other constraining factor (e.g., the risk of inciting board or shareholder anger or scrutiny), that executive would prefer that the company invest \$100,000 in a perk or pet project so long as the executive places a personal value on that investment of \$1,000 or more.

47 See Bainbridge, *supra* note 14, at 1620 (explaining that incentive pay generally should not be useful to deter excessive perks).

48 For more on the question of observability, see Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979) (introducing his "informativeness principle").

49 See Murphy, *supra* note 8, at 2521 ("In general, increasing shareholder wealth involves investing in positive net present value projects, increasing profits on existing capital, and diverting resources from negative net present value projects. There is a wide array of actions that affect shareholder value, including defining the business strategy, choosing between debt and equity financing, making dividend and repurchase decisions, identifying acquisition and divestiture targets, selecting industries and markets to enter or exit, allocating capital across business units, setting budgets for developing new products and businesses, hiring productive (and firing unproductive) subordinates, and designing, implementing, and maintaining the nexus of implicit and explicit contracts that defines the organization. Expanding the set of potential actions that affect shareholder value diminishes the role for 'informativeness' and increases the benefit of tying pay to the principal's objective rather than to measures of inputs.").

sions affect firm percentage returns rather than dollar returns.⁵⁰ It is for these cases that incentive pay is usually offered as a cure. Most famously, executives' nondiversifiable firm-specific investment of their human capital may cause their risk-taking decisions to diverge from those that would be preferred by diversified shareholders.⁵¹ This disjuncture might not be as problematic as has been previously assumed,⁵² but nevertheless we, consistent with much of the literature, treat it as a concern in this Part. Similarly, commentators have suggested that properly designed incentive pay may be effective in deterring empire building⁵³ and the accumulation of excessive free cash flow.⁵⁴ Whatever the example, the idea underlying incentive pay is that it is uniquely well suited to counteract these more subtle divergences between managers' preferences and those of shareholders.

Of late, however, non-pay-related mechanisms have begun to evolve to better align these preferences. Importantly, at least since 2000, various related trends have worked together to reduce the ability of CEOs to make decisions that systematically deviate from share price maximization.⁵⁵ Institutional shareholders have become even more significant forces in the corporate governance arena.⁵⁶ By 2006, a majority of shares of NYSE firms were held by institutions. Among those companies, the percentage of shares owned by public pension funds have become progressively smaller, while the percentage ownership of hedge funds, which are generally more comfortable with

50 See Baker & Hall, *supra* note 45, at 778.

51 See Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN. 21, 29 (2003) ("One of the most commonly alleged benefits of options is that they help overcome managers' natural aversion to risk.").

52 See e.g., Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 403 (2001); Bratton & Wachter, *supra* note 35.

53 See BEBCHUK & FRIED, *supra* note 12, at 16. Because CEO compensation and prestige are correlated with firm size, CEOs may receive personal benefits from an acquisition program. See Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 685 (2005).

54 See, e.g., George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1247 (2008). CEOs' preferences for hoarding excess cash may be an example of risk aversion or a strategy aimed at permitting future acquisitions. See Michael C. Jensen, *Agency Costs of the Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324-26 (1986).

55 See Kahan & Rock, *supra* note 32.

56 See Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 998 (2010); see also Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1353, 1356 (2010).

aggressive forms of shareholder activism, have increased.⁵⁷ Proxy advisory firms have gained clout, making monitoring of firms even cheaper for large investors.⁵⁸ Staggered boards now appear to be in decline, for large companies at least, perhaps making the market for corporate control more viable.⁵⁹ Majority voting and proxy access have become ascendant, making withhold-the-vote campaigns a more powerful tool for disciplining boards. And shareholders are more empowered than ever before in effecting other changes to corporate policy, from investment decisions to financial ones.⁶⁰ These changes are obviously interrelated. The presence of institutional holders with greater and greater concentrations of minority positions and greater and greater proclivities for governance-related activism has driven many of the specific legal and functional changes just described.

As shareholders have gained power, boards have become more likely to exercise the power that they already held. Generally, boards have become more “independent,” though this change has occurred over decades rather than years.⁶¹ Corporate governance committees have become nearly universal, and succession committees more prevalent.⁶² The committees that do exist meet more often,⁶³ and boards are more likely to have formalized the CEO evaluation process.⁶⁴ Kahan and Rock conclude that the changes to board behavior demonstrate that “[r]ather than help[ing] the corporate insider with managing the business of the corporation, boards are now increasingly engaged in monitoring management and planning for management changes.”⁶⁵ Again, these changes are interrelated and likely driven in part by the shareholder changes described above.

These phenomena, in total, show that shareholders (and boards responding to shareholder pressure) are more active today than ever before in terms of monitoring managers and even driving corporate decision making. Kahan and Rock, for example, compile a list of

57 See Kahan & Rock, *supra* note 56, at 998–1004.

58 See *id.* at 1005–07. For an example of the way in which proxy advisory firms wield influence over governance questions, see Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 Ky. L.J. 119, 125–28 (2010).

59 See Kahan & Rock, *supra* note 56, at 1007–09; Rose, *supra* note 56, at 1366.

60 See, e.g., Rose, *supra* note 56, at 1376 (citing Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD. 3941 (2009)).

61 See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1472–76 (2007).

62 See Kahan & Rock, *supra* note 56, at 1027.

63 *Id.*

64 *Id.* at 1029.

65 *Id.*

thirty-four well-known firms that have been subject to activist campaigns.⁶⁶ Others have noted that activists have waged as many as 137 campaigns in a single fiscal quarter.⁶⁷ Through these campaigns, activist shareholders are able to exert significant influence on corporate policy, from shaping buyout policies to influencing governance changes. Along with its obviously disempowering effect on executives, this increased activism also exacts psychological costs. CEOs must devote more time to investor relations and relate to them with a level of obsequiousness greater than that to which they are likely accustomed.⁶⁸

1. The New Managerial Labor Market

One of the more startling results of these trends has been a new-found instability in the managerial labor market. As shareholders and boards have become more assertive, they have exerted more and more pressure on managers, up to and including firing those managers at an unprecedented rate. In the discussion that follows, we focus on this labor market and how the incentives it currently provides for CEOs largely overlap with those provided by incentive pay structures. We note, however, that the other mechanisms previously mentioned, e.g., the increased activity of institutional shareholders,⁶⁹ inextricably intertwined as they are with the managerial labor market, exert pressures that similarly duplicate the incentives created by incentive pay but are not properly considered as labor market pressures. As we will explain, however, the managerial labor market shares more obvious characteristics with incentive pay and is therefore easier to map onto the incentive terrain thought to be covered by it.⁷⁰ We think this par-

66 *Id.* at 998–1000.

67 *Id.* at 1000 (citing *Hedge Fund Activism, Possible Recession Will Play Roles in Upcoming Proxy Season*, CORP. L. DAILY, Feb. 1, 2008).

68 See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005) (describing CEOs approaching proxy advisors “on bended knee[s]”).

69 See Robert Daines et al., *The Good, The Bad and The Lucky: CEO Pay and Skill* 17 (Univ. of Pa. Inst. for Law & Econ. Research, Paper No. 05-07, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=622223 (finding a correlation between continued positive firm performance and high incentive pay, but only in the presence of large blockholders). *But see id.* (finding a correlation between reversals of prior poor firm performance and high incentive pay even absent large blockholders).

70 Others have pointed this out before. See Greg Hallman & Jay C. Hartzell, *Optimal Compensation Contracts with Pay-for-Performance and Termination Incentives* 1–2 (New York Univ., Working Paper No. FIN-99-053, 1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1298277 (“The basic result of the model is that the pay-for-performance incentive and the termination incentive are substitute incentive

ticular overlap best shows how incentive pay has become largely redundant, a point made only stronger if the other disciplinary mechanisms described above are also exerting additional pressure on executives.

a. The Labor Market as Ex Post Settling Up

The conventional wisdom has long been that CEO terminations occur extremely rarely and, consequently, the threat of dismissal adds little in the way of managerial incentives.⁷¹ Research of CEO terminations during the latter part of last century largely confirmed the conventional wisdom.⁷² More recent work, however, demonstrates that the ground has shifted in the managerial labor market. Since 1998, CEOs as a group experience a 17.4% annual turnover rate, which means that the average tenure of a CEO is less than six years.⁷³ As important, for purposes of evaluating incentive pay's marginal benefits, CEO terminations have become more significantly related to share price performance, as measured by industry-adjusted firm performance, industry-wide performance and/or market-wide performance.⁷⁴ More than ever before, a floundering share price will get a CEO scrutinized, disciplined, and fired.⁷⁵

devices; holding effort constant, optimal compensation schemes contain increasingly more intense pay-for-performance incentives as the cost of firing increases and the termination incentive weakens."); see also E. Han Kim & Yao Lu, *CEO Ownership, External Governance, and Risk-taking*, J. FIN. ECON. (forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1635943 (2011) (stating that external governance and CEO ownership levels are substitutes).

71 See, e.g., Core, et al., *supra* note 7, at 45 n.2 (ignoring, for incentive purposes, the threat of termination, but noting that "[t]his assumption likely does not hold for CEOs with large turnover probabilities").

72 See Kevin J. Murphy & Ján Zábajník, *Managerial Capital and the Market for CEOs* 28–30, (Apr. 2007) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376.

73 See Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?* 2 (Aug. 2008) (unpublished article), available at <http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf>.

74 See Dirk Jenter & Fadi Kanaan, *CEO Turnover and Relative Performance Evaluation* 20–24 (Stanford Univ. Graduate Sch. of Bus., Research Paper No. 1993, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885531.

75 See Kahan & Rock, *supra* note 56, at 1040 ("[I]f a CEO makes mistakes (or perhaps just has bad luck), both shareholders and directors will voice their criticism sooner and more strongly than in the days of yore, be it informally, through . . . a board-induced CEO resignation. . . . Moreover, since independent directors and even activist shareholders have limited capacity to micromanage a company, it is likely that CEOs still have substantial decision-making power over most nonstrategic business matters, as long as their decisions produce acceptable results." (emphasis added)); cf. *Of*

This conclusion is consistent with the results of a recent study, which found that as of April 2010 the typical CEO of an S&P 500 firm had served for only 6.6 years. In addition, the study found that only twenty-eight CEOs of the 500 S&P firms had served for more than fifteen years, suggesting that the archetypal entrenched CEO barely exists anymore. Furthermore, of the twenty-eight long-serving CEOs, twenty-five had led firms whose share price performance had beaten the overall S&P index over the term of their tenure.⁷⁶ Put differently, only three long-serving CEO's had failed to beat the S&P index. This data suggests that the only way to have a long tenure as CEO is to maintain your company's stock price as it relates to the broader market.

Our argument in this respect is similar to one made most famously by Eugene Fama who contended that the managerial labor market served as a "full ex post settling up" that resolved the lion's share of agency costs in a large public firm.⁷⁷ Fama's view has been subject to a fair amount of criticism, based primarily on its failure to account for transaction costs,⁷⁸ the market's inability to extract optimal labor supply from managers,⁷⁹ and managerial risk aversion.⁸⁰ Essentially, the critics argued that Fama was too optimistic about the labor market's ability to fully discipline managerial slack. Even if these criticisms were fair at the time and/or today, we think they cannot defeat the modified version of Fama's argument that we adopt in this Part to prove incentive pay's redundancy.

Fama described two necessary conditions for concluding that the managerial labor market would operate to minimize agency costs.⁸¹

CEOs and Congressmen, WALL ST. J., Aug. 10, 2010, at A14 ("If CEOs were ever given the benefit of the doubt, . . . those days are over. A single misjudgment, personal or strategic, can cost a corporate boss his job."). The converse appears to also be true. Incumbent CEOs have more incentives than ever to raise share price in order to be more attractive "serial CEOs" in the increasingly unstable labor market. See Mariasunta Giannetti, *Serial CEO Incentives and the Structure of Managerial Contracts* 26 (ECGI-Finance, Working Paper No. 1831 2007, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=889040.

⁷⁶ See Joann S. Lublin, *CEO Tenure, Stock Gains Often Go Hand-in-Hand*, WALL ST. J., July 6, 2010, at B5.

⁷⁷ Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 297 (1980).

⁷⁸ See Core et al., *supra* note 7, at 28 ("[Fama's] view abstracts away from information costs, contracting costs, and frictions in the market for corporate control.").

⁷⁹ See Bengt Holmström, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUDIES 169, 170-77 (1999).

⁸⁰ See *id.* at 178-81.

⁸¹ The third condition specified by Fama is that an executive's "talents and his tastes for consumption on the job are not known with certainty, are likely to change

First, labor markets must appropriately use available information to evaluate executive performance.⁸² Admittedly, share price is a noisy measure of executive performance,⁸³ and therefore a labor market solely responsive to share price movements operates somewhat inefficiently.⁸⁴ Our project is different than Fama's in that we merely aim to show that labor market incentives are coextensive with those of incentive pay. To assess this redundancy, whether a particular measure (e.g., share price movements) is a good assessment of managerial performance is unimportant; the only issue is whether it is the *same* measure used by the two mechanisms being studied. Accordingly, we reformulate Fama's first condition for our purposes as follows: incentive pay outcomes must be a function of the same observations that determine the outcomes in the managerial labor market.

