Pay without Performance: The Unfulfilled Promise of Executive Compensation. By Lucian Bebchuk and Jesse Fried. Cambridge, Mass.: Harvard University Press, 2004. xii, 279 pp. ISBN 0-674-01665-3, $24.95 (cloth).

Every once in a while someone comes out with an important book concerning corporate governance or executive compensation. Like Aldolf A. Berle and Gardiner C. Means's *The Modern Corporation and Private Property* (New York: Harcourt, Brace, and World, 1932) and Graef S. Crystal's *In Search of Excess: The Overcompensation of American Executives* (New York: W.W. Norton, 1991), Bebchuk and Fried's new book is thought-provoking and interesting. It is a very important book and should be read not just by those interested in executive pay or corporate governance but by anyone interested in how corporations work.

The main idea in *Pay without Performance* is that there has been a fundamental breakdown in how executives are paid in the United States. Bebchuk and Fried argue that most researchers of executive pay have focused on the "arm's-length bargaining model," according to which CEOs report to objective, independent board members who, in turn, report to shareholders. This standard principal-agent framework has been used in hundreds of academic papers. Bebchuk and Fried argue that empirical facts point to a very different explanatory framework—a "managerial power" model.

Pay without Performance has four main parts. In the first part the authors describe the "official view" of executive pay, the one most scholars hold. In this view, "boards, bargaining at arm's length with CEOs, negotiate pay arrangements designed to serve shareholders' interests." In stoutly arguing that this model is not "a sufficiently accurate reflection of reality," Bebchuk and Fried marshal a long list of considerations: for example, directors seek to be reelected to boards; CEOs have power to benefit directors (and vice-versa); boards may favor CEOs for a variety of social and psychological reasons; directors' costs for favoring CEOs are very low; and shareholders have very limited power to countervail these forces.

The second part of the book elaborates the "managerial power" perspective and employs it to explain the "unfulfilled promise" of executive pay. Bebchuk and Fried argue that CEOs use their power "to secure rents—that is, extra value beyond what they would obtain under arm's-length bargaining." Although there are many new reporting requirements for firms, managers and boards are able to "camouflage" executives' compensation. The authors cite evidence that CEOs are more richly paid when

"(1) the board is relatively weak or ineffectual, (2) there is no large outside shareholder, (3) there are fewer institutional shareholders, and (4) managers are protected by anti-takeover amendments." As further evidence of "managerial power," they mention such extras as generous severance packages and lucrative retirement arrangements that are given on top of the perks contractually agreed to in advance, and generous executive loans that are often forgiven.

Part 3 continues with the "managerial power" perspective. Bebchuk and Fried argue that there is little link between pay and performance in large American firms. In part, this is due to the fact that bonuses are sometimes not offered for performance, there are bonuses for acquisitions even though they may not be in the best interests of shareholders or related to firm performance, and there is generous severance even for CEOs who "fail." Moreover, since stock options are not indexed to market prices, CEOs may profit handsomely just by riding a growing stock market; and options are often "re-priced" when stock prices fall and lose their incentive effects.

Although Bebchuk and Fried say that their purpose is to point out problems with the system and not necessarily to provide remedies, the last part of the book discusses a set of potential reforms that they argue would help to improve both executive pay and, more generally, corporate governance. They feel that recent reforms have done some good but that much more can be done. The root of the problem, they argue, is the failure to recognize that boards of directors need a fundamentally different set of "incentives and constraints." Central to their host of recommendations is the premise that directors are too independent of shareholders (the owners of the firm). According to *Pay without Performance,* little can be done about CEO pay until limits are placed on director independence, including new rules for director compensation, elections, and accountability. These types of reforms, the authors argue, would help lead to more transparency in CEO pay, and would promote compensation that is more closely linked to firm performance.

The book is exceptionally well written and clear. The authors succinctly present their main argument early on, then dedicate the rest of the book to elaborating and supporting it. If one ignores the endnotes, the reading is very smooth, quick, and easy, suiting it for a mass audience. Readers who are already familiar with the corporate governance literature are not left high and dry, however, because the extensive endnotes—497 of them following only 216 pages of text—provide plentiful details. Poring through these notes is somewhat grueling, but it is essential for anyone who wishes to evaluate the validity of Bebchuk and Fried's claims. The nature of the literature they cite in support of a given argument, for example, can itself be revealing: sometimes they refer to papers published in the best journals in economics, law, and finance, sometimes to newspaper accounts; sometimes they refer to only a part of an academic study, or to a study that is out of date in the light of recent governance reforms.

The book's main weakness, I believe, is too heavy a focus on the thesis that "managerial power and influence have shaped the executive compensation landscape." In comparing the explanatory power of the "arms-length bargaining" model to that of the "managerial power" model, the authors imply that the former is practically worthless and the latter almost full-purpose. For example, to support their claim that "boards often lower the goal posts when it appears that CEOs are unlikely to achieve their designated targets, or indeed have already missed them," Bebchuk and Fried cite anecdotal evidence and an article from the *New York Times,* but not convincing academic empirical support. The strain of trying to fit all relevant phenomena into the "managerial power" framework is also clear, for example, in some rebuttals of other scholars' criticisms. For example, Kevin J. Murphy argued that new CEOs are likely to have less power when they negotiate their pay package than do continuing CEOs, who may be more entrenched ("Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," *University of Chicago Law Review,* Vol. 69, 2002). This is certainly a plausible and empirically testable idea. But rather than accept it and move on, Bebchuk and Fried maintain that negotiations with these new CEOs "still have deviated substantially from [the arm's-length] model." Another example is an issue raised by Brian Hall and Kevin J. Murphy in "The Trouble with Stock Options" (*Journal of Economic Perspectives,* Vol. 17, 2003): whereas new, stricter disclosure requirements that were instituted in the early 1990s should have slowed CEO pay growth if the "managerial power" model is correct, in fact CEO pay continued to escalate. Bebchuk and Fried counter that other circumstances that also were changing at the time (such as anti-takeover defenses) "more than offset the effect

of better disclosure"—but they support this claim with no empirical tests.

One can easily agree with the main points Bebchuk and Fried make and with the reasonableness of several of their recommendations without being convinced that all roads lead to the "managerial power" theory. Speaking for myself, I would have found the book more persuasive if the authors had reined in their horses at certain points.

This stimulating book raises many questions that can inspire future work. For example, what accounts for the big difference in pay-setting between the United States and the rest of the world? Will the new exchange reforms make a big difference, and if so, how big, relative to the extent of the changes Bebchuk and Fried advocate? Will Sarbanes-Oxley, the 2002 act regulating corporate financial record-keeping and providing penalties for its abuse, make much of a difference in the long run?

Bebchuk and Fried's book is important for a variety of reasons. First, it carefully articulates the difference between the often-relied-upon "arm's-length bargaining" framework and the "managerial power" perspective. Second, it neatly organizes a wealth of new evidence on executive pay in America today. Not only do the reference section's 257 entries comprise a comprehensive listing of important academic studies, but the authors also present scores of anecdotes illuminating the "facts on the ground"—actual CEO pay plans and corporate governance situations. Third, the book is accessible to a wide audience. Even though there have been many recent reforms in corporate governance (Sarbanes-Oxley, for example, and new regulations affecting stock exchanges), this clear, forceful book will doubtless fuel additional reforms and academic studies in the corporate governance arena. The book has helped spark many new papers already, and I feel this is just the beginning.

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