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MORE PIECES OF THE CEO COMPENSATION PUZZLE

BY FRANKLIN G. SNYDER*

ABSTRACT

No current issue in corporate governance is more hotly debated than the question, "Why are American CEOs paid such high salaries?" A recent and influential answer, dubbed the "managerial power" approach, has an appealing simplicity: CEOs so thoroughly control their firms' compensation-setting machinery that they simply pay themselves whatever they want, restrained only by the tenuous limits of their own avarice and the vague need to avoid public "outrage." As an explanation for a complex process, however, the simplistic managerial power approach is so flawed as to be nearly useless. The single most intriguing feature of CEO compensation, for example, is its meteoric rise during the 1990s, the very period when CEO control over boards was declining and public outrage was increasing, yet the managerial power approach has no convincing explanation for the anomaly. This article argues that the managerial power approach's failure is rooted in several theoretical problems, including (1) its tacit assumption that we can tell how much CEOs ought to be paid; (2) its reliance on a model of arm's-length bargaining, instead of the relational bargaining model that modern contract theory suggests is usual in employment relationships, (3) its failure to distinguish between the bargaining power *of the CEO and the CEO's* control *of the bargaining process, and (4) its failure to examine CEO compensation in the context of the drastic rise in compensation of those at the tops of many other fields, including baseball players. The article argues that a full explanation of the compensation process will necessarily have to take these factors into account. The managerial power approach is simple and it fits nicely with common ideas about the greed of corporate executives, but it is not a useful description of the CEO compensation process.*

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I. INTRODUCTION

Few recent issues in American corporate governance have generated more scorn from the public, and more puzzlement from scholars, than compensation for chief executive officers (CEOs) of public companies. American CEOs are some of the best-paid in the world.[1] Over the past decade CEO pay—particularly incentive-based compensation founded on stock options—has skyrocketed.[2] During the 1990s, labor unions withered and the income of many ordinary workers barely outpaced inflation.[3] Meanwhile, CEO compensation at large publicly held American firms rose to levels usually associated only with actors, ballplayers, popular novelists, and rock musicians.[4] The increase came at a time of greater informational transparency, greater involvement by institutional investors in monitoring businesses,[5] greater public outrage at the increasing pay,[6] and greater public emphasis on "creating shareholder value."[7] For a great many people, this paradox begs the question, "why?"

The question has moved to the forefront in the wake of a series of financial and accounting scandals that have recently rocked the nation's securities markets.[8] Former Wall Street darlings such as Kenneth Lay of Enron, Dennis Kozlowski of Tyco, and Bernhard Ebbers of WorldCom, who made millions of dollars throughout the 1990s, have now seen their

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[1]*See* Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 508-10 (2001) (summarizing various studies).

[2]*Id.* at 506-07.

[3]Susan C. Faludi, *Reckoning at Safeway*, *in* COLOSSUS: HOW THE CORPORATION CHANGED AMERICA 407, 411-12 (Jack Beatty ed., 2001).

[4]*See* ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US 61-82 (paperback ed. 1996).

[5]*See generally* Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance*, 11 DEPAUL BUS. L.J. 43 (1998) (discussing greater awareness and involvement by institutional investors as well as increased government accountability standards).

[6]*See generally* Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713 (1995) (outlining the public and political reaction to CEO pay in the early 1990s).

[7]ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE (1986). The phrase was popularized during the original Decade of Greed, the 1980s.

[8]Former Federal Reserve Chairman Paul Volcker told a recent conference, "The alarming exposure of a series of financial reporting and auditing lapses in recent months is finally forcing the Congress, the SEC and the investing public to face up-to [sic] the need for reform." Paul A. Volcker, Finally a Time for Auditing Reform, Remarks at the Conference on Credible Financial Disclosures, Kellogg School of Management, Northwestern University (June 25, 2002), *at* http://www.kellogg.northwestern.edu/news/whatsnew/volcker_text.htm.

firms' stocks "crash" and their own names figuring prominently in grand jury proceedings.[9] Arthur Andersen, once widely regarded as the world's most prestigious accounting firm, has simply disintegrated amid the series of scandals.[10] Even those corporate titans not directly touched by any allegations of wrong-doing, like Jack Welch of General Electric, have turned in the public's mind from entrepreneurial geniuses to greedy robber barons.[11] As the shares of those blue-chip firms plummeted in the bear market of 2000-2002, and shareholders saw substantial portions of their wealth melting away, the question why these people made so much money burned even brighter.

One of the most recent attempts to answer the question comes in an important article by three corporate law scholars: Professors Lucien Bebchuk, Jesse Fried, and David Walker (Bebchuk, Fried, and Walker), entitled "Managerial Power and Rent Extraction in the Design of Executive Compensation."[12] The article theorizes that CEOs are so highly compensated because they so completely control the firms they run (and the boards of directors of those firms) that they are free to siphon money to themselves almost at will;[13] this improper influence allows them to dictate the terms of their own compensation, which will be the highest amount they can take without triggering what the authors call public "outrage."[14] To avoid triggering the outrage boundary, CEOs will also engage in "camouflage" to conceal large payments from investors.[15] This is described as the "managerial power approach."[16]

The article's timing could not have been better. The recent wave of corporate scandals has catapulted the argument from the staid pages of a law review to the op-ed pages of major newspapers. It has been lauded in

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[9]*See*, Tim Carvell, *Let Us Now Braise Famous Men: It's Been Quite a Fiscal Year for CEOs*, FORTUNE, Nov. 18, 2002, at 135; James R. Peterson, *Financial Executives Join the Criminal Class*, INT'L ACCTG. BULL., Oct. 25, 2002, at 9; Peter Carbonara & Jon Gertner, *The Blame Game*, MONEY, Oct. 4, 2002, at 110.

[10]Steven R. Strahler, *An Icon Crumbles*, CRAIN'S CHI. BUS., Oct. 7, 2002, at 1 (detailing the firm's "self-immolation").

[11]*See, e.g.,* Philip Kennicott, *Rich With Irony: When Golden CEO Jack Welch Stepped Down, It Was Into the Mud*, WASH. POST, Oct. 14, 2002, at C1.

[12]Lucien Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

[13]*See id.* at 754-56.

[14]*Id.* at 756.

[15]*Id.*

[16]Bebchuk et al., *supra* note 12, at 754.

the *Economist*[17] and blasted in the *Wall Street Journal*,[18] and the concept of "managerial power" seems likely to become a staple of public discussion.[19]

This prominence is not due to the novelty of the thesis. As the authors themselves are careful to point out, there is nothing new to the ideas that CEOs are greedy, that they are not effectively controlled by their boards, and that they overpay themselves for the services they provide. "The salary of the chief executive of the large corporation is not a market reward for achievement,"[20] opined the economist John Kenneth Galbraith. "It is frequently in the nature of a warm personal gesture by the individual to himself."[21] Thirty years ago a corporate insider wrote:

> While ostensibly the seat of all power and responsibility, directors are usually friends of the chief executive put there to keep him safely in office. They meet once a month, gaze at the financial window dressing[, provided to them by the] managers [who] run the business[], listen to the chief and his team talk superficially about the state of the operation, ask a couple of dutiful questions, . . . and adjourn until next month.[22]

What is new is that Bebchuk, Fried, and Walker have turned this old populist truism into an economic explanation of the process by which executive compensation is set. In doing so, they have directly tackled the contrary theory (which they call the "optimal contacting approach") that has been dominant in the law-and-economics literature, though not in the popular press. They supplant it with their own model (the "managerial power approach") which, they claim, better explains how executive compensation works. Their theory gives academic support to the populist rallying-cry that boards of directors are puppets who do not prevent greedy

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[17]*Taken for a Ride*, ECONOMIST (U.S. ed.), July 13, 2002, at 64.

[18]Holman W. Jenkins, Jr., *Outrageous CEO Pay Revisited*, WALL ST. J., Oct. 2, 2002, at A17.

[19]*See, e.g.*, Ross Gittins, *So Much Money, So Little Risk*, SYDNEY MORNING HERALD, Mar. 27, 2002, at 15; Paul Krugman, *The Outrage Constraint*, N.Y. TIMES, Aug. 23, 2002, at A17; Sebastian Mallaby, *Too Soft on Stock Options*, WASH. POST, July 15, 2002, at A17; Robert J. Samuelson, *Stock Option Madness*, WASH. POST, Jan. 30, 2002, at A23.

[20]JOHN KENNETH GALBRAITH, ANNALS OF AN ABIDING LIBERAL 79 (Andrea D. Williams ed., 1979).

[21]*Id.*

[22]ROBERT TOWNSEND, UP THE ORGANIZATION 49 (1971).

CEOs from overpaying themselves. This theory will no doubt play a part in the public debate over what to do about the problem.