Fama's second condition is that the weight of the discipline wrought by the labor market must be sufficiently powerful to create meaningful incentives.⁸⁵ Again, since we are assessing redundancy, this second condition must be reformulated to create a comparison between the effects of the two mechanisms under study. For our purposes, then, the second condition is whether the disciplinary measures meted out through incentive pay create meaningful *additional* incentives beyond the managerial labor market. For reasons discussed below, we think that it is satisfied.

b. The Importance of Share Price in Both Incentive Pay and the Managerial Labor Market

Regarding the first condition, the disciplines meted out by incentive pay and the executive labor market indisputably share a similar trigger—stock price movements. Share price drops or stagnation is the motivating force behind increased shareholder and board pres-

through time, and must be imputed by managerial labor markets at least in part from information about the manager's current and past performance." Fama, *supra* note 77, at 296. As Fama notes, however, this condition is noncontroversial, *see id.*, so we omit discussion of it.

82 *Id.*

83 See Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901, 909 (2001); Jenter & Kanaan, *supra* note 74, at 8–9.

84 Hence the widely-held view that boards should discipline executives appropriately through relative performance evaluation. See Jenter & Kannan, *supra* note 74, at 22.

85 See Fama, *supra* note 77, at 297.

sure discussed above.⁸⁶ Given shareholders' and boards' informational disadvantages, executives' performance is exceedingly difficult to evaluate aside from share price,⁸⁷ even if the link between the two is actually quite attenuated.⁸⁸ Naturally, activist investors and energized directors look to the most available proxy when exercising their disciplinary muscles.

Similarly, it is clear that share price is the most important input for determining rewards under incentive pay structures.⁸⁹ Cash bonus plan awards, which may themselves be conditioned on stock performance,⁹⁰ are generally dwarfed by equity-based incentive pay, such as stock options and stock grants, and an executive's existing portfolio holdings.⁹¹ Moreover, even the relatively small cash bonuses not

86 See, e.g., Bratton & Wachter, *supra* note 35, at 694–96; Holmström & Kaplan, *supra* note 32, at 137–39.

87 See Bratton & Wachter, *supra* note 35, at 694 (“Shareholder proponents take the market price, as modeled in traditional financial economics, as the best available projection of a corporation’s expected future cash flows. They then hold it out as an essential point of reference in the detection and reduction of management agency costs. They do not deny the existence of information asymmetries but, at least implicitly, assume them to have been minimized by increases in market efficiency and a thick layer of disclosure requirements.”); Holmström & Kaplan, *supra* note 32, at 138–39.

88 It has been argued that further shareholder empowerment is inadvisable given the inefficiencies in the stock market. See Bratton & Wachter, *supra* note 35, at 694–96 (contrasting the appropriateness of share price as a measurement of firm value in the informationally-rich context of a takeover attempt with that in informationally-poorer contexts); see also Patrick Bolton et al., *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD. 577 (2006) (characterizing equity prices by a speculative component); Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5 (2005) (describing the tendency of managers of firms with overvalued equity to make ill-advised decisions in order to satisfy market pressures). For our purposes, however, this is irrelevant. That (1) there is existent shareholder power and (2) its exercise is generally stimulated in movements in stock price means that alternative disciplines are triggered by stock prices.

89 See John E. Core et al., *Are Performance Measures Other Than Price Important to CEO Incentives?* 13–20 (June 2000) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214132.

90 See *id.* at 16. (When comparing variance ratios for annual pay, on the one hand, and equity-based gains, on the other “[t]hese ratios may be interpreted under the *very strong* assumption that all variation in annual pay is due to performance measures orthogonal to price.” (emphasis altered)).

91 See *id.*; see also Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 260 (2010) (for executives at Bear Stearns and Lehman Brothers, equity-based payouts exceeded cash bonuses by factors of 3.5 and 5, respectively); Jensen & Meckling, *supra* note 13, at 11 (showing that, in 2002, stock options accounted for forty-seven percent of S&P 500 CEO pay while cash bonuses accounted for only seventeen percent).

based on actual stock performance are typically based on accounting metrics that tend to move stock prices, such as earnings per share.⁹² Thus, even non-equity-based incentive pay correlates closely with stock price movements. In short, incentive pay structures discipline executives based on the same considerations—short-term share prices—that shareholders and boards do when they utilize alternative mechanisms, including termination or the threat thereof, to discipline managers.⁹³

c. Comparing the Force of Disciplinary Measures

Second, the managerial labor market must provide similarly painful consequences for poor share price performance (so as to encourage the same behaviors) as do incentive pay structures. In considering the level of punishment for incentive purposes, one must consider both the magnitude of the discipline and its likelihood.

The consequences of poor share price performance for executives from incentive pay include a reduced level of annual income and, more consequentially for most executives, reduced portfolio value. These losses, whatever their magnitude, will be more or less painful to the executive depending upon the amount of her wealth.⁹⁴ But in any event, we can be confident that at least significant levels of poor performance will matter a great deal to the average CEO with a typical incentive-pay laden compensation arrangement, both currently and on an historic basis.

92 See Core et al., *supra* note 89.

93 This is not to say that the link between incentive pay and share price is inevitable. Indeed, a variety of commentators have sought to de-link incentive pay from short-term share price fluctuations and/or equity prices generally, which would have the consequence of similarly de-linking the basis for incentive pay discipline from the basis for the alternative mechanisms. But, for the reasons discussed in Part I.A.2 below, we think the promise of such an alteration is overstated precisely because of the presence of the alternative mechanisms.

94 John Core & Wayne Guay have argued for greater consideration of executive wealth in setting incentive pay contracts. See John Core & Wayne Guay, *The Use of Equity Grants to Manage Optimal Equity Incentive Levels*, 28 J. ACCT. & ECON. 151, 179–80 (1999). Although we agree with them, we do not think executive wealth will affect the redundancy of incentive pay. To the extent wealthier executives will be hard to incentivize through alternative mechanisms, they will also be hard to incentivize through incentive pay. At most, incentive pay provides wealthy executives with an incentive to avoid cataclysmic decisions that would wipe out a large portion of their wealth. Outside of this limited set of potential outcomes (which may actually cause executives with high levels of firm stock to be even more risk averse), we see no reason to think the makeup of a wealthy executive's assets will have significant incentive effects (even though the level of wealth itself might).

The discipline meted out by the managerial labor market, on the other hand, can be both financial and social. When combined, the magnitude of these consequences is likely large enough to constrain CEO behavior in all but a handful of cases if there exists a sufficiently high likelihood of enforcement.⁹⁵ Although being fired may not prove to be a perfect ex post settling up,⁹⁶ it is likely to impose serious financial costs on executives if their retirement horizon is not too near.⁹⁷

Termination necessarily entails the loss of significant expected future wage earnings from the terminating employer and a reduction in attractiveness to potential employers. Casual empiricism shows that some terminated CEOs are able to find work again relatively quickly,⁹⁸ but there are surely significant switching and uncertainty costs even for these few. Severance packages can help soften at least the financial blow of termination, though recent research shows that these packages are unlikely to make departing executives anything close to whole.⁹⁹ Moreover, commentators generally view generous severance

95 Simone Sepe reaches the same conclusion on the assumption that a “continuation payoff”, i.e. future wages, is significant enough to motivate manager behavior. *See supra* note 4, at 215. He does not, however, demonstrate that future wages as currently constructed actually provide that motivation at most firms, which is the operative question here.

96 *But see* Fama, *supra* note 77, at 298 (providing a model in which the settling up is perfectly correlated with shirking).

97 *See id.* (qualifying the settling-up analysis with the potential for problems in pre-retirement settings); Holmström, *supra* note 79, at 172 (observing that the effort-producing incentives of the labor market depend on uncertainty regarding an executive’s talent level, uncertainty which should diminish over time). Note, though, that the argument for incentive pay stemming from excessive risk aversion is turned on its head in the pre-retirement context when the expected returns from one’s firm-specific investment are lower. In such cases, then, the salient agency costs will be those unrelated to a CEO’s differing risk preference, e.g., a desire to empire build. Additionally, given some baseline level of executive share ownership and the impracticality of immediate portfolio liquidation upon termination, that loss will be coupled with the portfolio risk created by entrusting the firm to someone else’s control for some period of time. However, the existence of this risk assumes a level of incentive pay (in the form of owned shares). Thus, we exclude it from our analysis.

98 *See* Heidi N. Moore, *Chrysler: The End of Bob Nardelli. Again.*, WALL ST. J. BLOGS, DEAL J. (Apr. 21, 2009, 12:14 PM), <http://blogs.wsj.com/deals/search/%20nardelli.%20Again./?s+=nardelli.+Again>. (describing Bob Nardelli’s fall from the executive suite at General Electric, followed by his installation as CEO of Home Depot, followed by his fall therefrom and relatively quick installation as CEO of Chrysler).

99 *See* David Yermack, *Golden Handshakes: Separation Pay for Retired and Dismissed CEOs*, 41 J. ACCT. & ECON. 237, 255 (2006). Yermack found that the mean separation pay awarded dismissed executives between 1996 and 2002 was \$15.1 million (median \$6.5 million) and that such pay was generally awarded in the board’s discretion rather

packages as deviations from optimal incentive pay arrangements in the first place,¹⁰⁰ largely mooted their impact on our analysis of the marginal benefits of an idealized incentive pay package. At the very least, for younger executives expecting a relatively long stay in the labor market, the case for incentive pay is particularly tenuous. Those executives can achieve significant gains by signaling their skill through an increased share price even if the potential of being fired never crosses their minds. These gains could come in the form of higher salaries and better opportunities to lead larger and more prestigious firms. And obviously it is hard to see how high levels of incentive pay would make a difference, incentive-wise, to executives with long-term career concerns if the threat of termination is real.

Still, it remains the case that there may be less redundancy between incentive pay and the managerial labor market in the near-to-retirement context. Even there, though, the labor market may provide significant nonfinancial sanctions for executives facing termination. Like others (and maybe more so), corporate managers are susceptible to public shaming,¹⁰¹ and being terminated by a public company is unlikely to be a quiet affair.¹⁰² Outside of termination threats, increased scrutiny by shareholders and boards brought on by poor stock performance will be unpleasant for most CEOs, providing incentives through the final period in their employment. In addition, a near-retirement CEO will most likely have had a very successful career to arrive at and stay in that position; such a CEO would appear to have strong social incentives to end his career on a positive note. There may certainly be CEOs who are willing to risk such consequences absent sufficient pay incentives. But, at the very least, it seems reasonable to expect shareholders and boards in a world with less incentive pay to take account of this possibility by increasing monitoring of CEOs who are nearing retirement age or to favor younger CEOs in the first instance.

than by contract. However, classifying departures as forced or voluntary is an imprecise exercise. *See, e.g.,* Jenter & Kanaan, *supra* note 74, at 18. Across all departures, the mean separation pay was less than the average CEO's annual compensation. *See* Yermack, *supra*, at 238.

100 *See, e.g.,* Jensen & Murphy, *supra* note 6, at 167; Yermack, *supra* note 99, at 262.

101 *See* Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 106–07 (2008) (discussing moral sanctions as deterring securities fraud).

102 *See, e.g.,* Kahan & Rock, *supra* note 32, at 897 ("Finally, departing in the context of a sale of control is likely to be better for a CEO's reputation than being fired by the board.").

d. Sensitivity to Underperformance

Rather than focusing on the first two conditions, labor market skeptics have traditionally minimized its significance by pointing to the low probability of termination.¹⁰³ On this account, CEO termination, even if sharing a coextensive trigger with incentive pay and sufficiently painful when triggered, does not occur quickly or frequently enough to serve as an effective substitute for incentive pay.¹⁰⁴ Terminations were thought to happen only rarely,¹⁰⁵ perhaps only in cases of precipitous share price drops and even then after a grace period in which executives were allowed to linger. Incentive pay, on the other hand, works immediately and linearly—even small price drops or stagnation results in a true cost today to executives with incentive-laden contracts. The requirement of a threshold level of poor performance prior to the activation of the labor market discipline meant that incentive pay, by permitting relatively less slack, was significantly more useful in nonextreme cases. The possibility of delayed discipline made labor market discipline less salient in managers' minds.

As mentioned above, however, recent research indicates that the tide has turned. Due to its often nonpublic nature, it is difficult to measure precisely the increased sensitivity of general shareholder activism to poor firm performance.¹⁰⁶ On the other hand, the managerial labor market is capable of more exacting study. In particular, CEO turnover studies demonstrate the sensitivity of the managerial labor market to firm performance.¹⁰⁷ Since at least the turn of the century, CEOs' positions have become more precarious than ever. As previously discussed, several studies indicate a high current turnover rate for CEOs of public companies, with average tenure lengths of approximately six years.¹⁰⁸ This turnover rate has increased markedly

103 See, e.g., Murphy & Zábojník, *supra* note 72, at 29–30 (finding that “departure probabilities for CEOs realizing returns 30% below the industry average were increased by 0.4% in the 1970s, 0.7% in the 1980s, and 0.4% in the 1990s” and concluding “that the turnover-performance relation . . . has fallen since the 1980s”); Murphy, *supra* note 8, at 2547 (finding a 7.9% probability of departure for young CEOs at average-performing firms increasing only to an 8.5% probability if the young CEO's firm realizes returns 30% below industry average).

104 See Michaud & Gai, *supra* note 9.

105 See Murphy, *supra* note 8, at 2547–48.

106 Anecdotal evidence suggests that general shareholder activism in response to poor firm performance is increasing. See Kahan & Rock, *supra* note 56, at 1039–40.

107 But see Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking* 11 n.6 (Eur. Corp. Gov. Inst., Finance Working Paper No. 285, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1502762 (noting the high R-squareds involved in Kaplan and Minton's study).

108 See *supra* notes 73–76 and accompanying text.

in recent years.¹⁰⁹ Moreover, there is a significant correlation between share price and CEO turnover.¹¹⁰ The managerial market thus has become more penal with respect to underperforming share prices.¹¹¹

And while there surely remains some threshold level of poor stock performance before termination (or other similar disciplinary measures) will be triggered,¹¹² as the threshold gets lower it becomes harder to make the case that executives will strategically exploit the slack that it might provide. Slack exploitation requires a degree of confidence on the part of a CEO as to the threshold amount. But recent evidence indicates that CEOs should not feel confident in predicting how much rope they have with which to play.

First, the relevant threshold is dynamic over time, and there is no reason to think the trend towards less slack will abate.¹¹³ Thus even if the costs of switching CEOs,¹¹⁴ for instance, provide frictions that make an entirely efficient labor market impossible, those costs appear small enough (and getting smaller) to allow the market to perform reasonably well in its disciplinary role.

109 See John C. Coates IV & Reinier Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* 27 (Eur. Corp. Gov. Inst., Finance Working Paper No. 191, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925532 ("When [three-year market] returns decline . . . CEOs are fired. . . . [That factor increased the risk of being fired and t]his result strongly suggests that (consistent with Jenter and Kanaan) poor market performance over several years is the best predictor of [being fired]"); Kaplan & Minton, *supra* note 73, at 8. Jenter and Kanaan find frequencies more similar to the traditional picture of CEO turnover, though they limit their turnover variable to forced turnover. See Jenter & Kanaan, *supra* note 74, at 41.

110 See Jenter and Kanaan, *supra* note 74, at 20 (limiting their analysis to "forced turnover"); Kaplan & Minton, *supra* note 73, at 11–16.

111 We emphasize that carrots are in play here as well as sticks. Incumbent CEOs with career concerns are intrinsically focused on stock prices because, in addition to the desire to retain their current positions, they often hope for more lucrative CEO positions at other firms. See Giannetti, *supra* note 75 (noting "serial CEO" phenomenon). And the best way to move up the CEO ranks is to raise your current firm's stock price.

112 See Jenter & Kanaan, *supra* note 74, at 3 (citing research to the effect that CEO quality must fall below a threshold before a board will dismiss a manager). There may be other factors entering into the calculus as well. Coates and Kraakman, for example, demonstrate that CEO tenure has something of a term structure with respect to resignations and replacements via takeover (but not internal forced departures) for CEOs with low share holdings wherein the CEOs are relatively insulated for the first three to four years of their tenure, followed by a period of increased turnover, culminating in a period of lower turnover (perhaps demonstrating a survival effect, managerial power or both). See Coates & Kraakman, *supra* note 109, at 14–16.

113 See Kahan & Rock, *supra* note 56, at 1041–42.

114 See *supra* note 69 and accompanying text.

Additionally, studies of CEO turnover have found a surprising level of randomness in the termination decision-making process. Not only do boards terminate managers when firm performance falters relative to its peers, but boards tend to fire managers based on exogenous industry- or market-wide shocks, contrary to theory that predicts a filtering out of such shocks.¹¹⁵ For instance, when the performance of the industry in which a company is based is shifted from the seventy-fifth percentile to the twenty-fifth percentile within the economy as a whole, the chance of a CEO termination increases by fifty percent, regardless of a particular company's industry-adjusted firm performance.¹¹⁶ Interestingly, though, the failure of boards to filter industry- or market-wide effects is more pronounced if the CEO's company is underperforming relative to its industry.¹¹⁷ On the other hand, boards are apparently better at filtering out exogenous shocks as long as the CEO outperforms her industry peers.¹¹⁸ That is to say that negative "noise" in a firm's share price increases termination risk for executives once a firm is a below-median performer within its industry. Effectively, the noise (or, ex ante, potential for noise) makes the price of being an underperforming CEO relative to industry peers higher than it ought to be in a perfectly functioning market. This arbitrariness is apt to have an *in terrorem* effect for any CEO at firms where below-median industry-adjusted performance is a possibility, meaning that a much larger number of firms are actually subject to discipline via CEO turnover. That *in terrorem* effect will push managers not only to supply more labor, but also to pursue projects with the highest expected impact on share price, in spite of their inherent risk aversion that would otherwise cause them to be overly conservative (from the shareholders' perspective) in making investment decisions.¹¹⁹ Essentially, that risk aversion, borne out of their firm-specific investment, is able to come full circle in an uncertain labor market and incentivize share-maximizing behavior. In other words, for executives with career concerns, the arbitrariness of the labor market coupled with the increased vigilance of monitors makes incentive pay more redundant, and therefore less consequential, than ever before.

115 See Jenter & Kanaan, *supra* note 74, at 20–24.

116 See *id.* at 21–22.

117 See *id.* at 29.

118 See *id.*

119 See Holmström, *supra* note 79.

e. Summary

Incentive pay's agency-cost-reducing effects are largely duplicative of those stemming from alternative disciplining mechanisms, most significantly a newly vigorous managerial labor market. Discipline under each of these mechanisms is largely if not entirely triggered by poor stock price performance.¹²⁰ For most CEOs, the prospect of disciplinary action, including termination, in the event of poor stock performance will be at least as troubling as incentive pay losses. Although the alternative mechanisms allow more slack than incentive pay with its linear payout structure (like stock shares and in-the-money options), it is difficult for CEOs to exploit the slack.¹²¹ We therefore agree that, as a general matter, being terminated for failing

120 See, e.g., Holman Jenkins, *Bank CEOs and the Bewitching Carrot*, WALL ST. J., July 14, 2010, at A17 ("Most of the authors were admirably reluctant to offer remedies, but let's not doubt that somebody somewhere is already polishing up a proposal to solve the problem by regulating CEO pay. Such faith is touching, though it overlooks a hard reality: The stock market would continue to assert its influence over managements.").

121 This conclusion is not weakened by studies that have purported to demonstrate a link between compensation-based incentives and firm performance. See Carola Frydman & Dirk Jenter, *CEO Compensation* 20–22 (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 77, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1582232 (offering a sample of such studies). First, the majority of those studies covered earlier periods when the vigorous alternative mechanisms described above were not nearly as strong. Even if incentive pay affected firm performance in an era of weak shareholder and board oversight, it might not any longer. Second, leaving aside the possibility of evolving alternative governance mechanisms, it is difficult to make a determination of causality from those studies. Compensation structure is as likely to be an endogenous output, given a firm's characteristics, as it is an exogenous input. See Michaud & Gai, *supra* note 9, at 1 (finding that only cash bonuses were correlated with improved firm performances and that even that relationship is vulnerable to endogeneity concerns, i.e. compensation "was simultaneously determined with performance"). Any correlation between pay and firm performance could be due to "compensation affect[ing] performance, . . . firm performance affect[ing] pay, or because an unobserved firm or CEO characteristic affects both variables." Frydman & Jenter, *supra*, at 20. The redundancy hypothesis proposed by this Article is consistent with the latter explanation—recently empowered shareholders and boards drive firm behavior toward share price maximization independent of incentive pay and, propelled by a (possibly mistaken) belief that incentive pay is an important piece of the puzzle, impose incentive-laden contracts on executives. For more on observable and nonobservable firm characteristics other than pay structure driving firm performance, see Charles P. Himmelberg et al., *Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance*, 53 J. FIN. ECON. 353 (1999).

to meet short-term share price expectations is a more significant motivator than performance-based pay.¹²²

At the same time, we concede that incentive pay is not completely redundant in all cases. For some CEOs, the prospect of increased pressure from shareholders and boards may not be troubling. Some CEOs may be confident that they will be able to turn around a firm's fortunes during the period between first failure and subsequent termination. Some CEOs on the verge of retirement might experience little concern over being fired, let alone more minor nuisances like returning institutional shareholders' phone calls. Similarly, CEOs with exceptionally generous severance arrangements may feel insulated from at least the managerial labor market though, as alluded to before, this militates in favor of reducing the severance package rather than increasing incentive pay. Finally, incentive pay will not be redundant to the extent an incumbent CEO believes (perhaps incorrectly) that she can accurately gauge the amount of slack she has before risking termination or other alternative discipline.

We suspect that the conditions that make incentive pay non-redundant do not obtain as often as has been implicitly presumed by incentive pay proponents. Consequently, we think incentive pay's marginal benefit is smaller than assumed, even under an idealized version of incentive pay. Accordingly, firms should, at a minimum, analyze how redundant incentive pay might be in their particular circumstances, rather than simply assuming a homogenous level of incentive pay benefits. Thus, for example, firms with relatively young CEOs and firms who have a reputation of giving their CEOs less slack should realize that they might receive little marginal benefits by using large amounts of incentive pay components. To the extent that such inquiries are prohibitively costly,¹²³ boards should apply a blanket discount to the expected incentive effects by an appropriate amount considering the redundancies discussed above.

122 See Cheng et al., *supra* note 107, at 5. ("But in practice, there is plentiful evidence that institutional investors care greatly about companies making quarterly earnings targets, presumably because the accompanying growth in share prices helps the institutional investors' portfolio performance. . . . We stress that we do not view this hypothesis as incompatible with the hypothesis that entrenchment is a significant problem that led to the crisis. But in light of the non-correlation between shareholder rights and both risk-taking and price performance, our results at a minimum suggest that further research should explore investor preferences as an alternative hypothesis to failures of governance.").

123 See *infra* Part I.B (describing the difficulty in crafting the optimal incentive pay contract in light of the numerous relevant firm- and executive-specific factors).

2. Attempted Improvements to Incentive Pay Practices

Before moving on, we should note that much of the recent work dedicated to reforming incentive pay has focused on breaking the link between incentive pay and short-term share prices. Indeed, the response to the recent financial crisis predictably included calls for changing the structure of bankers' pay.¹²⁴ In theory, this would reduce incentive pay's redundancy with respect to alternative mechanisms, which would necessarily continue to be a function of those short-term equity price signals. Our analysis suggests, however, that the alternative mechanisms that *overlapped* with incentive pay in the current paradigm are likely to instead *overwhelm* any divergent incentives produced by a reformed version of incentive pay.

Two somewhat related moves have recently been offered to improve managerial behavior via reformed incentive pay. First, a group of commentators has sought to key incentive pay off of long-term share value as distinct from short-term share value. It is fairly well established that there will often be a disconnect between the two, particularly in frothy markets where speculation is at its peak.¹²⁵ It is thought that excessive focus on short-term price fluctuations may harm long-term firm value and that incentive pay design as currently practiced may provide incentives for executives to undervalue long-term performance.¹²⁶ These proposals to instill a longer-term focus in managers vary.¹²⁷ Lucian Bebchuk and Jesse Fried would impose a number of restrictions on equity awards. Under their proposal, equity grants would not be made on an ad hoc basis,¹²⁸ and the exercise price for options would be based on something other than grant-date share price.¹²⁹ Moreover, Bebchuk and Fried would impose post-vesting holding periods on equity awards¹³⁰ and more tightly control the

124 See Michael diFilipo, Note, *Regulating Executive Compensation in the Wake of the Financial Crisis*, 2 DREXEL L. REV. 258 (2009) (describing legislative and regulatory attempts to reform compensation practices in response to the crisis).

125 See Bolton et al., *supra* note 88, at 587–95 (discussing a speculative component contained in current share price).

126 See Bebchuk & Fried, *supra* note 2, at 1917; see, e.g., Bhagat & Romano, *supra* note 16.

127 See Bebchuk & Fried, *supra* note 2, at 1919.

128 See *id.* at 1940.

129 See *id.* at 1942. Bebchuk and Fried do not, however, specify exactly what the exercise price should be in reference to other than a note that the hiring date share price might serve such a role. *Id.* at 1941. Neither of the two measures aimed at preventing gaming of equity grants seems to be directly related to Bebchuk and Fried's general attempt to encourage long-term incentive horizons.

130 *Id.* at 1925. Bebchuk and Fried would permit immediate sales to the extent necessary to pay taxes arising from any vesting event. *Id.* at 1924.

unwinding process.¹³¹ Sanjai Bhagat and Roberta Romano would require executives to hold equity awards through some post-retirement period.¹³² Both proposals share the central feature of erecting barriers to liquidating equity positions with a view towards extending executives' incentive horizons.