As a reminder that corporate insiders often overreach, the managerial power approach has some merit. As an explanation of the entire process of setting executive compensation, however, it is seriously flawed. Its most obvious shortcoming is its inability to answer the question that provoked the discussion in the first place: why has CEO compensation increased so rapidly? After all, CEO compensation has risen sharply (and paradoxically) at a time when boards are increasing their independence,[23] CEO tenure is declining,[24] and accounting rules are becoming more transparent.[25] Under the managerial power approach, which requires tame boards, entrenched CEOs, and opaque reporting, this should not happen.

Some of the problems with the managerial power approach are outlined in a thoughtful response by Kevin Murphy which appeared in the same issue as the Bebchuk, Fried, and Walker article.[26] Murphy argues convincingly that the managerial power approach relies on concepts so vague ("outrage" and "camouflage") that they cannot be measured, let alone proved or disproved.[27] More important, he shows that it fails to explain some important features of executive compensation that we observe in the real world.[28] If the managerial power approach were true, for example, current CEOs ought to make more than new hires into those jobs, but they do not; CEOs whose hefty compensation comes from undue influence over their captive boards should not be able to transfer their hefty benefit packages to new firms where they lack such influence, but they do.[29]

The basic assumptions of the new model are also undercut by a new study of CEO hires in the 1990s by Rakesh Khurana.[30] While Khurana shares the view that CEO compensation is irrationally high, his thesis is that the growth in CEO compensation over the past decade has come about

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[23]*See generally* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (tracing growth of independent directors in public companies).

[24]Press Release, Booz Allen Hamilton, *Booz Allen Hamilton Study Reveals CEO Job Security is Declining Throughout the World*, June 21, 2002 (on file with author).

[25]*See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 861-62 (2002).

[26]*Id.*

[27]*See id.* at 855-57.

[28]*See id.*

[29]Murphy, *supra* note 25, at 852-54.

[30]*See* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS (2002).

because of greater shareholder involvement and director independence. As insider control erodes, outside directors feel pressure from large institutional shareholders—who often are the dominant shareholders in large firms—to remedy the problems of a flagging firm or keep up the successes of a winning firm. As a result, these directors have been in the forefront of a CEO-as-superstar movement that has resulted in a virtual bidding war for the limited number of perceived "superstars." Khurana's thesis is bold and provocative and appears to run directly contrary to the assumptions of Bebchuk. Indeed, many of Khurana's own findings are flatly inconsistent with the implications of the managerial power approach.[31]

The work of Murphy and of Khurana suggests that the managerial power approach is wrong as an explanatory mechanism; this article will argue that its shortcomings flow from at least four serious problems. First, the managerial power approach tacitly assumes that we have some basis for determining how much compensation is optimal for any given CEO. This presupposes a much larger degree of knowledge than boards actually possess. A board's compensation negotiations are likely to be infected by several problems that are unrelated to the CEO's relative power, most of which relate to the impossibility of really quantifying any of the important issues and the perceived importance of the decision.

Second, the managerial power approach assumes that the appropriate standard for analyzing compensation negotiations is adversarial arm's-length bargaining. But there is substantial literature asserting that parties in long-term relationships of interdependence do not (and should not) follow the arm's-length model, even where bargaining power is equal.

Third, the managerial power approach conflates the bargaining power of the CEO with his or her undue influence over the process. If the CEO's demands are granted because the board is made up of sycophants who are repaying him or her for their own positions, the outcome is improperly influenced by managerial power; this is a classic case of self-dealing. But if the demands are granted because the CEO merely exercises his or her bargaining power—by threatening to quit or to work less, for example—there is no improper abuse of power even if the threatened act would have dire consequences for the firm and the board has few other options.

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[31]If the managerial power approach were correct, for example, there is no reason to assume that the relationship between the compensation of the CEO and that of other top managers in the firm should vary over time. But Khurana's data shows that the gap between the CEO and the rest of the management team widened greatly between 1992 and 1996. *Id.* at 197, tbl. 7.1.

Fourth, the managerial power approach, in its narrow focus on what goes on within the walls of the corporate boardroom, fails to take into account the larger social factors that likely influenced the huge rise in CEO compensation. The compensation of many elite groups—athletes, investment bankers, lawyers, physicians, actors, musicians, fashion models, painters, and so on—rose dramatically during the same period that CEO compensation did.[32] The reason for this comparable rise is partially understood, and hotly debated, but there is a pattern. If we see a similar pattern across several groups, we ordinarily look for similarities between those groups as an explanation for the pattern. Bebchuk, Fried, and Walker, however, focus on the aspect of the CEO job that is *least* like that of the other groups as the explanation for the phenomenon. Baseball players, for example, have no control over the team's compensation-setting mechanism, yet their compensation has risen in much the same manner and during much the same period as the rise in CEO compensation.

In sum, the managerial power approach is, at best, only a partial picture of the CEO compensation puzzle and, at worst, entirely misguided. Part II of this article gives a brief recapitulation of the managerial power approach, the optimal contracting approach, and Murphy's argument that the managerial power approach does not work as a description of the reality of CEO compensation. Part III sets forth the reasons the managerial account fails, and some of the factors that any full analysis of the process must take into consideration. Part IV looks at the evidence that Bebchuk, Fried, and Walker claim supports the managerial power approach, and shows that it can be explained on the basis of a number of propositions that are either explicitly or implicitly accepted by these authors, or that seem otherwise to be relatively uncontroversial.

The managerial power approach, while helpful in calling attention to the possible abuses of the system, is not itself a useful picture of the process as a whole. Any full picture of the process must take into account much more than greed, outrage, and camouflage.

II. THE MANAGERIAL POWER APPROACH AND MURPHY'S CRITICISMS

It is helpful, before going further, to briefly sketch the managerial power approach and the critique offered by Murphy. The managerial

[32]Two major works on the subject, providing a good deal of data, are DEREK C. BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA (1993); FRANK & COOK, *supra* note 4.

power approach is a critique of an older explanation of how executive compensation is set,[33] so it is useful to start there.

A. *"Optimal Contracts"*

The standard account of the compensation process is what Bebchuk, Fried, and Walker call the "optimal contract approach."[34] That approach starts by recognizing that how much CEOs should make and how their compensation should be structured is simply a version of the classic problem of agency.[35] While principles of agency law require agents to work for the benefit of their principals—a fiduciary relationship "in which thought of self [is] to be renounced"[36]—the economic interests of the agent and the principal are not always identical.[37] Some of these conflicts are profound. There is, for example, a tension between the economic interests of any employee and his or her employer.[38] It is usually in the employer's interest to pay less for more effort but it is in the employee's interest to receive more for less effort.

CEOs are no exception.[39] The principals (the corporation, and ultimately its shareholders) want the CEO to work hard to create additional wealth for the corporation; but the CEO will gain at most only a small slice of the increase in wealth that she creates,[40] whereas she will get the full value of her leisure time if she goes home. Similarly, the average CEO is likely to be much more risk averse than the average diversified shareholder, because a much higher percentage of the CEO's wealth (most of her income) is tied up in the firm.[41] The CEO should thus tend to favor less

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[33]The older model is described at Bebchuk et al., *supra* note 12, at 784.

[34]*Id.* at 761-83. The Bebchuk, Fried, and Walker article contains a detailed discussion of the principal works, which will not be repeated here.

[35]*Id.* at 761.

[36]Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928).

[37]*See, e.g.*, Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1381-82 (1982) (modeling principal and agent behavior in the safety context).

[38]That tension plays out in a number of areas. *See, e.g.*, Carol A. Glick, *Labor-Management Cooperative Programs: Do They Foster or Frustrate National Labor Policy?*, 7 HOFSTRA LAB. L.J. 219, 225-27 (1989) (analyzing whether labor-management cooperative programs can mitigate divergent interests and foster economic competitiveness).

[39]*See generally* George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593 (1988) (demonstrating that executive compensation rises as a firm's total sales increase).

[40]*Id.* at 611.