Second, a number of commentators have contended that incentive-laden pay arrangements stimulated excessive risk-taking by financial institutions, which might have contributed to the current financial crisis.¹³³ Note that the traditional argument in favor of incentive pay emphasized that, absent sufficient amounts of incentive pay components, executives would have the tendency to take too *little* risk.¹³⁴ Now, the worry is that executives might prefer too much risk. Nevertheless, the perceived problem of excessive risk taking is thought particularly worrisome in the financial industry context where, because of FDIC explicit guarantees or "too-big-to-fail" implicit guarantees, the federal government is or is perceived to be a guarantor if firms fail.¹³⁵ As a result of the government guarantees, creditors cannot be counted on to effectively counteract this preference. Therefore, some commentators argue, executives-as-shareholders are apt to take on too much risk. To mitigate this problem, these commentators suggest expanding the reference assets for incentive pay to include some component of preferred stock and/or firm debt rather than only common stock.¹³⁶ Preferred stockholders and debtholders prefer less risk-tak-

131 *Id.* at 1928–34. The unwinding limitations would come in the form of both grant-specific limitations and annual aggregate limitations. Recipients would additionally be barred from hedging their exposure to long-term share price. *Id.* at 1954.

132 See Bhagat & Romano, *supra* note 2, at 364.

133 See Lucian Bebchuk & Jesse Fried, *Equity Compensation for Long-Term Results*, WALL ST. J., June 16, 2009, at A20 (noting that the current design of certain incentive pay structures "provided executives with powerful incentives to seek short-term stock gains even when doing so involves excessive risk-taking"); Statement from Timothy Geithner, *supra* note 2 (noting that "compensation design unintentionally encouraged excessive risk-taking"); see also Tung, *supra* note 2, at 13 ("Analysts have decried the role of perverse managerial incentives in precipitating the Financial Crisis.").

134 See *supra* note 51 and accompanying text.

135 See Deborah Lucas & David Torregrosa, CONG. BUDGET OFFICE, FANNIE MAE, FREDDIE MAC, AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET 17 (2010). The problem is perceived to exist in the broader context as well. See Blair & Stout, *supra* note 52, at 411–14 (explaining that, "under a rule of strict shareholder primacy," company directors take excessive risks); Statement from Timothy Geithner, *supra* note 2 (describing a broader problem of excessive risk-taking incentives, though noting that "financial firms, in particular" were afflicted with it).

136 Other measures, unrelated to resolving the debt/equity conflict, may be available to solve for at least a portion of any excessive risk-taking. As noted above, Bhagat

ing by the firm than common stockholders because they have fixed claims with no upside potential. As a result, making incentive pay more preferred-stock- and debt-sensitive and less common-stock-sensitive is expected to cause executives to prefer less risk. For this reason, Lucian Bebchuk and Holger Spamann propose using incentive pay that is linked to a diversified basket of the firm's securities, including common stock, preferred stock, and debt.¹³⁷ Likewise, Fred Tung has proposed giving bank managers, in addition to traditional incentive pay components, subordinated debt instruments issued by the bank.¹³⁸

There are two reasons to doubt these reform proposals' abilities to change managerial behavior significantly. First, there is the matter of implementation. In the bank context, there is the potential for a shift in incentive pay via regulation, but there is little chance that regulators will be able to impose their will on compensation patterns outside of that industry where regulatory influence is less pervasive.¹³⁹

and Romano recommend that equity-based incentive pay include a restriction that would prevent the executive from exercising stock options or selling stock before a specified time period after the executive leaves the employ of the company. This significant long-term holding period would reduce the executive's appetite for risk, *see* Bhagat & Romano, *supra* note 2, at 364–65, though it might do so to a suboptimal extent. The proposal in essence creates a long-term equity account that cannot be liquidated nor diversified. This is similar to the human capital investment in the firm, which generates salary, perks, and reputational benefits that likewise cannot be liquidated or diversified. Once the combined balances of these two "accounts" becomes sufficiently large, the executive will have strong incentives to be suboptimally conservative in order to preserve these values. Furthermore, to offset the lack of liquidity available to executives during the pendency of the long-term equity account, Bhagat and Romano suggest increasing cash salaries, which may increase the incentive to be suboptimally conservative. While companies could counteract this effect by granting additional current-year incentive pay with risk-preference kickers (e.g., options), there are potential problems with this approach. First, if the current-year options are subject to the long-term holding period, the incentive effect will be severely blunted; this will presumably require a very significant option grant. Second, if the kicker is too high, the pendulum will have swung too far back towards excessive risk taking.

137 *See* Bebchuk & Spamann, *supra* note 2, at 283–84.

138 *See* Tung, *supra* note 2. Bebchuk, Spamann, and Tung all appear to prefer substituting debt for a portion of traditional incentive pay (stock options and stock grants) over simply reducing the amount of incentive pay and commensurately increasing salaries, though they never say this explicitly. Each would decrease the incentive to take risk, because rights to fixed pay are similar to debt instruments in that holders do not benefit from corporate growth.

139 If anything, the opposite conclusion is drawn from the financial overhaul legislation recently passed in Congress which permits shareholders a "say on pay." *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 83 Stat. 1376–2223 (2010). Reform advocates have noted the inconsistency between a

This means that some degree of private ordering will be necessary to achieve the changes that the reformers desire in those sectors. Given the state of corporate law described above, this ordering will have to be driven by, or at least require the approval of, shareholders.¹⁴⁰ Yet it is hard to see why newly powerful shareholders and the boards that have become more responsive to them should be interested in new incentive structures that push managers' interests away from their own interests, whether it be short-term share price maximization, exploitation of the (explicit or implicit) federal guarantee of their debts in the bank context, or both.

Second, even assuming that either of these proposals was implemented, the newly strengthened alternative forms of discipline described above would remain. As those alternatives make the received version of incentive pay linked with short-term equity prices redundant, they are likely to make any modified version delinked from those prices *impotent*. Even if incentive pay is keyed off of something—long-term equity value or some mix of firm-related securities—other than short-term common stock price, the shareholder and board pressures described above will remain functions of fluctuations in short-term common stock price. There is no reason to think that today's investors will stop pushing for adjustments in strategy to improve short-term share price. To the extent proxy advisory firms use firm performance as a filter for recommendations on director elections and other power-conferring votes,¹⁴¹ that performance will continue to be measured by relatively short-term (e.g., three-year or less) equity price movements. And continuing from the earlier analysis, the pull of short-term share prices is likely to be strongest in the context of possible termination. Different executives will balance incentive pay considerations against job security and other intrusions on their autonomy differently, but we agree with other commentators that these pressures and, in particular, the threat of termination for failing to meet short-term expectations are apt to be powerful

move away from short-term equity incentives and increased shareholder power over pay decisions. See, e.g., Bebchuk & Spamann, *supra* note 2, at 276–77.

140 For more on the limitations of debtholders in regard to aligning pay incentives, see Bebchuk & Spamann, *supra* note 2, at 266–67.

141 But see Lund, *supra* note 58, at 137–40 (contending that proxy firm recommendations for say-on-pay votes are generally not dependent on firm performance); Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 694 (2009) (arguing that firm performance is generally not predictive of proxy firm vote recommendations).

motivators.¹⁴² We are therefore pessimistic regarding the effectiveness of any executive compensation proposal that is designed to counteract shareholders' intense focus on current stock prices.¹⁴³

B. The Likelihood of Arriving at an Optimal Contract

When we relax the assumption of an idealized version of incentive pay, its marginal benefits—whether they be of the traditional (agency-cost-ameliorating) or reformed (risk-dampening) sort—become even harder to discern. Most fundamentally, there remains disagreement over what constitutes an optimal set of pay-related incentives for increasing firm value.¹⁴⁴ Moreover, asking incentive pay to also function as a check on excessive risk taking, as some of the reformers described above would have it do, only serves to complicate matters, making it even more likely that incentive pay structures will fail to live up to their promise. Nevertheless, these theoretical problems are driving most of the work being done on incentive pay, and it is conceivable that commentators have or will develop a knock-out incentive pay structure that dominates all others (assuming, at a

142 See *supra* note 112 and accompanying text. This may be particularly true if a CEO's employment is reconceived as a valuable call option on future incentive pay flows. See Karl S. Okamoto & Douglas O. Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159, 197–98 (2010) (describing the way in which an incentive-laden compensation structure grants executives an annual call option where any effort used to achieve a performance hurdle is the option price). The impact of our thesis is that incentive pay should be utilized more judiciously, perhaps making an executive's employment qua call option less valuable than it is currently. But we do not expect incentive pay to be completely eradicated, meaning that some similarities to an option will remain. As such, we agree that, "tinkering with the components of an executive's exposure will not change the incentive to take risk" given the managerial labor market's sensitivity to short-term equity prices. *Id.* at 199.

143 Financial firms should be no different. Substantive regulation can certainly reduce the discretion of managers driven by career concerns. But such regulation does not attempt to adjust those career concerns the way that the incentive pay reform proposals would. Our claim is not that it is impossible to regulate risk taking in the financial sector because of powerful shareholders. Rather, it is that we should be leery of "soft" attempts to do so through compensation-related incentive structures.

To the extent banking became significantly less risky than currently through substantive regulation, it is possible that different types of shareholders might begin to invest more heavily in financial firms. Nevertheless, activism arbitrage opportunities would remain as long as some gap remained between firm behavior and regulatory limits.

144 Most obviously, there is significant disagreement over the appropriate level of risk taking at public companies. See *infra* Part II.B.I.

minimum, that a consensus is reached over the ends toward which pay structures are to incentivize behavior).

Even then, however, there is likely to be an irreducible level of idiosyncrasy in the idealized incentive pay contract.¹⁴⁵ Ideal incentive pay amounts and structures will depend in part on a firm's unique characteristics. For example, firms with weaker shareholders may need one sort of incentive pay framework while those with stronger shareholders may need another. Alternatively, there are likely to be nongovernance-related, firm-specific differences with respect to optimal pay design. Mature firms will often require far different incentives than younger firms.¹⁴⁶ Similarly, firms with more significant growth opportunities should theoretically have a more convex compensation design than those with less upside.¹⁴⁷ And that optimal level of convexity theoretically should shift with the riskiness of desired firm investments and firm leverage.¹⁴⁸

Leaving aside differences among firms, there remains a great deal of *CEO-specificity* involved in determining optimal pay-related incentives. For example, wealth-constrained CEOs experience significant wealth effects related to firm performance by holding even a small amount of firm equity.¹⁴⁹ The confusion introduced by that simple sort of CEO heterogeneity pales in comparison to less transparent idiosyncrasies regarding retirement horizons, risk preferences, work ethics, self-confidence, etc.¹⁵⁰ Different people will react differently to

145 *But see* Alex Edmans & Xavier Gabaix, *Tractability in Incentive Contracting*, 24 *REV. FIN. STUD.* 2865 (2011) (contending that, at least in large firms, high-powered incentives will always be optimal).

146 *See* Filatotchev & Allcock, *supra* note 8, at 21 (“[O]lder firms in the mature phases of their business life cycle may have a more diversified resource pool and ‘professionalized’ management team. As a result, they may be in greater need of formal incentive alignment mechanisms compared to younger, founder-owned firms in their start-up phase, which may have narrower resource bases and thus higher focus on reputational, capability-related aspects of governance.”).

147 *See generally* John E. Core & Jun Qian, *Option-like Contracts for Innovation and Production* (Jan. 2000) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=207968 (2000).

148 *See, e.g.*, David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence* 11 (Bos. Univ. Sch. of Law, Working Paper No. 10-32, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1688560 (discussing the work of Chongwoo Choe).

149 *See* Richard A. Lambert et al., *Portfolio Considerations in the Valuation of Executive Compensation*, 29 *J. ACCT. RES.* 129 (1991).

150 *See* Frydman & Jenter, *supra* note 121, at 13 (“The optimal incentive strength depends on parameters that are unobservable, such as the marginal product of CEO effort, the CEO’s risk aversion, the CEO’s cost of effort, and the CEO’s outside wealth. These free variables make it easy to develop versions of the principal-agent

incentive structures,¹⁵¹ and this CEO heterogeneity necessarily makes the bargaining process toward an optimally-incentive-pay-laden contract extremely complicated.

Any attempt to wade through the complexity brought on by firm- and CEO-specificity is bound to generate significant transaction costs that make idealized results unlikely, as firms are forced to economize away from first-best contracts.¹⁵² Compensation committees lack the time and expertise to perform this task, so they generally outsource it to compensation consultants.¹⁵³ Yet compensation consultants (whose own compensation is also a cost of the process) themselves face pressures to economize. Shortcuts they take—applying one-size-fits-all structures across client firms, for instance—are likely unobservable to their principal (i.e., the board), meaning the incentive pay structures they propose will deviate from the ideal.¹⁵⁴ And, of course, the further transaction costs push observed incentive pay contracts from the ideal, the less reason there is to believe that incentive pay is

model that are consistent with a wide range of empirical patterns.”). Regarding the role of overconfidence in the selection of CEOs, see Anand M. Goel & Anjan V. Thakor, *Overconfidence, CEO Selection, and Corporate Governance*, 63 J. FIN. 2737 (2008).