[41]Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 872 (1992).

profitable but less risky strategies over higher-risk higher-return strategies, because she will gain only a small benefit if the venture is highly successful, but will suffer a near-total loss (unemployment) if the venture causes the business to fail. Even if the CEO is risk-seeking, she might prefer the kind of risk involved in corporate empire-building (e.g., large and gaudy acquisitions) rather than building shareholder value, because the CEO will get the prestige which comes from running the larger firm, but only a small share of the profits.[42] In addition, given that CEO pay also tends to increase with the size of the organization, even acquisitions that are bad for shareholders may result in more compensation for the CEO.[43]

The optimal contracting approach suggests that boards of directors will seek to align the financial interests of the CEO with those of the shareholders by tying a much larger portion of the CEO's compensation to the increase in shareholder wealth.[44] Shareholder wealth is generally thought to increase when the price of the firm's shares rise.[45] One way to align these interests might be by issuing stock options to the CEO. When the stock price goes up, the value of the options will go up, and the CEO will become richer. The specter of getting fabulously rich will drive CEOs to take intelligent risks that will tend to increase wealth for diversified shareholders. Thus, the optimal contract approach suggests that the great increase in CEO compensation—much of which is in the form of stock options and incentive compensation—is a valid effort by boards to align the interest of the CEO/agent with those of the shareholders/principals. Stock options, in this account, bring the interests of shareholders and CEOs into closer alignment. The large stock option awards are likely due to the fact that contingent compensation has to be much larger than guaranteed compensation to have a significant impact on behavior.[46]

B. *"Managerial Power"*

Bebchuk, Fried, and Walker note that the optimal contract approach depends on the notion that the parties are bargaining freely, that the board actively represents the interests of shareholders, and thus that the amount

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[42]*See id.*

[43]*See id.*

[44]Bebchuk et al., *supra* note 12, at 762-63.

[45]There is some dispute about whether this is true. *See generally* Lynn A. Stout, Stock Prices and Social Wealth (Nov. 2000) (unpublished working paper), *at* http://.students.olin.wustl.edu/ ~choya/ Lynn%20(2000).pdf (visited Nov. 21, 2002) (analyzing the relationship between stock prices and social wealth). But for present purposes it is assumed that stock price is an appropriate measure of increases in shareholder wealth.

[46]Bebchuk et al., *supra* note 12, at 775-76.

settled on by the parties reflects an efficient deal. But those assumptions, they say, do not hold.[47]

The authors adduce a good deal of evidence on this issue, but it can be reduced to the contentions—which are not likely to be controversial—that bargaining is not really done at arm's length, and that the CEO frequently dominates the board selection process.[48] Instead of seeing themselves as watchdogs for the shareholders, board members frequently see themselves as members of the CEO's management team. In many firms the CEO plays the key role in nominating and selecting directors to their lucrative positions, which naturally means that the directors will tend to be friendly with and supportive of the CEO.[49]

The sort of people who are usually selected for boards are, themselves, likely to put shareholder interests behind those of the CEO.[50] Inside directors, for example, usually work for the CEO and support him or her.[51] Outside directors who are themselves senior executives of large public firms have a vested interest in keeping CEO pay high, because of the natural tendency of boards to look at "average" compensation at other firms as a yardstick for their own decision making.[52] These executives, who expect deference from their own boards, are likely to favor giving deference to the CEO. Personal dynamics probably also play an important role, because most directors (given their business backgrounds) want to feel like they are part of a successful management team and not some kind of regulatory agency.[53] This means that they will in most cases support the CEO.

To add to this structural dominance, even the information that directors get is controlled or influenced by the CEO.[54] When the compensation committee meets, all of the firm's performance data will come from the CEO or his or her subordinates; the committee will have

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[47]*Id.* at 774.

[48]*Id.* at 769, 784.

[49]*Id.* at 768, 785.

[50]*See* Bebchuk et al., *supra* note 12, at 768.

[51]*Id.*

[52]*Id.* at 769, 771.

[53]*See* Bhagat & Black, *supra* note 23, at 950 (finding evidence that companies with cohesive boards outperform those with monitoring boards); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 265-66 (1997) (pointing out the importance of the board's role as part of company management); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001) (explaining why directors prefer to cooperate rather than assume a monitoring stance).

[54]Bebchuk et al., *supra* note 12, at 772.

outside advisors, but in many cases these advisors are picked by the CEO.[55] Even if they are independent, they are well aware that if their recommended compensation structures displease management their contracts may not be renewed.[56] The consultants, moreover, have no vested interest in securing the best value for the firm's shareholders. On the contrary, their incentive is to arrive at a compensation number that management likes and that the board can adopt with a straight face.[57] If the numbers recommended by the consultants are too low, and management balks, the directors may be placed in a difficult position. If they follow the consultant, they are faced with angry management; if they pay more than the consultant recommends, they face potential shareholder action. Either way, the low figure may discourage future employment of that consultant.

Thus, say Bebchuk, Fried, and Walker, the process is so dominated by the CEO that we cannot assume its outcomes are likely to be efficient.[58] This would not be such a problem, if there were other mechanisms that assured that CEOs could not be paid too much. But those mechanisms do not exist. First, market discipline is insufficient.[59] There is some amount of executive compensation that, paid in cash, might drive the cost of a firm's products up to the point that the firm would be noncompetitive, and so competition might be thought to put some limit on compensation.[60] But this does not apply in the CEO case because the normal method of providing outsized competition is through awards of stock options, which transfer money from the shareholders to the CEO directly without affecting the cost structure of the business.[61] Second, the greed of the CEO might be restrained if there were some outside means of overriding the board's decisions.[62] But there is no such mechanism. Management and the board control the firm's proxy machinery, so the likelihood of getting shareholder accord to disapprove compensation agreements is small, and the chance of ousting current directors by a proxy contest approaches zero.[63] Nor is there any avenue for review in the courts. CEO compensation decisions are usually reserved for the board of directors, and judged under the highly

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[55]*Id.*

[56]*Id.* at 772-73, 790-91.

[57]*Id.*

[58]*See* Bebchuk et al., *supra* note 12, at 772-73, 790.

[59]*Id.* at 778.

[60]*See id.*

[61]*See id.*

[62]Bebchuk et al., *supra* note 12, at 778-79.

[63]*Id.* at 779.

deferential business judgment rule.[64] The chance is slim that a judge will strike down a compensation agreement solely because it is grossly excessive.[65]

Given all this, Bebchuk, Fried, and Walker see numerous forces at work in the compensation process. The primary force is CEO greed; the drive is to maximize compensation. The only check on this otherwise unfettered greed is what the authors call the "outrage factor": the CEO's compensation will rise until it reaches the point where shareholders and other members of the public are so livid that negative publicity forces the CEO to rein in his or her demands.[66] Outrage, however, can be avoided or deferred by disguising the compensation in various ways, such as by issuing large numbers of amorphous and un-accounted-for stock options in lieu of cash. The authors call this "camouflage."[67]

Putting these concepts together, we would predict that CEO salaries would be set not at levels that provide optimal value to shareholders, but at the maximum amount that the CEO, using as much camouflage as possible, can get away with without triggering public outrage.

C. *Murphy's Critique*

Professor Murphy's critique of the managerial power approach is both theoretical and practical. As a theoretical matter he points out that the concepts of "outrage" and "camouflage," while attractive, are far too vague to be of much use.[68] This is certainly true. After all, if we ask why CEO Larry Ellison of Oracle earned $706 million in compensation in 2002,[69] the managerial power approach suggests that it is because this is the maximum he could earn without triggering public outrage. If we ask why he received it in the form of options rather than cash, the answer is obviously camouflage. But if we ask why CEO John Chambers of Cisco Systems—whose performance during the period was not markedly different from

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[64]*Id.* at 781 (giving a brief explanation of why the presumptions created by the business judgment rule make shareholders' suits in these situations very difficult).

[65]*See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000) (holding that compensation award of $140 million to departing Disney executive passed muster under the business judgment rule, even though "the processes of the boards of directors . . . were casual, if not sloppy and perfunctory"). *But see In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (denying motion to dismiss amended complaint; allowing plaintiff's discovery based on finding that the business judgment rule may not now fully protect the actions of the Disney board).

[66]Bebchuk et al., *supra* note 12, at 786-87.

[67]*Id.* at 788.

[68]Murphy, *supra* note 25, at 855.

[69]*Forbes Best-Paid CEOs*, FORBES.COM (2003), *at* http://www.forbes.com/lists/results.jhtml?passListId=12&passYear=2002&passListType=Person (last visited May 26, 2003).

Ellison's— made only $270,000 in 2002,[70] the managerial power approach suggests it is because Chambers faced outrage constraints that Ellison did not, and that he was not able to camouflage any larger amount. The trouble is that we could switch the two men and the theory would explain their compensation equally well. A theory that can justify *any* given outcome is of limited explanatory value.

The practical criticism is even more powerful. If the managerial power approach were an accurate picture of the process, we should be able to draw certain predictions about what should happen to CEO compensation under different circumstances. The problem is that those predictions seem to be flatly contradicted by the information we have about CEO compensation. If the managerial power approach were true, we ought to be able to confidently predict the following:

CEO salaries should decline as public outrage increases. If outrage operates as a serious constraint, CEO compensation should decline (or at least not increase dramatically) in periods where public outrage is high. But Murphy makes a strong case that public outrage was unusually high in the early 1990s—it was a major theme of the 1994 presidential elections—and remained high through much of the following decade, at the same time that CEO compensation was skyrocketing.[71]

CEO compensation should decline on a relative basis as boards become more independent. If the CEO's domination of the process is the key to the high compensation levels, then a movement toward a more independent board with more outsiders ought to serve as a brake on compensation. Boards became increasingly independent over the decade of the 1990s,[72] but it was during that period that compensation soared to previously unheard-of levels.[73]

Increased transparency should result in lower compensation. If outrage is the primary check on compensation and camouflage is the primary means for disguising outrageous pay, then greater informational transparency ought to result in lower compensation. But CEO compensation rose to new heights *after* new SEC disclosure rules went into effect in 1992 which made compensation more transparent.[74]

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[70]*Id.*

[71]Murphy, *supra* note 25, at 856.