151 See, e.g., Okamoto & Edwards, *supra* note 142, at 191–92 (suggesting that forced deleveraging via a shift from equity compensation to debt compensation may cause some executives to take even greater risk in an attempt to replicate the returns they had originally experienced).

152 See Core et al., *supra* note 7, at 32 (“Furthermore, the empirical findings suggest that it is inappropriate to use a single firm characteristic, such as firm size, to benchmark executive equity holdings against mean or median equity holdings. Instead, the regression models reveal that multiple firm characteristics, such as size and proxies for investment opportunities, must be weighted to construct a prediction of the expected level of equity incentives.”). For more on the complexity of achieving an optimal incentive pay contract, see Jeffrey N. Gordon, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case of Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 329–35 (2009).

153 See Michael B. Dorff, *Confident Uncertainty, Excessive Compensation & the Obama Plan*, 85 IND. L. J. 491, 528 (2010).

154 Complexity becomes even more costly as the number of parties at the bargaining table increases. As mentioned, shareholders are now entitled to a say-on-pay vote annually. Even prior to Say on Pay’s enactment, institutional investors and their representatives were playing an increased role in compensation decisions. See Gordon, *supra* note 152, at 339–40. Similar to boards and compensation consultants, these investors and their advisors face pressure to reduce the costs attendant to voting their shares. This may lead to their establishing one-size-fits-all rules, which, while solving the problem of complexity, do so at the cost of disregarding firm- and CEO-specificity. See *id.* at 347–48. Idiosyncrasy may be imported back in by firms negotiating with investors or their advisors for particular departures from the guidelines, but there is reason to suspect that such negotiations will be infrequent. See, e.g., Lund, *supra* note 58, at 14.

capable of producing even the probably-redundant positive governance effects as described above.

In fact, there is some recent empirical evidence that compensation patterns are far more uniform than theory would suggest. David Walker has found a tri-modal distribution for firms with respect to 2007 equity awards.¹⁵⁵ Seventeen percent of executives received only options, a quarter received only restricted stock, and another quarter received roughly half stock and half options.¹⁵⁶ Given the CEO- and firm-specific factors that should, in theory, drive compensation design, this uniformity is surprising. Walker suggests that the tri-modal distribution may be due to transaction costs arising from the complexity of designing optimal equity compensation.¹⁵⁷ Walker also found that incentive pay awards to different executives within a particular firm tended to be far more uniform than theory would predict.¹⁵⁸ Walker again suggests that complexity-related transaction costs again may explain these results.¹⁵⁹ The extent of firm- and CEO-specificity in the optimal incentive-laden contract (and thus the departure from optimality implied by Walker's findings) may be more or less than is supposed, but, in conjunction with the redundancy described in this Part, we feel confident concluding that observed incentive-laden contracts will systematically deviate from their idealized version, thus further minimizing their marginal incentive benefits.

It is worthwhile noting at this point that there are more subtle transaction costs that make optimal contracting nearly impossible. Consider Bebchuk and Fried's famed managerial power thesis.¹⁶⁰ Their basic claim is that boards do not negotiate with executives over compensation at arm's length because the executives (primarily the CEO) have significant influence over the board.¹⁶¹ Consequently, they argue, observed pay structures are not optimal and tend to favor executives at the expense of shareholders.¹⁶² According to Bebchuk and Fried, the amount of deviation is constrained only by the potential outrage of shareholders, politicians, employees, the press, etc.¹⁶³

155 David I. Walker, *Evolving Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 609, 645 (2011).

156 *Id.* at 645–46.

157 *Id.* at 648. Walker concludes that the “naïve diversification” bias is more likely the cause. *Id.* at 652–54. For discussion, see *infra* notes 211–212.

158 *Id.* at 657.

159 *Id.* at 660–61.

160 See BEBCHUK & FRIED, *supra* note 12.

161 See *id.* at 23–34.

162 *Id.* at 85–86.

163 *Id.* at 64–66.

The fact of board power over compensation decisions, however, is largely a function of the complexity of the compensation-setting process in the first place. If it were easy to determine how to pay CEOs, shareholders could conceivably do it. Authority rests with the board under law, but shareholders have successfully breached the wall of such authority in achieving a nonbinding Say on Pay vote.¹⁶⁴ Direct shareholder approval of (and therefore ex ante negotiation of) compensation contracts is not hard to imagine.¹⁶⁵ Yet pay structure is presumed to be enormously complicated in light of the numerous firm- and CEO-specific factors alluded to above.¹⁶⁶ Because of this complexity, authority for pay setting must be shifted from shareholders to the board; this shift creates the opportunity for the exertion of managerial power over the board. Once complexity requires that authority over pay setting rest at the board level, pay reformers are constrained by the fact that the pay-setting body performs many other functions.¹⁶⁷ A multi-tasking board allows for managerial capture over pay, both because the board cannot devote sufficient attention to pay design and because the board's multiple tasks require that it be able to work cooperatively with management. Thus, in addition to the more explicit transaction costs arising from firm- and CEO-heterogeneity, Bebchuk and Fried's thesis suggests others stemming from board capture by management. Combined, these explicit and subtle costs make the likelihood of boards arriving at or near an optimal incentive-laden contract remote.

II. THE COSTS OF INCENTIVE PAY

While the significance of incentive pay's benefits has been something of an article of faith for its proponents,¹⁶⁸ the costs that it might impose on adopting firms have been more fully examined. This Part identifies a number of those costs in some detail, as well as some that have been overlooked. The costs we discuss here are not fully exhaustive of those commonly mentioned in the law and finance literature, however. Because we believe that many of the value-maximizing

164 See *supra* note 4.

165 Indeed, one of us has argued that an ex ante, albeit advisory, shareholder approval mechanism is the best outcome once a commitment to shareholder discipline over executive pay is taken for granted. See Lund, *supra* note 58.

166 See Gordon, *supra* note 152, at 329–35.

167 See Core et al., *supra* note 14, at 1162.

168 See, e.g., Michaud & Gai, *supra* note 9, at 4 (“The current most persuasive argument of not only financial economics research but also management research is that increasing CEO compensation improves corporate performance.”). See *supra* note 9 and accompanying text for some of Michaud and Gai's skepticism of this account.

incentives created by incentive pay are largely redundant of those resulting from other mechanisms (for reasons discussed in Part I), we must grant that some of the commonly noted pathologies blamed on incentive pay would exist with or without high levels of incentive pay components. For instance, many have observed that high-powered pay incentives have the potential to encourage executives to commit fraud by manipulating the metrics (usually stock price) on which their incentive pay is based.¹⁶⁹ Given our argument in Part I, alternative mechanisms, most notably the managerial labor market, already provide this incentive. Accordingly, in identifying the costs of incentive pay, we must distinguish incentives that are redundant with those provided by alternative mechanisms from the incremental fraud incentives created by incentive pay.

A. *Raising Firms' Compensation Costs*

There are a number of costs that firms incur when they choose to compensate via incentive pay. Many of these are related and work together to raise compensation expenses for firms. That is, in a world with lower amounts of incentive pay, executives would be paid a lower proportion of firm revenue while the firm would retain a higher one. This view is hardly novel. In fact, incentive pay proponents have readily admitted as much over time.¹⁷⁰ What has not been discussed fully, however, are the myriad ways in which reliance on incentive pay pushes compensation costs upward.

1. Risk Premiums

Incentive pay proponents recognize that a shift from fixed pay to incentive pay increases compensation costs because managers will charge a premium for receiving riskier pay. As previously mentioned, executives are averse to firm-specific risks because they have a significant, undiversifiable human capital investment in the company.¹⁷¹ If

169 See, e.g., Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats* 14 J. MGMT. INQUIRY 96, 96–97 (2005); James C. Spindler, *Endogenous Compensation in a Firm with Disclosure and Moral Hazard* (Univ. S. Cal. Law Legal Studies, Paper No. 09-41, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1481300; cf. Austin Reitenga et al., *CEO Bonus Pay, Tax Policy, and Earnings Management*, 24 J. AM. TAX. ASS'N 1, 22 (Supp. 2002) (finding that earning smoothing is more prevalent in firms with formulaic bonus arrangements).

170 See BEBCHUK & FRIED, *supra* note 12, at 73.

171 See *supra* note 51 and accompanying text; see also Melvin A. Eisenberg & Brett H. McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 HASTINGS L.J. 1335, 1366 n.36 (2003) (explaining why managers in control of corporations behave in a risk averse manner).

their company does poorly, an executive risks losing both her job and status, and her reputation and future earning capacity could be significantly impaired. Incentive pay, assuming it works as intended, places even more risk onto the executive by tying pay outcomes to the company's performance, over which the executive has only limited control.¹⁷² Accordingly, to induce risk-averse executives to accept incentive-laden pay structures, they must be made more valuable (on an expected-value basis) than pay arrangements that include greater proportions of fixed pay. This risk premium is thus one cost of substituting incentive pay components for fixed pay.¹⁷³

How significant is the risk premium? As previously discussed, the answer depends on a number of executive-specific factors.¹⁷⁴ Taking all of these factors together with respect to stock option grants, Hall and Murphy conclude that executives may apply anywhere from a thirty-seven percent to a seventy-nine percent discount to the Black-Scholes value of an option grant.¹⁷⁵ Even if restricted stock awards are discounted less (because they are less risky than options), it is clear that firms are paying a great deal for incentive pay's purported incentive effects.¹⁷⁶ Because of this risk premium, commentators have

172 See *infra* notes 241–43 and accompanying text (describing the role of luck in incentive pay outcomes).

173 See Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 739 (“Executives shifting from salaries to performance-based compensation will demand a premium for bearing more risk, resulting in higher pay levels.”).

174 See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives* (Univ. S. Cal. Fin. & Bus. Econ., Working Paper No. 01-16, 2001) 8–9 [hereinafter Hall & Murphy, *Undiversified Executives*] (devising executives’ certainty-equivalent value lines for option awards). The riskiness of the compensation will also depend on the ability of the executive to hedge the risk through the purchase of derivatives and other devices. Of course, it is central to most incentive pay proponents that executives not be able to rebalance in this manner. See, e.g., *id.* at 7. The recent financial reform bill requires greater disclosure around executive hedging activities. To the extent executives are limited in their ability to hedge against firm-specific risk, the risk premium they charge will obviously be higher. Previous scholarship has suggested that executive hedging was practically difficult and quite rare, see David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 459–93 (2000) (practically difficult); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP., 49, 55 (2003) [hereinafter Hall & Murphy, *Trouble with Stock Options*] (“quite rare” in practice), and the recently enacted disclosure requirement should make hedging even more difficult and rare. As a result, we ignore the prospect of executive hedging in this Article.

175 See Hall & Murphy, *Undiversified Executives*, *supra* note 174, at 11.

176 But see Tung-Hsiao Yang & Don M. Chance, *The Effect of Executive Confidence, Ability and Private Beliefs on the Valuation of Executive Stock Options* 24 (unpublished manuscript) (on file with authors), available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=1783034 (suggesting that executives’ overconfi-

noted that equity-based incentive pay is an inefficient way of compensating executives¹⁷⁷ if (1) equity provides negligible marginal incentive effects and (2) a firm has no reason other than incentive effects for preferring equity compensation (e.g., the firm does not have cash flow limitations preventing the payment of high salaries).¹⁷⁸

2. Less Effective Accountability Mechanisms

The risk premium paid by firms to executives exists even if boards effectively negotiate executive pay packages. But if we relax the assumption of arms'-length bargaining by boards—for instance by assuming some pathologies within the pay-setting process akin to the Bebchuk-Fried managerial power thesis¹⁷⁹—incentive pay further increases the potential for increased compensation costs. Under the Bebchuk-Fried model, the board's ability or willingness to negotiate effectively is compromised,¹⁸⁰ and the only significant constraint on executive pay amounts stems from the possibility that outsiders will become outraged. Incentive pay tends to dampen the risk that these outrage costs will be incurred.¹⁸¹ It does so by making it harder for outside groups—shareholders and their advisors, the business press, and government—to identify and appreciate the full extent of overly generous pay packages.

a. Reduced Transparency for Third Parties

While the value of cash compensation, which includes salaries and discretionary bonuses,¹⁸² is relatively transparent, common incentive pay components are not. Consider, for example, formulaic bonus arrangements. In determining whether these arrangements are fairly designed (i.e., not overly generous), the appropriate time to evaluate them is *ex ante*, at the time they are created, rather than *ex post*, at

dence may overwhelm their risk-aversion so that, in some cases, they would value options more highly than the firm).

177 See generally Hall & Murphy, *Undiversified Executives*, *supra* note 174, at 16–17 (“[T]he economic cost to shareholders of granting options often far exceeds the value that employee-recipients place on the option.”).