[72]Bebchuk et al., *supra* note 12, at 773.

[73]Murphy, *supra* note 25, at 852.

[74]*Id.* at 856. This is true even if the reporting mechanisms for CEO compensation are still inadequate, as many argue. Any relative increase in transparency should nevertheless decrease camouflage and increase the potential for outrage, thus limiting compensation.

CEOs hired from inside should earn more than those recruited outside the firm. If domination is the key, then successors from within the firm (those who are cronies of the outgoing CEO) should be in the strongest position to extort higher compensation. Yet Murphy provides data showing that CEOs hired from outside the firm earn substantially more than those promoted from inside.[75]

CEOs should rarely leave their jobs, and if they do they should not get higher salaries. If the entrenched CEO can obtain above-market returns from dominating his or her current board (returns which by definition are higher than those he or she would obtain in arm's- length bargaining), few CEOs would want to leave voluntarily because they are by definition moving to a place where they do not dominate the process and cannot get above-market returns.[76] And if they are obtaining above-market compensation due to their current domination, that level of compensation should not be transferable to a new firm where they do not dominate the board. Yet Murphy's data suggests that the overwhelming majority of CEO changes resulted in substantial raises, and that outside CEOs usually get their existing options in their old firm (which they will forfeit by moving) replaced by an equivalent number in the new firm.[77] Interestingly, Bebchuk, Fried, and Walker concede this point:

> CEOs hired from the outside who at the time of their hiring are CEOs of other firms are likely to be using their power at those firms to extract rents. Thus, the hiring firm cannot attract them without compensating them for whatever rents they currently enjoy and must give up to take the new positions.[78]

But Bebchuk, Fried, and Walker apparently have not considered the implications. Certainly these outside CEOs will have higher *reservation* values but they will not be hired unless the acquiring firm values them more highly than the current firm—and that means that the value cannot come from any undue rent extraction due to domination at the old firm. Such executives should in theory have reservation values that are too high for the

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[75]*Id.* at 853.
[76]*Id.* at 854.
[77]Murphy, *supra* note 25, at 854.
[78]Bebchuk et al., *supra* note 12, at 842.

acquiring firm.[79] That they do not directly contradicts the managerial power approach.

Most options should be issued to the CEO and senior management. If the point of option compensation is to satisfy the greed of the CEO, then we would expect most options to be earmarked for top management. But Murphy notes that 80% of options granted to employees are granted to those who are not among the top five officers.[80]

CEO pay should decline on a relative basis as the tenure of CEOs declines. The longer a CEO serves in office, the more chances the CEO has to appoint his or her cronies on the board.[81] As the average tenure of CEOs goes down we would therefore expect to see CEO compensation decline; but the opposite was the case in the 1990s. That period saw a dramatic decrease in CEO tenure and job security[82] during a period when compensation rose sharply.[83]

In sum, Murphy's data shows that there are other things going on in the CEO compensation process besides managerial abuse.[84] What are those other factors? What effects do they have on the process?

III. LIMITATIONS AND DEFECTS OF THE MANAGERIAL POWER APPROACH

I find at least four factors at play in the CEO compensation process that the managerial power approach ignores: (1) the limits of our knowledge of what compensation is optimal; (2) the fact that arm's-length

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[79]A corollary in baseball is the problem of the overpaid but underperforming player, who is not contributing to the team but who cannot be dealt because no one will assume his salary.

[80]Murphy, *supra* note 25, at 858, tbl. 3.

[81]Bebchuk et al., *supra* note 12, at 785.

[82]*See* Drake Beam Morin, *CEO Turnover and Job Security: A Special Report* 6 (2000), *at* http://dbmext.dbm.com/portal/public/dbmnav.nsf/DDCBD6A9D18652DF88256A6C00742F8B/$file/CEO+WP.pdf. Between 1984 and 2000, the number of CEOs who had been in office for three years or less rose from 33% to 45%, while the number of CEOs in office ten years or more declined from 35% to 15%. *Id.* at 9, tbl. 4. The study attributes much of the turnover to the rise in corporate acquisitions, and the data may also reflect the increase in large-cap start-up firms at the time of the study. But the reason for greater CEO turnover should not affect the analysis because shorter tenure should reduce the CEO's ability to dominate the board regardless of the reason.

[83]Murphy, *supra* note 25, at 848, fig. 1; 849, tbl. 1.

[84]*Id.* at 857-62. Murphy's explanation for the explosion in CEO pay is the increased use of options as a means of compensation. *Id.* at 857. If CEOs are going to be paid on a contingent basis, they will demand more compensation than they would if they were getting cash, because they underestimate how *valuable* they really are. On the other hand, accounting rules have hitherto permitted firms to exclude option costs from their compensation expenses, which leads board members to underestimate how *expensive* they are. Thus, the use of option compensation itself will necessarily result in increasing compensation for executives.

bargaining is not the yardstick by which outcomes should be measured; (3) the distinction between CEO dominance and CEO bargaining power; and (4) the powerful social trends that have driven up compensation for many groups other than CEOs. A full solution to the CEO compensation puzzle will need to take all of these points into account.

A. *Limits of Knowledge*

For both the optimal contracting and managerial power camps, the debate over CEO compensation revolves around the question, "What compensation is optimal?" The former camp tends to suggest that CEO pay is generally optimal, the latter argue that it is likely to be suboptimal. The problem is that we have no idea what the optimal pay level is for CEOs in general or for a given CEO in particular.

We are, in fact, ignorant on several levels. First, we cannot measure exactly how big a role the CEO plays in an organization. The importance of the job falls between two schools of thought, either: (1) the "CEOs play a critical role in affecting firm performance," or (2) the "CEOs are so constrained that they have little impact on company performance."[85] The critical important of the CEO may, in fact, be a "myth,"[86] but no one knows. Intuitively, we know that the impact of the CEO can be huge—try to imagine Wal-Mart without Sam Walton, Dell Computer without Michael Dell, or Berkshire Hathaway without Warren Buffett. But given the complex interrelation of the series of feedback loops that make up a firm, it may be impossible to make even a rough estimate with any confidence. The daily acts of the CEO are affected by thousands of different factors.[87] Moreover, the qualities needed in a competent CEO vary widely from firm to firm, as each enterprise has its own set of unique problems.[88] We simply have no basis to say that, for example, the average CEO of a $50 billion firm is worth $10 million a year, when the right number might be $1

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[85]KHURANA, *supra* note 30, at 21-22.

[86]*Id.* at 36.

[87]It is estimated that general industry trends and year-to-year economic changes account for 40-65% of a given firm's performance. Rakesh Khurana, *The Curse of the Superstar CEO*, HARV. BUS. REV., Sept. 2002, at 63. Internal factors over which the CEO has relatively little control—the existing firm culture, its available resources, its cost structure vis-a-vis its competition, the power of its brand names, breakthroughs made by R&D scientists, good decisions by myriad subordinates—also contribute heavily. Over time the CEO can influence these internal factors, but he or she always must operate within them.

[88]FREDERICK W. WACKERLE, THE RIGHT CEO: STRAIGHT TALK ABOUT MAKING TOUGH CEO SELECTION DECISIONS 3-4 (2001). Wackerle's book gives several examples of real-world parameters set by boards for their incoming CEOs, which show something of the range of situations CEOs face.

million or $100 million. We simply don't know how much money is at stake in the CEO hiring decision.

Second, even if we knew in general how much CEOs should be paid, we cannot reliably distinguish good CEOs from bad, let alone make fine gradations among them on a spectrum. Even in hindsight, it is impossible to sort out exactly how much of a firm's success or failure was due to the individual CEO. Certainly it is possible *ex post* to identify particular decisions that turned out well or poorly, but it is entirely conjectural whether another CEO would have made a different decision and, if different, whether the alternate decision would have been better or worse. And when we get to the particular situation in which the CEO is placed, we see just how difficult it is to sort out the CEO's particular accomplishments from all of the other factors that affected the performance of his or her business.[89] During the twenty years that Jack Welch ran General Electric, for example, the firm grew shareholder value by some $400 billion, and since his departure in 2001 to the time of this writing the firm's worth has shrunk by some $160 billion—but how much of that is due to Welch and how much to other factors cannot be quantified.[90] Even fans of Welch

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[89]Wal-Mart, for example, outperforms competitors Sears and J.C. Penney in virtually every way. Does that mean that Wal-Mart's CEO (H. L. Scott) is better those of the two competitors (Alan Lacy and Allen Questrom, respectively)? At the time of this writing, since January 1, 2000, the share prices of both Sears and Penney's have outperformed the stock of Wal-Mart. Can we conclude that Lacy and Questrom are better managers than Scott?

[90]Welch became CEO of GE on April 1, 1981, and held that job until September 7, 2001. JACK WELCH & JOHN A. BYRNE, JACK: STRAIGHT FROM THE GUT 87, 424 (2001). But Welch was not writing on a blank slate—GE was already a $25 billion giant, earning $1.5 billion a year in profits on a rock solid AAA-rated balance sheet. *Id.* at 92. It had a long history of outstanding management. Welch's predecessor, Reg Jones, had already greatly strengthened the firm—Jones himself was in his time regarded as "America's most admired [CEO]"—and had already begun the process of removing under-performing units by unloading the troubled computer division to Honeywell. *See* Mark Lewis, *History Won't Know Jack*, FORBES.COM, Sept. 7, 2001, *at* http://www.forbes.com/2001/09/07/0907welch.html. Welch's own approach to growth-through-cutting-the-deadwood (he earned the "Neutron Jack" nickname by eliminating 118,000 employees in five years, while simultaneously building a lavish new office park and health club and increasing salaries for "stars") worked well in the downsizing ethos of the 1980s and the excellence craze of the 1990s. Welch also took office two years before the start of the longest bull market in American history. While GE during his tenure averaged a respectable 8% a year in profit growth, most of the increase in GE's value came from an increase in its market multiple. Moreover, Welch's departure came just four days before the September 11 disaster, when terrorist aircraft destroyed the World Trade Center in New York City. GE's reinsurance arm lost at least $400 million in that disaster—forcing GE's first profit warning in over five years—on policies written while Welch was in office. One of GE's largest customers, Boeing, cut back orders for GE's highly profitable jet engines, while GE's aircraft leasing arm faced defaults from its airline customers. Even its media subsidiary, NBC, was hit by the loss of advertising caused by disaster coverage. *See* Andrew Hill, *Immelt in at the Deep End as GE Suffers*, FIN. TIMES, Sept. 20, 2001, *available at* http://news.ft.com/ft/gx.cgi/ftc?pagename=View&c=Article&cid=FT3XLTYXURC &live=true&tagid=IXL99I3TICC&subheading=basic%20industries. Ironically, one spot of good

recognize the problem:

> We cannot deny that Welch played a huge role in revitalizing GE. . . . But obsessing on Welch's leadership style diverts us from a central point: Welch grew up in GE, he was a product of GE, as much as the other way around. Somehow GE *the organization* had the ability to attract, retain, develop, groom, and select Welch the leader. GE prospered long before Welch and will probably prosper long after Welch. . . . Welch's role was not insignificant, but he was only a small slice of the entire historical story of the General Electric Company.[91]

In sum, we know what Welch did, but we have no way to tell how well another candidate would have performed, and no way of telling whether shareholders would have been better or worse off.[92]

Third, even if we could truly estimate *ex post* how much impact the CEO had on the organization's performance, we cannot do so *ex ante*. This is critical, especially since hiring and compensation decisions are made prospectively. When the board reviews CEO compensation, it is seeking to motivate the CEO and align his or her interests with that of the shareholders.[93] A contract is not a reward for past performance, it is payment for future services, and since no one can predict the future, boards are inevitably forced to guess. Even proven track records of success are not reliable indicators. Executives like Kozlowski of Tyco and Ebbers of WorldCom can go from genius to goat almost overnight. A new CEO might bring about a dramatic turn-around, driving the stock price up 225% and creating $6.3 billion in shareholder wealth in eighteen months, as happened at Scott Paper.[94] On the other hand, a new CEO might lead a firm

news for Welch's successor turned out to be the fact that Welch's last big deal, an attempted purchase of Honeywell for $43 billion, was blocked by European regulators. Two weeks after Welch's retirement Honeywell was issuing its own profit warnings and saw its market value slide far below GE's bid price. *Id.*

[91]JAMES C. COLLINS & JERRY I. PORRAS, BUILT TO LAST 34 (paperback ed. 2002).

[92]Probably Welch's biggest rival for the top job at GE was Stan Gault, who in 1979 was the favorite candidate of most of GE's senior management. Gault was subsequently pushed off the short list in August 1979 and forced to leave the firm. WELCH & BYRNE, *supra* note 90, at 78-79, 81-82. He later took over the ailing Goodyear firm, which during his tenure saw its market value increase sixfold. He later became chair of Avon Products. Lisa Watts, *The Energizer*, WOOSTER MAG., Oct. 4, 2000, *at* http://www.wooster.edu/ magazine/gault.html.

[93]*See* Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 125-26 (2000).

[94]JOHN A. BYRNE, CHAINSAW: THE NOTORIOUS CAREER OF AL DUNLAP IN THE ERA OF PROFIT-AT-ANY-PRICE 31 (1999).

into a bankruptcy death spiral and be fired before two years are out, as happened at Sunbeam.[95] The trouble is the two CEOs might be the same man: here, Albert "Chainsaw Al" Dunlap, who was a hero at Scott (at least to Wall Street investors) and a bust at Sunbeam.[96] In 2000, one book on planning for CEO succession used, as an example of excellent practices, the naming of M. Douglas Ivester to succeed Roberto Goizueta as CEO of Coca-Cola.[97] But another book on the same topic, written only a year later, lists the Ivester hiring as one of the cautionary tales of processes gone wrong.[98] In recent years, high profile appointments of new CEOs have gone horribly awry at many blue chip firms, where "very bright people with sterling track records as managers and leaders" have turned out to be flops.[99]

Fourth, we do not know how many people have the skills to be competent CEOs of large business enterprises. Running a large business requires specialized skills. How many people have them? Of those who do, how many are truly outstanding? We cannot know the answer to those questions. The general perception is that the number is small: data from executive search firms shows that the average search for a vice president of marketing is conducted for about a month and considers more than 300 candidates, while the average CEO search lasts nearly six times as long and involves one-tenth the number of candidates.[100] Khurana notes:

> [T]he most commonly held perception of directors, executive search firms, and CEO candidates about [the CEO job] market [is] that the supply of qualified candidates for the CEO position in large corporations is thin. When contrasting the search for a CEO with that for other executives, one search consultant . . . commented that "the number of people who can run a 50,000-person organization is small, and most of us know them off the top of our head."[101]

It is entirely possible that this perception is wrong. Khurana, for example, confidently asserts that the number of CEO candidates is artificially low

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[95]*See id.* at 318-19, 324-26.

[96]*See id.* at 326.

[97]DENNIS C. CAREY & DAYTON OGDEN, CEO SUCCESSION 15-16 (2000).

[98]WACKERLE, *supra* note 88, at 1.

[99]*Id.* The writer singles out Apple Computer, Proctor & Gamble, Coca-Cola, Xerox, AT&T, Mattel, Compaq, and Maytag as examples of instances in which the CEO either failed or did not have the chance to succeed. *Id.*

[100]KHURANA, *supra* note 30, at 29, tbl. 2.1.

[101]*Id.* at 28.

because of "extremely limiting criteria" that unnecessarily constrain the search.[102] The "perceived shortage of qualified CEO candidates," he writes, is "social fiction," not "empirical reality."[103] It is a "waste of talent" that "many individuals who could be CEOs are not even on the radar screens of those who could be tapping them for the position."[104] But while he assumes there is some sort of large pool of perfectly capable individuals, he provides no evidence of that. Nor does he tell us how to identify the ones who can do the job from the ones who cannot.

In sum, we cannot accurately measure the relative scarcity of the resource we are talking about (exactly how many people are there who are capable of effectively running large and complex business organizations?) and we cannot readily measure the value of the resource (just how much difference in shareholder value does a good CEO make?). If we cannot tell how much of something we have, and cannot measure the benefit it gives to the purchaser, we have trouble determining what the price ought to be.

This is a reminder that boards, when operating in this arena, are always shooting in the dark—looking for the proverbial black cat in the darkened coal cellar who may not be there. They are at all times operating under serious informational handicaps that no amount of investigation can eliminate.

At the same time, they are operating in a large stakes arena. If the CEO of GE can boost the firm's share price by just $1, shareholders will collectively realize nearly $10 billion in additional wealth. How much is an executive worth who can deliver an extra $10 billion in wealth?