178 See Core et al., *supra* note 7, at 28.

179 See *supra* note 14 and accompanying text (describing managerial power thesis).

180 For reasons why this might be so, see BEBCHUK & FRIED, *supra* note 12 (setting forth their managerial power thesis); *supra* Part I.B (positing other grounds for concern about boards' negotiating capacities).

181 See BEBCHUK & FRIED, *supra* note 12, at 64 (introducing “outrage costs”).

182 Discretionary cash bonuses are bonuses paid at the discretion of the board of directors in contrast to formulaic bonus arrangements where the bonus amount is derived from a previously negotiated formula.

the time they pay out. To put an ex ante cash value on formulaic arrangements, one must make predictions about the range of possible results and their likelihood. Because these predictions are difficult and easily manipulated by the firm,¹⁸³ observers might be tempted to use a wait-and-see approach. Under this approach, formulaic bonus arrangements would be assessed for appropriateness only when they pay out.

But there are several problems with such a wait-and-see approach. Large payouts will always occur after the company has hit the previously identified “mark.” The hitting of the mark has the potential to obscure the fact that the mark may have been insufficiently ambitious (in light of the circumstances that existed ex ante) to justify the amount of the payout. Moreover, a wait-and-see approach does not distinguish between the compensatory element of the bonus arrangement and the investment return (i.e., the return to risk) thereon. In assessing the appropriateness of pay levels, the latter should be ignored, as that is properly considered a return on capital, not labor. A final problem with the wait-and-see approach relates to timing. A bonus payout typically occurs after the end of the accounting period to which the bonus relates. Accordingly, the payout is for services that the executive performed during the preceding accounting period or periods. In evaluating the executive’s compensation level, the value of the bonus arrangement must therefore be amalgamated with the executive’s other compensation components for those preceding accounting periods. A wait-and-see approach may cause the bonus arrangement’s value to be erroneously considered in the later accounting period in which the payment is made.¹⁸⁴

Similar concerns exist in the context of stock option grants. The ex ante value of compensatory options is notoriously difficult to discern, primarily because the options are not transferable and have long exercise periods. The traditional Black-Scholes model for pricing options was not designed with these characteristics in mind.¹⁸⁵ For that reason, even though the model is used for financial accounting purposes, the appropriateness of applying the model to compensatory options has been “highly contested.”¹⁸⁶ Furthermore, in determining

183 See 17 C.F.R. 229.402(d) (2011) (providing for disclosure of expected bonus payouts at threshold, target, and maximum levels).

184 See 17 C.F.R. 229.402(c)(2)(vii) (2011) (requiring the summary compensation table to include only cash bonuses earned in a given year rather than awarded in a given year).

185 See David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399, 424 (2009).

186 *Id.*

whether an option grant is overly generous, the value to the executive must be determined. A Black-Scholes value is intended to estimate the opportunity cost to the firm of issuing the option, not the value of the option to the executive. Given that risk-averse executives would discount the value of risky instruments that they cannot effectively hedge, even if Black-Scholes correctly estimates the cost to the firm, it would overstate the value that the executive received.¹⁸⁷ And, even if a Black-Scholes valuation were useful in estimating value to the executive, a Black-Scholes value depends on “firm-specific assumptions regarding stock price volatility, expected time to exercise, and dividend policy, [which makes the value] highly manipulable.”¹⁸⁸ Finally, companies can game the valuation of options through techniques such as springloading, backdating, repricing, or refreshing.¹⁸⁹

In light of these problems for evaluating option awards *ex ante*, a wait-and-see approach for assessing the appropriateness of option pay might seem sensible. The popular and business press and general public appear to use this approach, as uproar over options inevitably occurs when options are exercised for large gains, not when they are granted.¹⁹⁰ *The Wall Street Journal*, in a recent report of CEO pay over the past decade, used the wait-and-see approach.¹⁹¹ Yet, for the same

187 See Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 213–14 (2000) (noting that Black-Scholes deltas overestimate the value received by risk-averse executives).

188 Walker & Fleischer, *supra* note 185, at 431.

189 See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 565 (2007) (noting that each of these techniques involves option value manipulation to surreptitiously transfer value to executives). Springloading refers to granting options in advance of the release of nonpublic favorable information, backdating to the grant date to provide for a lower exercise price, repricing to the practice of changing the exercise price of an option after the stock drops in price, and refreshing to granting new options after a stock price drop. Some of this manipulation has recently been made more difficult or impossible, yet the broader point—that companies can game option valuations in various ways—persists.

190 See, e.g., Susanne Craig & Eric Dash, *Study Points to Windfall for Goldman Partners*, N.Y. TIMES, Jan. 18, 2011, at A1 (noting that a Goldman Sachs December 2008 option grant of thirty-six million stock options, which was over ten times the number of options granted in the previous year and which exceeded the entire number of options previously outstanding, “was disclosed as required, but received scant attention at the time”); Pradnya Joshi, *Sure, We Knew They Got Raises, But This Much?*, N.Y. TIMES, July 3, 2011, at BU1 (increase in compensation due to options granted during downturn resulting in “many executives sitting on windfall profits”); cf. Walker & Fleischer, *supra* note 185, at 438–39 (noting the extreme salience of option exercises that result in huge gains).

191 See *Oracle's Ellison: Pay King*, WALL ST. J., July 27, 2010, at A1.

reasons discussed above in the context of formulaic bonus arrangements, this approach is problematic.

Even ardent proponents of incentive pay seem to appreciate the transparency problems inherent in these pay structures. Bebchuk and Fried have extensively criticized various prevailing incentive pay designs on the ground that they have been subtly rigged in executives' favor. They reason that executives are able to exploit the opacity of incentive pay components to their benefit, resulting in outsize pay arrangements.¹⁹² The remedy, according to Bebchuk and Fried, is to improve transparency. But the critical question is how transparent incentive pay components can ever be. At the very least, their value will always be both less transparent and more susceptible to manipulation than commensurate amounts of cash compensation.

The presence of significant amounts of incentive pay components also makes it difficult to compare the compensation levels of executives of different firms. As discussed above, the *ex ante* value of compensatory stock options depends on a number of firm-specific factors. Thus, simply comparing the number of options granted by different firms is not a useful apples-to-apples comparison, even where the firms' stock prices are similar.¹⁹³ And even though the values of option grants are estimated and disclosed by companies, these values, as discussed above, are subject to subtle manipulation and gamesmanship.¹⁹⁴

b. Reduced Salience to Third Parties

Even if observers were able to overcome the opacity of incentive pay, the granting of cash compensation is generally a far more salient event than the granting of incentive pay components. For instance, as Bebchuk and Fried note, while "Apple CEO Steve Jobs was able to obtain an option package worth more than half a billion dollars, albeit with some outcry," "[c]ash compensation of this magnitude is still inconceivable."¹⁹⁵ To the extent that there is outrage over option packages, it generally occurs when options are cashed out, rather than when they are granted.¹⁹⁶ This delay likely stems from the fact that

192 BEBCHUK & FRIED, *supra* note 12, at 72–74.

193 Comparing formulaic bonus structures is even more difficult because metrics and targets can vary substantially from company to company. Even similar bonus structures can have significantly different *ex ante* values because the likelihood of achieving the same target (e.g., a ten percent increase in revenues) often differs substantially from firm to firm.

194 See *supra* note 189.

195 BEBCHUK & FRIED, *supra* note 12, at 74.

196 See *supra* note 190.

observers do not fully appreciate that at-the-money options provide a significant economic benefit to executives (and a significant cost to firms) despite the options' lack of intrinsic value.¹⁹⁷ Intrinsic value, which is the spread between the exercise price of the option and fair market value of the underlying stock, is the most publicly salient feature of an option,¹⁹⁸ as demonstrated by the recent uproar over backdating. In the backdating scandal, a large number of executives at different firms received options that were backdated, so that the options were effectively in-the-money at the time of grant. These options therefore had intrinsic value. However, as David Walker has shown, the economic value of the benefit from backdating was quite small because of long vesting restrictions and the high volatility of the underlying stock.¹⁹⁹ Nevertheless, the scandal resulted in a tremendous controversy disproportionate to the value gleaned by executives.²⁰⁰ Juxtaposing the Steve Jobs anecdote with the backdating scandal illustrates that the public focuses unduly on intrinsic value, even though it is often insignificant in valuing compensatory options.²⁰¹

While the granting of incentive pay components will not be a salient event for observers, eventually these components are cashed out. This cashing out is a very salient event. At that point, however, large payouts may not stimulate significant outrage for a number of reasons.

197 Brian J. Hall, *The Pay to Performance Incentives of Executive Stock Options* app. A at 32 (Nat'l Bureau Of Econ. Research, Working Paper No. 6674, Aug. 1998) (noting a "bias toward valuing options according [to] what they would be worth if exercised today"); Walker, *supra* note 155, at 628 ("[E]xplicitly discounted options might be viewed by investors or the financial press as a give-away to the executive."). Intrinsic value is the amount of the excess, if any, of the fair market value of the underlying stock over the exercise price of the option.

198 See David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505, 1549 (2009) ("[T]he intrinsic value of an option at grant is likely to be much more salient than the value of the option privilege—the opportunity to benefit from further increases in stock price without risking capital.").

199 See generally David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 562 (2007) (noting that "given the high volatilities of the stocks . . . and the fact that options granted to executives and employees typically may not be exercised for several years, press reports that focus on the size of the strike price 'discounts' achieved by backdating significantly overstate the impact on the value per share of backdated options").

200 See Holman W. Jenkins, Jr., *Apple's Gore*, WALL ST. J., Jan. 10, 2007, at A16 (criticizing the intense media coverage for "its fallacious thinking . . . in valuing stock options packages" during the backdating scandal).

201 See generally Walker, *supra* note 199 (describing the insignificance of intrinsic value in long-term options with vesting restrictions).

First, large payouts can be justified because they were made pursuant to a mathematical formula²⁰² that was previously determined and passed on without objection. As a result of their mechanical nature and prior acquiescence to the formula, these payouts have a certain presumption of validity, even in cases where the sheer size would raise red flags if granted as a discretionary bonus. Second, large payouts will necessarily be accompanied by positive accounting results or upward stock movements, potentially diverting observers' attention from the size of the payouts. Finally, boards and executives can also justify the ex post value by overstating the risk that the executive faced of not earning the incentive pay because it is difficult for outsiders to determine the appropriate risk premium.

To summarize, the granting of incentive pay components will generally not be a salient event for the public. While the public is more focused on the cash outcomes from incentive pay components, large payouts will at that time be subject to lower levels of criticism by shareholders and third party monitors, and the criticism that is leveled will be blunted given the failure of parties to object at earlier stages. If we are correct, this confluence poses a problem in models where observer outrage must be relied on to constrain board discretion over management pay.

3. Bargaining Effects

To this point, we have argued that incentive pay will push compensation costs higher because firms must pay executives' risk premiums even with effective bargaining and that, assuming less-than-effective bargaining, incentive pay will make it harder for third parties to discipline the pay-setting process. In this section, we contend that incentive pay exacerbates some of the conditions underlying those failures of process. In one way or another, incentive pay weakens a board's position at the compensation bargaining table.

a. Reduced Board Responsibility for Large Payments

Whether because of managerial capture or for a more benign reason,²⁰³ we assume boards do not like to offend their current or

202 While a stock option is not technically a mathematical formula, it can easily be reconceptualized as such. In fact, stock appreciation rights are mathematical formulas that replicate the economics of stock options. See Walker & Fleischer, *supra* note 185, at 404 (noting that stock appreciation rights "are economically equivalent to stock options").

203 See, e.g., Lund, *supra* note 58 (describing the reluctance of shareholders to offend successful managers).

future CEOs, all else being equal. As described in the previous section, incentive pay makes it easier for boards to overpay executives. Even when the board retains “negative discretion” to reduce payouts called for under mathematical bonus structures, anecdotal evidence suggests that boards regularly fail to exercise this discretion in any meaningful way.²⁰⁴

Similar to outside observers, boards are subject to the salience disparities between incentive pay and cash compensation. Just as those third parties tend to be far more sensitive to cash outlays, so too are directors. And this is not only due to the fact that boards are less likely to fear disapproval in the incentive pay context. Rather, there is a pervasive sense among directors that equity grants cost less than a cash award of the same value. This is particularly true in the case of option grants,²⁰⁵ even after the accounting treatment of options was synchronized with that of cash compensation. That equity grants require no cash outlay by the firm seems to alter boards’ views of the costs the firm is undertaking, despite the irrationality of such a view.²⁰⁶ The seriousness of this “misperception” problem is underscored by the fact that the commentator who has written most persuasively about it, Kevin Murphy, is one of the most prominent advocates of incentive pay.

In addition, boards routinely defend large incentive-laden pay packages on the relatively simplistic ground that the package is “performance-based” and aligns executive and shareholder interests. For instance, when Viacom recently disclosed that it doubled the value of its CEO and COO annual pay packages, to \$84.5 million and \$64.7 million respectively, the company justified the 100 percent raises by noting “that about 90 percent of the compensation . . . was in long-term options, which aligned the executives’ interest with those of the company.”²⁰⁷ Apparently, little more needed to be said than this nod to the incentive pay orthodoxy. While this is just one recent anecdote,

204 See Bevis Longstreth, *A Real World Critique of Pay Without Performance*, 30 J. CORP. L. 767, 769 (2005) (noting the failure of boards to use negative discretion); see also Murphy, *supra* note 173, at 739 (predicting that boards will not use negative discretion).

205 See, e.g., Jensen et al., *supra* note 12, at 39 (“In our experience, US companies granting options generally do not make a careful comparison of the cost and value of options, but rather treat options as being essentially free to grant.”).

206 See Hall & Murphy, *Trouble with Stock Options*, *supra* note 174, at 66 (“The perception that options are nearly free to grant is readily acknowledged by practitioners and compensation consultants, but is usually dismissed by economists because it implies systematic suboptimal decision making and a fixation on accounting numbers that defies economic logic.”).

207 Graham Bowley, *Pay Doubles for Bosses at Viacom*, N.Y. TIMES, Jan. 21, 2011, at B1.

boards customarily rationalize extraordinary pay packages by pointing to the purportedly high-powered incentives that they create.

b. Mental Accounting Difficulties

The belief that executives need to be strongly motivated through incentive pay components to act in the best interests of shareholders creates an environment where complex compensation structures will proliferate. Instead of just paying executives mostly with a fixed salary and a discretionary bonus like most white-collar employees, executives are now also granted packages including some mix of stock options, restricted stock, stock appreciation rights, phantom stock units, and/or formulaic bonuses. As Bebchuk and Fried note, when executives were first granted these incentive pay components in the early 1990s when the enthusiasm for incentive pay began in earnest, executives did not have to give up a corresponding part of their existing compensation.²⁰⁸ This is consistent with the existence of a mental accounting problem in evaluating complex compensation structures.²⁰⁹ In evaluating the reasonableness of multi-faceted compensation arrangements, observers and participants may tend to focus on the specific parts of the arrangement, evaluating each one in isolation, thereby losing focus on the value of the entire package as a whole.

Consider, for example, David Walker's recent study of incentive pay structures. As previously discussed, Walker found an unusual trimodal distribution of pay structures among firms.²¹⁰ He also found that a large group of firms granted significant amounts of both stock options and restricted stock, a result that is nearly impossible to justify theoretically. He attributes this result primarily to the "naïve diversification heuristic."²¹¹ According to Walker, firms opt for a particular number of compensation types and then exhibit an irrational tendency to allocate compensation evenly among the selected vehicles no matter what.²¹² This tendency of firms to diversify pay components

208 See Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 83 (2003) ("[O]utsiders' enthusiasm about equity-based compensation enabled managers to obtain additional compensation in the form of options without offsetting reduction in cash compensation.").

209 See generally Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183 (1999) (defining mental accounting as the way in which individuals keep track of transactions and other financial events and explaining how it can cause choices to differ from those that would result from complete information).

210 Walker, *supra* note 155 (describing the study).

211 *Id.* at 652.

212 *Id.*

irrationally is consistent with a mental accounting problem for boards in designing executive pay structures.

c. Admission of Significant Unchecked Agency Costs and CEO Centrality

Perhaps most importantly, incentive pay requires acceptance of a premise—CEO centrality—that makes it difficult for boards to negotiate effectively with executives over their pay packages. The market for CEOs is distorted to begin with, resulting in incredible leverage for the CEO-to-be at the time pay is being negotiated.²¹³ The ranks of viable CEO candidates are held artificially low by the vagaries of the search process.²¹⁴ Moreover, compensation is only seriously discussed once a CEO has been chosen by either the search committee or the entire board. The prospective CEO at that point knows that it would be difficult for the board to allow negotiations over pay to fail.²¹⁵

Making effective negotiation even more difficult for the board is the necessary assumption behind incentive pay. Implicit in every incentive-laden arrangement is the notion that the executive's behavior will be crucially determinative of some performance metric,²¹⁶ up to and including share price. Absent that assumption, a high level of incentives is an inefficient way of compensating individuals.²¹⁷ The implication of CEO incentive pay, therefore, is that overall firm performance is largely a function of CEO behavior.²¹⁸ This "CEO-centricity" is not unique to incentive pay, as others have shown by documenting the public's CEO-dominant view of large corporations.²¹⁹ But introducing a heavy dose of equity-based incentive pay into the CEO compensation contract provides a different and significant rhetorical weapon for CEO candidates in negotiations: it seems only *fair* for the executive to retain a sizable amount of firm profits if they are generated by her extra effort and/or talent. Incentive-laden packages, as opposed to more salary-centered arrangements, thus

213 See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR* 26–30 (2002).

214 *Id.* at 62.

215 *Id.* at 93.

216 It is for this reason that many have complained about equity awards granted to nonexecutives who have little ability to affect stock price. See, e.g., Murphy, *supra* note 8 at 660.

217 See Core et al., *supra* note 7, at 34–35.

218 This is more or less the point made by incentive pay proponents from the beginning of its ascent.

219 For more on this phenomenon, see KHURANA, *supra* note 213. Indeed, the volatility of the CEO labor market described in Part I is evidence of the same phenomenon.

reinforce and exacerbate the tendency toward a base-level overestimation of CEO importance and, as a consequence, overpayment.

B. Incentives for Excess

In addition to increasing firms' compensation costs, incentive pay imposes other burdens on firms. Incentive pay components may encourage excessive risk-taking and may also provide increased incentives for executives to engage in stock price manipulation.²²⁰

1. Option Awards and Excessive Risk

Recall that one of the traditional arguments in favor of incentive pay is that it will better align the risk preferences of managers with those of shareholders. Absent incentive pay, the argument goes, managers would be less risk seeking than shareholders. For this reason, it was thought that stock options (rather than outright stock grants) might be the preferred form of incentive pay.²²¹ Option-holders are more risk seeking than stockholders because while they benefit from stock price appreciation, they (unlike stockholders) do not suffer from depreciation. This extra preference for risk associated with options should, in theory, balance out managers' ex ante (i.e., pre-incentive-pay) risk aversion.²²²

We think, however, managers' current ex ante level of risk aversion may diverge from their historical levels because the alternative mechanisms described in Part I have evolved to provide incentive effects that overlap with those provided by as incentive pay. Managers must now take enough risk to satisfy shareholder expectations for growth, or they risk triggering the sanctions associated with those mechanisms. Because, as discussed above, the disciplinary process operates in a relatively unpredictable way, a low risk/low reward strategy would itself entail a great deal of risk for the executive.²²³ Accordingly, we believe that, in the current corporate governance

220 Other examples of the misalignment between executive and shareholder interests resulting from option awards exist. For instance, high levels of option compensation are correlated with low levels of dividend payments. See Core & Guay, *supra* note 94.

221 See David Hirshleifer & Yoon Suh, *Risk, Managerial Effort, and Project Choice*, 2 J. FIN. INTERMEDIATION 308, 309 (1992).

222 A similar effect could result from a formulaic bonus structure whose value grows exponentially as the company's results satisfy higher and higher benchmarks.

223 Again, we emphasize that managerial risk aversion may remain a serious problem, albeit one that incentive pay does little more to solve than the alternative mechanisms.

environment, incentive pay has little marginal effect in moving the risk preferences of managers towards that of shareholders.

On the other hand, high enough levels of option awards *could* push managers towards suboptimally high levels of risk taking. Because of the convexity of option payouts, large option awards have the potential to encourage executives to decide to pursue a riskier course of action over a less risky one, even though the decision is wealth reducing (on a risk-adjusted basis).²²⁴ If the upside is high enough, it could dwarf the career and reputational concerns relied on to provide the incentives described in Part I.

In fact, this potential for overincentivizing risk taking has stimulated a number of current reform proposals. As described in Part I.A.3, the Tung, Bebchuk/Spamann, and Bhagat/Romano proposals imply that the agency cost benefits of current incentive pay arrangements are not worth the extra risk they apparently induce, at least at financial firms. Each proposal appears relatively unconcerned that its reforms, which are intended to reduce substantially managers' incentive to take risks, might result in suboptimal risk taking. This is quite a reversal of course from traditional incentive pay advocacy, which was concerned about the exact opposite problem that undiversified managers would prefer too little risk.²²⁵ This reversal speaks both to the potential for incentive pay to have unintended consequences and to the difficulty in calibrating pay-related incentives precisely. But perhaps most importantly it may imply that the *ex ante* (i.e., pre-incentive pay) level of managerial risk aversion, constrained as it is by the alternative mechanisms described in Part I, is not as significant a concern as traditional incentive pay proponents believe.

²²⁴ See Tung, *supra* note 2, at 8 n.24 (using example to show how moral hazard for banks can cause shareholders to prefer value-diminishing risky projects over value-maximizing less risky projects).

²²⁵ This point deserves emphasis. One of the strongest arguments, if not the strongest argument, in favor of incentive pay is that it helped to ensure that managers were not too risk-averse. Now the concern suddenly is that managers could seek to take too much risk. While the issue of risk is complicated in the bank context because of explicit or implicit government guarantees, the concern about excessive managerial risk has spread far more broadly. For example, Exxon's most recent proxy emphasizes features of its executive compensation program that "discourage inappropriate risk taking." Exxon Mobil Corp., Definitive Proxy Statement, 14 (2011), *available at* <http://www.sec.gov/Archives/edgar/data/34088/000119312511095944/ddef14a.htm>. Yet, if the presumption underlying incentive pay that managers are highly risk-averse were true, it would seem that Exxon's investors should have little worry about its executives taking too much risk; in fact, they should be worried about the exact opposite problem. Yet, the proxy focuses on ways that its compensation programs dampen managerial risk preferences.

2. Increased Accounting Fraud

Incentive pay may also cause executives to engage in more fraud than they otherwise might. Empirical and theoretical work has shown that high levels of incentive pay are correlated with higher levels of accounting fraud.²²⁶ Obviously, we do not believe that this sort of malfeasance can be blamed exclusively on incentive pay. Indeed, it is a natural extension of our argument that the increased pressure on executives provided by alternative disciplinary mechanisms can lead managers to engage in deception to avoid such discipline. But just as high levels of incentive pay might overproduce risk, it may also increase the incentive to commit fraud. We think it likely that there are at least some cases in which (1) an executive would resist the temptation to manipulate earnings despite the pressures exerted by the labor market and shareholders more generally, out of fear of criminal or reputational sanctions, but (2) might nevertheless succumb to the pressure jointly applied by those disciplinary mechanisms and the promise of wealth increases generated by short-term share price increases in a high-incentive-pay world.

III. EXPLAINING THE RESILIENCY OF INCENTIVE PAY

We have thus far argued that the net marginal benefit of incentive pay is less than conventionally understood and is decreasing. As a result of this misunderstanding, we believe that the pendulum has generally swung too far in favor of incentive pay, causing the performance-based components of executive pay packages to become too large relative to other components like salary and discretionary bonuses. Like other critics of the compensation status quo, however, we must respond to the claim that the capital markets would not allow the compensation system to move so far out of equilibrium. If incentive pay as currently practiced makes little economic sense, investors would bid up the stock prices of low-incentive-pay firms, which would encourage other firms to change their compensation practices. Alternatively, institutional investors could use their clout directly, advocating for change at their portfolio firms. In this Part, we explore the reasons why inefficient levels of incentive pay may persist despite competitive markets.

A. *Status Quo Bias, Herding, and Signaling*

We do not argue that high levels of incentive pay in compensation contracts were always inefficient. Indeed, incentive pay may have

226 See Spindler, *supra* note 169.

played an important role in an earlier era, when the alternate mechanisms described in Part I were not nearly as robust. In those earlier times, high levels of incentive pay became an important marker for governance quality, causing incentive-laden pay packages to become prevalent. As the status quo, it now enjoys positional advantages.²²⁷ Furthermore, it is well understood that the bias has stronger force in decision making where the issue is complicated.²²⁸ As discussed earlier, the cost/benefit analysis of various pay structures is complicated and proper design is subject to numerous firm- and CEO-specific idiosyncrasies. Given these complexities, it is likely that the status quo bias will be difficult to overcome in the executive compensation context.

Other related factors reinforce the status quo bias. Bebchuk and Fried describe how boards tend to conform to traditional pay practices, which makes change less likely. Such herding behavior “requires less explanation, less justification, and less confidence in one’s own judgment than carving out a new path.”²²⁹ Because boards prefer existing norms, “the evolution of compensation arrangements is slowed down.”²³⁰ Further, in the wake of the financial crisis, the prevailing cynical view of boards and executives makes this herding tendency and the resulting stickiness even more powerful. Any significant move away from traditional practices in the current environment would surely be met with great suspicion.

Finally, consider the signaling effect of a move towards greater proportions of fixed pay. Given the current cynicism, this would be viewed as an indication either that the board was captured by management or that management does not believe in the firm’s future prospects.²³¹ Together, the status quo bias, herding tendencies of boards,

227 See, e.g., Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Nw. U. L. Rev. 135, 144 (2002) (“Cognitive conservatism is an extremely robust behavioral construct showing that people change their views slowly even in the face of persuasive evidence. In other words, people cling as long as possible to what they previously believed.”).