This leads to the fifth level of ignorance: we lack any basis for determining the "fair" allocation of profits between the CEO who has worked to create the wealth and the shareholders who have financed it. If a CEO can create an extra $10 billion in shareholder wealth, shareholders are better off even if the CEO is paid $9 billion. So how much is the CEO worth? There is no formula for deciding what percentage of that number is the "optimal" figure. We may believe it outrageous that "the average CEO of a major corporation received a record-breaking $20 million in total compensation "in 2000, while the typical hourly worker received a three percent raise."[105] We can also point out how unfair it is that 26-year-old Reese Witherspoon will make $15 million for the film *Legally Blonde 2*,[106]

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[102]*Id.* at 29.

[103]*Id.*

[104]KHURANA, *supra* note 30, at 187.

[105]*Id.* at 190-91.

[106]*See Hollywood darling Witherspoon to go "Legally Blonde"—again*, Agence France Presse, Sept. 5, 2002.

while the caterers on the set are making minimum wage. But without any data on the relative contributions of each to the enterprise, it is difficult to decide what levels are "optimal." We are stuck with the relative bargaining of the parties as the only real measure of how that money ought to be split.

B. *Arm's-Length Bargaining*

The second problem with the managerial power approach is that it relies on an unduly simple model of the contracting process. Bebchuk, Fried, and Walker assume that the proper analysis of the board's role in setting compensation is the classic "arm's-length" model, in which two parties are free to negotiate in their best interests and walk away from the deal if dissatisfied. Neither party owes the other any particular duty, other than basic legal notions of honesty or normal commercial practices. Each makes a contract and each is supposed to stick to that deal. In this picture, the board's role in the compensation process is essentially adversarial—to represent the interests of the shareholders in getting the best possible deal with the CEO, in much the same way a car buyer tries to negotiate the best possible deal with the salesman.

The trouble is, this ignores the substantial body of contract law scholarship that suggests that individuals engaged in mutually beneficial contractual relationships over time do not—and ordinarily should not—behave in the way the arm's-length model postulates. All long-term contracts where the parties will have regular opportunities for performance and interaction are relational, in the sense that the written agreement is only part of the larger relationship in which they work. This observation has given rise to the relational contracts school of contract theory which derives chiefly from the work of Ian Macneil.[107] Some of the conclusions of that school as to the role of courts in enforcing relational norms are controversial,[108] but the basic concept, that parties in relational contracts deal with each other cooperatively, is today almost a truism.[109]

Parties to relational contracts realize that the relationship itself has

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[107] *See* Melvin A. Eisenberg, *Why There is No Law of Relational Contracts*, 94 NW. U. L. REV. 805 (2000) (explaining that the relational contract theory was "'fathered by Ian Macneil"); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 855 (1978) (expanding on the concerns over the clash between economic structure and the need to reorganize and implement change).

[108] *See, e.g.*, Eisenberg, *supra* note 107 (explaining why there is no body of relational contract law).

[109] Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 852 (2000) (observing that "[w]e are all relationists now.").

value over and above the terms of any particular deal, and understand that backing out of the relationship will be both costly and disruptive. When disputes arise in the future, they are likely to adjust contract rights and obligations, giving up valuable benefits, even where their bargaining power is equal:

> Adjustment [of the contract terms] often may be precisely what the parties expect. The best way to maintain an informal, harmonious relationship, preserve goodwill and reputation, and protect one's investment is to remain flexible and avoid disputes and litigation. Indeed, disagreements in long-term settings are most often settled without pursuing legal remedies. Contracting parties view their obligations as growing not only out of the contract, but also out of the norms of their relationship such as cooperation and compromise. As Karl Llewellyn long ago pointed out, the written contract is only a "rough indication around which [real working] relations vary."[110]

Parties to such a relationship do not push every advantage; they regularly accept contractual modifications that are not in their immediate interest; they pay more than they have to; they accept less than they have been promised.[111]

They do not do this because they are foolish or ill-advised. On the contrary, it would seem that they do it because cooperation between business entities frequently yields economic results superior to confrontation and hard bargaining. In an important sense, persons in a long-term contractual relationship are interdependent. The buyer might pay more for the goods today than he or she is strictly required to pay, but the value of the on-going relationship outweighs the additional costs. The ultimate profit from the relationship outweighs the economic value of the particular adjustment being sought.[112]

Employment relationships are classic cases of long-term relational

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[110]Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law*, 1987 DUKE L.J. 1, 7-8 (quoting Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 737 (1931)).

[111]Hillman notes a recent situation in which a coal supplier faced with large cost increases requested price relief from more than forty utility company customers. Only two customers turned down the request. *Id.* at 8.

[112]*See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1801-02 (1996).

contracts.[113] The terms set at the beginning, even in a formally signed agreement, are merely a jumping-off point for a relationship where the parties are engaged continuously in rewriting the contract as circumstances change and the relationship develops.[114] Thus, we would expect that the parties to an employment contract would treat those terms not as sacred writ, but as guidelines that are likely to be varied as circumstances change over time. This is, in fact, how employers and employees tend to view their legal relationships.[115] As noted, these changes should be expected to occur not because one side controls the other's decision-making apparatus, but because the interests of both will be furthered by cooperative rather than adversarial bargaining.

Thus, many of the features that the managerial power approach finds to be flaws in the compensation process arguably are beneficial to the firm. The directors' perception that they should support the CEO, their reluctance to override substantive decisions except under unusual circumstances, and their desire to be part of the "team" are not necessarily abdications of authority but may instead reflect the board's view that the long-term interest of the corporation is furthered by cooperation and team-building. The board is a monitor; but with greater director participation and independence, it does have a greatly enhanced role to play.[116] The board's decision to give the CEO things that are not provided in the contract may reflect a genuine and valuable desire to keep both parties happy with the arrangement. A board that deals with its CEO the way a regulatory authority deals with regulated entities might strike a better (or at least cheaper) compensation deal, but might cause serious damage to the firm by creating a hostile and bitter environment.

None of this is to say that boards do not sometimes abdicate their responsibilities. They do. Rather it is to say that it is simplistic to use the

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[113]*See* Paul J. Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 BUFF. L. REV. 763, 765 (1998).

[114]Gudel, *supra* note 113, at 769. Note that this descriptive aspect of the role of relationships in contracting does not necessarily mean, as many relational contract theorists argue, that courts should be in the business of enforcing those relationship norms rather than the letter of the agreed-upon contract. As Lisa Bernstein has shown, parties who are generally willing to be cooperative in agreeing to unfavorable contract modifications may rationally choose to refuse those modifications where the relationship is deteriorating. Drawing a distinction between the enforceable contract and unenforceable modifications may make a good deal of sense. *See* Bernstein, *supra* note 112, at 1787-96.

[115]*See generally* Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996) (finding that employers routinely act in ways beneficial to employees that are not required by legal obligations).

[116]*See* Fisch, *supra* note 53 (critiquing growing idea that board's role is merely that of monitor).

arm's-length model, that of a deal struck between two strangers, as a model for the CEO compensation process. Any robust explanation of the process—and any recommendations for how to deal with the perceived problem—must take into account that bargaining will likely be more cooperative than adversarial, and that it is in shareholders' interests for it to be so.

C. *Bargaining Power*

The third problem with the managerial power approach, which Murphy has already stated, is the failure to distinguish between (a) the CEO's improper influence over the compensation-setting process and (b) his or her bargaining power. To the extent undue influence exists, it compromises the likely efficiency of the bargaining process. But the fact that one party has more bargaining power than the other does not necessarily compromise the transaction. The party with more bargaining power will likely get a better deal, but that is what is supposed to happen when transactions are voluntary and power is asymmetrical.

Even an average CEO of a large firm is in a very powerful bargaining position. Leadership transitions are a huge distraction to a firm that is trying to focus on its business,[117] and the selection process itself is long, intense, and often extremely expensive.[118] In the process, it is normal for unsuccessful internal candidates to be purged from the firm—often by each other, and often by the new CEO[119]—which may leave the newly anointed CEO as the only practical option.[120] This is not the sort of process that a firm wants to go through often. Therefore, the board is not in a particularly powerful position to resist the CEO's compensation demands if they are backed by a credible threat of departure or retirement. Similarly, cracks in the CEO-board facade may cause serious fallout in the investment community;[121] the folks who make a living reading tea leaves may be

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[117]WELCH & BYRNE, *supra* note 90, at 408.

[118]A good example of the process is the hiring of Jamie Dimon, CEO of Bank One described in KHURANA, *supra* note 30, at 1-19.

[119]*See* WACKERLE, *supra* note 88, at 119.

[120]At General Electric in 1977, for example, there were seven men who were identified as candidates for the CEO job which was expected to be open in 1981. These were obviously the the seven most promising senior executives in the firm. Over the ensuing four years of intense competition—which monopolized much of the attention of those seven executives—Jack Welch was anointed the winner and the other six were all forced out of the firm. WELCH & BYRNE, *supra* note 90, at 77-81. Thus the firm had sacrificed six-sevenths of its best leadership in a process that the winner called "brutal" and a "divisive and highly politicized process." *Id.* at xiii.