228 See, e.g., Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1047 (2009).

229 BEBCHUK & FRIED, *supra* note 12, at 75.

230 *Id.*; see also Bratton, *supra* note 14, at 1557 (“But contracting practice provides an inadequate economic laboratory because firms herd to a small set of arrangements.”)

231 The possibility of a signaling function might also help to explain the world of private equity portfolio companies in which incentive pay is king. See Robert J. Jackson, Jr., *Private Equity and Executive Compensation* (unpublished manuscript) (on file with authors). Even if private equity purchasers are among the least subject to herding and advisor capture, they would face significant signaling issues were they to deviate from incentive pay orthodoxy. Enforcing high levels of incentive pay at pri-

and this potential signaling effect of pay structures make any change of existing pay practices toward greater fixed pay fraught with danger for firms.

B. Private Interests of Participants

Further supporting the status quo, key participants in the executive compensation arena have significant private interests in maintaining the incentive pay orthodoxy. With incentive-laden contracts, executives receive more pay, boards receive greater insulation against criticism for their compensation decision making, compensation

vate-equity-controlled firms is usually effected by requiring significant investment by managers through equity purchases at the time of the going-private transaction. See generally Phillip Leslie & Paul Oyer, *Managerial Incentives and Value Creation: Evidence from Private Equity* (Nov. 2009) (unpublished manuscript), available at www.stanford.edu/~pleslie/private%20equity.pdf. At that stage, incumbent managers are likely to have private information about the target firm that private equity firms may not be able to discover even with high levels of diligence. The managers' willingness to invest such a significant chunk of their wealth in the company going forward sends a credible signal about firm quality to private-equity firms considering purchase of the target. Edward Lazear concludes:

Put more intuitively, the sorting story boils down to this: Before a capitalist is willing to put resources into an enterprise, he wants to be confident that the investment will yield a significant payout. Worker behavior, and especially the behavior of those most knowledgeable, provides the capitalist with clues. In order to get informed managers to put their money where their mouths are, the capitalist makes pay contingent on profit. If those with the most knowledge are unwilling to take a job under a contingent pay arrangement, then the capitalist is less inclined to invest. It is sensible for a capitalist to be more willing to commit to an organization where all the knowledgeable people accept contingent pay than to an organization where those people demand a guaranteed wage. The capitalist is reassured when managers have "skin in the game."

Edward P. Lazear, *Output-Based Pay: Incentives, Retention or Sorting?*, 23 RES. LAB. ECON. 1, 17 (2003); see also Andrew C.W. Lund, *Compensation as Signaling* (forthcoming FLA. L. REV. 2012) (manuscript on file with authors).

Another explanation for high levels of incentive pay in private equity transactions is that private equity firms have a very short investment horizon, looking to dispose of investments within three to seven years. As a result, there is little time to replace an existing management team because that would make profitable exit within this horizon highly unlikely, which makes terminations extremely unpalatable to private equity investors. See JACK S. LEVIN, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS* ¶ 103 (2006) (describing the short investment horizon and the related difficulty in firing managers). Given this significant friction to firing the current management team (of which management is well aware), private equity investors simply cannot rely on the threat of termination to align management incentives; thus, they turn to incentive pay to do the heavy lifting.

experts garner more attention and work, and shareholder advisory businesses gain greater clout.

Incentive-laden arrangements cause overall executive pay to ratchet upwards. As previously discussed, this is partly the result of the premium charged by executives for bearing firm-specific risk. It is also the result of the reduced transparency and salience of incentive pay value relative to fixed compensation. Thus, even discounting for the riskiness of the pay, executives should prefer the received version of incentive pay.²³²

Boards also benefit from the incentive pay orthodoxy because they are able to justify large pay packages on the ground that they are performance based. For directors with career concerns, negotiating high levels of incentive pay has become a strategic choice unrelated to its effect on firm performance. For example, Ravi Singh has shown that directors signal their independence by using greater levels of incentive pay even when it is inefficient.²³³ This phenomenon is most pronounced when boards are more sensitive to investor pressure.²³⁴ Thus, as boards become increasingly responsive to shareholder sentiment, they are more likely to place a high value on the personal signaling benefits that high levels of incentive pay provide.

Secondary participants in the pay-setting process also benefit from the traditional emphasis on incentive pay. Corporate governance advisors—mostly proxy services firms—benefit from an overvaluation of the importance of incentive pay components: if executive pay is an important and complicated science, then their research is far more valuable.²³⁵ Greater and greater incentive pay furthers the interests of these advisors, whose services include analyzing the resulting complex pay structures for their clients. Moreover, the push for incentive pay implicitly reinforces the view that agency costs in public companies remain extremely high, thereby cementing the importance of proxy advisors in the corporate governance complex.²³⁶ Finally,

232 Of course, as arrangements become more transparent and exogenous constraints are applied to delimit the effect of any increased bargaining power (or, even more drastically, reduce risk-adjusted pay levels), the benefits of incentive pay to executives would diminish.

233 Ravi Singh, *Board Independence and the Design of Executive Compensation* 3 (Harvard Bus. Sch., Working Paper No. 673741, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=673741.

234 *Id.* at 20.

235 Compensation attorneys are similarly compromised. The work necessary to draft a less incentive-laden contract is far less, as is the need for tax and governance advice regarding the contract's implementation.

236 See Suzanne Stevens, *Inside the Corporate Governance Complex*, HARV. LAW SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 20, 2010, 9:10 AM), [hhttp://blogs.law](http://blogs.law)

the focus on pay incentives permits those advisors to largely avoid addressing the politically-charged issue of overall pay levels.

Compensation consultants likewise benefit from incentive pay orthodoxy. It is well known that these consultants exert significant influence over pay setting.²³⁷ Compensation consultants have long been criticized for having a conflict of interests when executives whose pay packages they pass on decide whether to retain the consultants' firms for human resources functions.²³⁸ Less often discussed is the conflict of interest inherent in simply providing compensation advice. Consultants benefit from an increased emphasis on incentive pay because it complicates the pay-setting process and exaggerates the benefits of "proper" pay design, thus increasing the demand for their services as well as their perceived value.

Beyond proxy advisors and compensation consultants, others play a role in shaping and monitoring pay decisions, including the indirect influence of academic researchers studying executive compensation. But like more direct participants, academics also have incentives to hew to the incentive pay orthodoxy. Pay data is among the most readily available in corporate law, making studies about pay design attractive.²³⁹ The incentive pay orthodoxy justifies the mining of this data. Furthermore, compensation issues are attractive subjects to people outside of the arcane world of corporate law and finance, providing researchers with a level of exposure and prestige otherwise unavailable.

C. *The Moral Pull of Incentive Pay*

Finally, and perhaps most important, incentive pay orthodoxy comports with an intuitive sense of fairness. In fact, we suspect that most lay people, including retail shareholders, would justify incentive pay components not based on the incentive effects routinely touted by economists and legal scholars but rather on equitable ones. People generally believe that talented and hard-working managers are more

harvard.edu/corpgov/2010/05/20/inside-the-corporate-governance-complex/ (describing the complex as "well-funded, sprawling and interlocking set of institutions that have grown up around corporate governance over the past 30 years or so. This governance complex, with major outposts across the country at research universities, law firms, the federal government, institutions, activist hedge funds and even blogs like this one, generates considerable intellectual and financial firepower").

237 See, e.g., Brian D. Cadman et al., *The Incentives of Compensation Consultants and CEO Pay*, 49 J. ACCT. & ECON. 263 (2010).

238 See *id.*

239 The most popular and complete database is ExecuComp owned by Standard & Poor's.

deserving of compensation than less talented or less hard-working ones. It is difficult to determine, in advance of performance, the respective talent or effort levels of managers. Thus, it is most fair to tie compensation levels to the managers' performance. The proof, as they say, is in the pudding. Put slightly differently, people may feel it *unfair* for high levels of compensation to be awarded in situations where there is no value added by the executive. Insofar as incentive pay prevents that from occurring, it appears to ensure fairness.

The theory is quite sensible in certain contexts. Where (1) the relationship between the input (talent and effort) and the observed output (firm value) is strong, and (2) the desired results are easily gauged, it will be appropriate to price talent and effort by looking at performance measures. Thus, the talent of professional tennis players is sensibly priced by their tournament results, and, maybe, the talent of law firm partners by the billings they generate.

On the other hand, pricing CEO talent by firm output is harder to justify in terms of fairness. First and most importantly, the relationship between the CEO's talent and labor and the output relevant for incentive pay purposes (e.g., stock appreciation) is highly attenuated, much more so than is generally appreciated by observers. As a number of researchers have shown, a host of factors that are well beyond a CEO's control have significant impacts on the stock prices that drive incentive pay outcomes even assuming that CEOs have significant control over firm performance.²⁴⁰ Some of the noise in stock prices is theoretically removable. Marianne Bertrand and Senhil Mullainathan call this "observable luck" and note that theory would predict shareholders would filter it out of both in the compensation scheme and, more generally, in their evaluation of the executive's performance.²⁴¹ They and others suggest that incentive-laden schemes that fail to account for observable luck—market-wide or industry-wide shocks, for example—are suboptimal, perhaps reflecting managerial power.²⁴² Even if observable luck were disposed of in incentive pay outcomes,

240 See, e.g., Bertrand & Mullainathan, *supra* note 83, at 901; Gueorgui I. Kolev, Pay for Luck in CEO Compensation: Evidence of Illusion of Leadership (May 29, 2006) (unpublished manuscript) (on file with authors).

241 Bertrand & Mullainathan, *supra* note 83, at 904.

242 *Id.*; see also BEBCHUK & FRIED, *supra* note 12, at 19. But see generally Radhakrishnan Gopalan et al., *Strategic Flexibility and the Optimality of Pay for Luck*, 23 REV. FIN. STUD. 2060 (2010) (arguing that sensitivity to industry-wide shocks may be appropriate to the extent an executive is responsible for situating the firm in that industry).

however, there remains the significant problem of unobservable luck.²⁴³

For these reasons, pricing CEO talent by output is not necessarily a *fairer* way to pay. CEOs at high-performing firms often may not “deserve” their incentive-pay based riches, while CEOs at poor-performing firms may “deserve” more than the discounted payments they receive.

Nevertheless, incentive pay’s appearance of fairness makes advocating for it very easy. This superficial appeal means that the public will be extremely receptive to calls for more incentive pay and skeptical of incentive pay detractors. Combined with the status quo bias and the self-interest of private actors in the pay-setting process, the public appeal makes the incentive pay orthodoxy extremely difficult to erode.

CONCLUSION

This Article has argued that incentive pay’s ability to positively influence firm performance is greatly overestimated. As corporate governance mechanisms have evolved, the marginal benefits of incentive pay have gotten smaller and smaller, to the point where we believe that incentive pay’s net overall effect is now negative. In many respects, this claim runs contrary to the tide of scholarly opinion in both law and financial economics. On the other hand, recent reform proposals implicitly acknowledge that, at least in some contexts, the pendulum has swung too far in favor of incentive pay.

If we are correct about incentive pay’s diminishing returns, several implications necessarily follow. First, boards should be more skeptical of incentive pay’s purported benefits in light of evolving alternative disciplinary mechanisms and more cognizant of performance-based pay’s subtle costs. Before using incentive-laden compensation arrangements, boards should perform a cost/benefit analysis that takes into account the many firm- and CEO-specific factors that are relevant to incentive pay’s efficacy. Alternatively, they should apply a discount to the expected benefits produced by incentive pay schemes.²⁴⁴ Second, institutional shareholders and shareholder advi-

243 See, e.g., Bertrand & Mullainathan, *supra* note 83, at 902 n.2 (“In any model, given the randomness of the world, CEOs (and almost everybody else) will end up being rewarded for unobservable luck.”). The problem of unobservable luck is heightened if CEOs are actually less important than popularly believed. For more on the case for “constrained CEOs” see KHURANA, *supra* note 213, at 22–27.

244 The exact magnitude of this discount is beyond the scope of this paper, though a necessary implication is that the discount should be large.

sors should be receptive to such skepticism. For better or worse, their influence is rising, making it harder for directors and managers with career concerns to deviate from the inefficient orthodoxy. Finally, policymakers should be dubious of claims that normative goals can realistically be attained or even advanced merely by regulating the manner in which firms pay their executives.²⁴⁵

We are, however, doubtful that the incentive pay orthodoxy can be abated in the near future. Congress's recent Say on Pay mandate, which brought shareholders more directly into the pay-setting discussion, will likely serve only to make matters worse. After Say on Pay, companies can be expected to justify their pay packages by pointing to their performance sensitivity, and the herding tendencies of directors will be exacerbated. The result, unfortunately, will almost certainly be more incentive pay rather than less. Thus, perhaps the most interesting and counterintuitive implication of our work is that a more democratic corporate governance environment may stifle efficient executive compensation reforms by firms.

²⁴⁵ A positive start might be the repeal of the performance-based pay exception to Section 162(m)'s limitation on the deductibility of compensation.