[121]Wall Street is very sensitive to issues involving CEO replacement and appointment. *See* KHURANA, *supra* note 30, at 91.

skittish about firms where the CEO is reported as unhappy. This is likely to be particularly true where the CEO is admired and viewed as being a component of the firm's success, but it probably applies even to average CEOs, simply because of the potential problems.

The same dynamic is at work in the search for a new CEO. The process is long and arduous, the stakes are thought to be high, and as a result, boards naturally tend to "convince themselves that the person they have identified through the search process is, in fact, worth the effort and expense—that he (or, more rarely, she) really is a better candidate."[122] The chosen candidate represents the culmination of a major effort, and failure to sign that candidate may be a serious problem for the firm.[123] Thus, the candidate "is in an unusually strong position to bargain with the board about subsequent power and compensation arrangements," and boards wind up yielding control of the process to the recruit's demands.[124] This is true even when those boards are not dominated by the CEO.[125]

The distinction between bargaining power and undue influence—and their conflation by Bebchuk, Fried, and Walker—is illustrated in the authors' discussion of the large gratuitous payments often made by boards of target firms to their CEOs in takeover situations. These large "bribes" paid to agents by principals are hard to explain under the optimal contracting approach, they say, because they involve naked transfers of wealth from shareholders to management not required by the compensation agreements:

> [The managerial power] approach suggests two reasons why boards might agree to make these payments. First, given a CEO's power to delay or prevent desirable acquisitions, the board might find it necessary to "bribe" the CEO to allow the acquisition to go forward smoothly. Second, the CEO might be able to convince the board to give him a parting gift (using shareholders' money). In each case, the CEO is using his power to extract rents.[126]

If the first of these situations is true, they argue, it shows "that managers

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[122] *Id.* at 20.

[123] A prospective CEO who turns down a job "may have caused tremendous harm to the hiring organization" by wasting months of time and expense. Particularly if the firm is "in a turnaround situation or in desperate need of leadership for any other reason," it is a serious blow of the CEO candidate withdraws. WACKERLE, *supra* note 88, at 122.

[124] KHURANA, *supra* note 30, at 21.

[125] *See, e.g.*, BYRNE, *supra* note 94, at 36, 58.

[126] Bebchuk et al., *supra* note 12, at 835.

use their power to extract rents."[127] If the second is true—if it is a mere gift—this also "reflects managers' use of power . . . to extract rents."[128] From the Bebchuk, Fried, and Walker perspective, the two situations are interchangeable. But they are not.

The first situation reflects the CEO's powerful bargaining position, but does not require us to posit that the board is under his or her control. The CEO in this situation is in a position to extract rents, which position does not depend on any undue influence. True, the CEO who insists on a side payment may be violating his or her agency duties. But the power to block a desirable deal comes not from control over the board (the example explicitly posits that the board is independently seeking to do the deal) but from the raw power of the CEO's position, independent of his or her board influence. The quarterback who refuses to play unless his contract is renegotiated, the star who walks off the movie set to get a change in contract terms, and the official who will not sign the construction permit without a large side payment, may all be acting in bad faith and may all be attempting to extract unearned rents. But their power comes not from their domination of the other party but from their ability to block a transaction the other party finds desirable. This is, in fact, one of the underlying principles of collective bargaining.

In the second situation, however, there are issues of domination, at least if we assume it was not the efforts of the CEO that helped lead to the advantageous buy-out. A lavish gift in that scenario might well raise an inference that the process is infected by the CEO's power over the board.

Thus, CEOs have some powerful bargaining chips even in situations in which they have no control over the board. This is likely to be true even in situations where major shareholders dominate the board directly.[129] Certainly CEOs' bargaining power enables them to drive harder bargains than shareholders might like—but that is not in itself a problem requiring an explanation by the managerial power approach. Where the CEO's job is thought to be extremely important, the current incumbent (or leading candidate) is thought to be above average, and the costs to the organization of changing horses is thought to be high, the CEO is going to be in a very

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[127] *Id.* at 836.

[128] *Id.* at 837.

[129] Thus, when the two major stockholders who controlled Sunbeam decided in 1996 that they wanted Al Dunlap to take over as CEO, the negotiation basically involved Dunlap dictating his own terms. BYRNE, *supra* note 94, at 35-36. This deal was cut not with a captive board, but directly with the controlling shareholders. Those shareholders, moreover, turned over not merely some lavish compensation, but control of the firm, agreeing to let Dunlap personally select a majority of the board. "'We put the kitchen sink in that contract and they accepted everything,' confided a Dunlap associate. 'Al got exactly what he wanted.'" *Id.* at 58.

powerful bargaining position. Much of the weakness in the managerial power approach results from blurring the distinction between this natural bargaining power and the CEO's improper domination of the board.

D. *CEO Compensation in Context*

The fourth problem with the managerial power approach is that it ignores the wider social landscape in which CEOs' and firms' compensation decisions are embedded. It has been widely noted that CEOs are not the only group in society whose earnings have been rising dramatically. Athletes, actors, lawyers, physicians, popular novelists, fashion models, musicians—all have seen skyrocketing compensation for those at the top. In his 1993 book *The Cost of Talent*, Derek Bok drew the parallel,[130] as did Robert Frank and Philip Cook in their 1994 book, *The Winner-Take-All Society*.[131] Interestingly, Bok attributed the gains to *insufficient* competition, while Frank and Cook concluded that the culprit was *too much* competition. But both recognized that CEO compensation was only a slice of a larger phenomenon in which a sliver of individuals at the top were gaining a larger portion of the pie.

Curiously, the managerial power approach fails to take into account trends that are widely observable in the rest of society. Bebchuk, Fried, and Walker do not try to explain why CEO compensation is different from that of elite lawyers or best-selling novelists—they do not even acknowledge the issue. This is another fundamental weakness of the managerial power approach, because if we were to see massive compensation increases for employees who lack the CEO's power, our reliance on the managerial power approach would be severely undermined.

1. *CEO Compensation*

Let us start with some numbers. The S&P 500 is the major league of management, comprising a group of the biggest and most successful firms in the country. According to Murphy's data, the median compensation of the CEO of a S&P 500 industrial corporation in 2000 was estimated to be around \$6.5 million dollars, up from an estimated \$2.3 million in 1992.[132] This is far more than what other employees in the firm receive, and more than what the foreign counterparts of these American CEOs

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[130]*See* BOK, *supra* note 32, at 114 (discussing executive pay).

[131]*See* FRANK & COOK, *supra* note 4, at 61 (comparing executive pay with other occupations).

[132]Murphy, *supra* note 25, at 848, fig. 1.

make. To put that in context, it is almost half of what Kevin Brown earned to throw a baseball, Edgerrin James to run a football, Patrick Ewing to slam a basketball, and Jeff Gordon to drive a car. It is a fifth of what Mike Tyson earned biting people's ears in a boxing ring, and a tenth of what author Steven King earned sitting at a keyboard.[133]

The eight-year period from 1992 to 2000 saw a striking rise of 183% (about 13.9% compounded annually) in CEO compensation at S&P industrial firms.[134] That rate of growth almost exactly matches that of average major league baseball salaries over a much longer period; the average baseball salary went from about $144,000 in 1980 to about $1.9 million in 2000.[135] Some of this was driven by increases in star contracts, but the minimum salary for marginal ballplayers also rose over that same period from $30,000 to $200,000 in 2000.[136] The highest-paid baseball player in 1997 was Albert Belle of the Chicago White Sox, who made $10 million; in 2001 it was Alex Rodriguez of the Texas Rangers, who made $22 million—120% of Belle's compensation.[137]

2. CEOs and Shortstops

Obviously, the jobs of major league shortstop and corporate CEO are very different. Baseball teams, unlike most businesses, are relatively simple. While there are some differences in market size and potential resources, all baseball teams have the same object (winning games) and are measured on the same scale against other teams with identical goals. Winning and losing is a zero-sum game, in which one team's success requires another's failure. All teams field the same number of players, who perform precisely the same tasks as the players on the other teams. They operate under the same set of rules and use identical technologies.[138] The precise performance of each player can be examined by management, and detailed, reliable statistics are available that permit fairly easy comparison

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[133]*The Celebrity 100*, FORBES.COM, June 20, 2002, *at* http://www.forbes.com/static_html/celebs/2002.html.

[134]Murphy, *supra* note 25, at 848, fig. 1. I am following Murphy, but it should be noted that using a different sample of companies and tinkering with the dates of the survey can yield much higher numbers. *See, e.g.*, Faludi, *supra* note 3, at 411 (finding CEO pay up 443% from 1990-1998).

[135]*Average Baseball Salaries*, SPORTINGNEWS.COM, Dec. 17, 2002, *at* http://www.sportingnews.com/baseball/articles/20021217/445909.html.

[136]*Id.*

[137]Sean Lahman, *Spend to Win? The Myth of Free Agency*, BASEBALL ARCHIVE, Mar. 13, 2002, *at* http://www.baseball1.com/lahman.

[138]GERALD W. SCULLY, THE MARKET STRUCTURE OF SPORTS 156 (1995).

of players.[139]

Each business firm, however, is unique in its inputs, outputs, goals, employees, and technologies. It is much easier to measure the impact of Derek Jeter on the New York Yankees—although we cannot measure it perfectly—than it is to measure the impact of Jack Welch on General Electric. Shortstops and CEOs also vary in their control over the enterprise. The CEO runs his or her business; the shortstop is a hired hand with no control over the team's decision-making process.

However, there are some similarities. The tenure of a major league ballplayer is, on average, a little under five years;[140] the average CEO tenure is dropping to nearly that level.[141] Both groups have career compensation structures that are heavily back-end loaded. In the case of baseball players, salaries in the early years tend to be relatively low, while those in later years increase dramatically for the handful of players who enjoy long and successful careers.[142] Compensation for the ten highest-paid baseball players in 2002 averaged $14.3 million, while the starting salaries for those same ten players averaged $157,000.[143] For most of those players the amounts earned in the past three years are much greater than the amounts they made in their entire prior baseball careers. There is a similar hierarchy in business firms. In most companies, junior managers start at relatively low salary levels and progress up a fairly standardized curve.[144] There is usually a huge leap between the pay for the CEO and that of his or her top subordinates.[145] The CEO is likely to earn more during his or her

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[139]All games occur in public and are easily viewed by anyone. Detailed statistics on pitching, hitting, and fielding are not only kept, they are regularly published, so that anyone can determine whether the individual player failed or succeeded in any given situation.

[140]Daniel C. Glazer, *Can't Anybody Here Run this Game? The Past, Present, and Future of Major League Baseball*, 9 SETON HALL J. SPORT L. 339, 366 (1999).

[141]*See* Drake Beam Morin, *supra* note 82, at 9. Nearly two-thirds of CEOs have been in their jobs for less than five years. *Id.*

[142]SCULLY, *supra* note 138, at 44.

[143]*Baseball Salaries Database*, USATODAY.COM, *at* http://asp.usatoday.com/sports/baseball/salaries/default.aspx (last updated Nov. 8, 2002). The ten players are Alex Rodriguez, Carlos Delgado, Kevin Brown, Manny Ramirez, Barry Bonds, Sammy Sosa, Derek Jeter, Pedro Martinez, Shawn Green, and Randy Johnson.

[144]*See* Jeffery N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1545 (1997) (explaining how employees normally progress up the organization with regular increases in salary and compensation).

[145]Typical CEOs earn about 150 times the compensation of the average workers in their businesses. *See* FRANK & COOK, *supra* note 4, at 67-68. One survey of compensation shows that average compensation for CEOs is two or three times higher than that of other top executives, such as chief financial officers, top marketing executives, and heads of operations. *See CEO and Top-Executive Compensation*, WORKFORCE ONLINE, Feb. 2002, *at* http://www.workforce.com/section/02/article/23/15/40.html (last visited May 26, 2003).

tenure as CEO than in the entire prior employment career.[146] For ballplayers, this back-loading plays a role in aligning the interests of the workers with that of the owners, by providing incentives for younger players and managers to work hard to grasp the brass ring.[147] The same motivations are likely at play in the corporate field. Once the ring is grasped, however, both ballplayers and CEOs have the incentive to obtain the maximum amount of money during their relatively brief stints at the top.

3. *The Winner-Take-All Effect*

As noted, the salaries of baseball players have been rising sharply at the same time as CEO salaries. This may be coincidental, or it may reflect some underlying forces that affect two groups in very dissimilar situations. Economists Robert Frank and Philip Cook have argued that it is not coincidence; the movement to what they call a "winner-take-all" society has, in fact, spread from sports and entertainment to the rest of the world, including the pay for corporate CEOs.[148] Their specific conclusions and their remedies for the supposed problem are controversial,[149] but their general observations are hard to dispute: top pay for star CEOs, lawyers, actors, musicians, fashion models, television personalities, and investment bankers have all risen much faster than pay for "ordinary" workers, and for much the same reasons.[150]

But we are using baseball as the specific example here, principally because of the characteristic that it does *not* share with CEOs—the ability to dominate the compensation-setting mechanism. The conventional explanations for why baseball salaries have risen sharply are: (1) the substantial increase in the amount of money involved in professional baseball; (2) the belief that individual star players improve the competitiveness of teams and make the teams more attractive to fans, thus increasing revenue and profits; and (3) the increasing availability of free agency, which means that teams must bid against competitors for the most valuable players:

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[146]As of 2003, nearly 200 CEOs had made at least $30 million in compensation over their preceding five years in the job; twenty-three had made more than $100 million. *See Forbes Best-Paid CEOs*, *supra* note 69.

[147]SCULLY, *supra* note 138, at 44.

[148]*See* FRANK & COOK, *supra* note 4.

[149]The thesis and its implications are the subjects of a spirited exchange in *The Wages of Stardom: Law and the Winner-Take-All Society: A Debate*, 6 U. CHI. L. SCH. ROUNDTABLE 1 (1999) (debate among Robert H. Frank, Kevin M. Murphy, Sherwin Rosen, and Cass R. Sunstein).

[150]FRANK & COOK, *supra* note 4, at 2-4.

> The same factors are at work determining the sizes of the big incomes in sports as in other areas of entertainment. These factors are demand by the public for tickets to see stars, the rarity of skilled and/or charismatic individuals with star qualities (in the economist's jargon, an inelastic supply of talent) and the bargaining power of stars relative to that of the promoters who hire them (team owners in the case of pro sports). In explaining the rise of salaries for sports stars, both increases in the demand for their output and changes in their bargaining power (for example, free agency's replacing a reserve system) are relevant.[151]

The increasing compensation for star players trickles down to some average players who also have substantial value:

> [W]hen one team signs a quality free agent[,] [t]he other teams realize that one of their competitors has just strengthened itself.... [The] teams begin to panic, and they jump into the free agent market in an attempt to keep pace with their rivals. The result is that the price for the remaining free agents escalates according to the law of supply and demand instead of in relation to the player's talent and usefulness.[152]

This process should also increase the compensation of current team members, even the marginal ones, who are eligible for free agency.

4. *Factors Affecting Compensation Increases*

When more money is at stake, and when competitors must bid against each other for a limited but highly valuable commodity, the price of that commodity will rise. This happens in baseball. The obvious question is to what extent are similar factors at play in the field of CEO compensation?

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[151] JAMES QUIRK & RODNEY D. FORT, PAY DIRT: THE BUSINESS OF PROFESSIONAL TEAM SPORTS 214 (paperback ed. 1997).

[152] Kevin A. Rings, *Baseball Free Agency and Salary Arbitration*, 3 OHIO ST. J. DISP. RESOL. 243, 251 (1987).

a. *Increase in the Stakes*

The market capitalization of American companies has risen sharply since 1992. (Again, I am for convenience using the period at which Murphy looked.) At the beginning of 1992, the S&P 500 average was 417.03. By the beginning of 2000 it stood at 1469.25—an increase of 252%.[153] (Recall that the rise in CEO pay during that period was 183%.) What this means is that the dollars at stake for investors grew enormously during that period. If we assume that the CEO's efforts, good or bad, can effect a 10% change in value for a $10 billion firm, shareholders stand to gain or lose $1 billion. If that firm size goes up to $25 billion, the CEO's effect on potential shareholder wealth increases to $2.5 billion. The value of the average CEO thus should tend to increase tremendously even if there is no actual increase in average CEO productivity, simply because there are more dollars at stake. Importantly, there is no reason to believe that the rise should be proportional; a great CEO who can produce $2 billion in additional shareholder wealth may be worth far more than twice what an average CEO who can produce $1 billion in new wealth is worth.[154]

b. *Increase in the Perceived Value of the CEO*

For much of recent history, analysis of business enterprises has been based on models of business that downplayed the importance of the individual. From the days of Alfred Marshall (whose influential *Principles of Economics*[155] first came out in 1890), to the dawn of the 1980s, most sophisticated work on business relied on models that focused on the structures of industry rather than the specific actions of firm decision

[153]Yahoo Finance, *at* http://table.finance.yahoo.com/d?a=0&b=1&c=1992&d=0&e=5&f=2000&g=m&s=%5Espx (as of Jan. 4, 2000).

[154]Assume that Firm *X* can make at least $1 billion a year under a terrible CEO, $1.2 billion a year if run by a CEO of average competence, and $1.4 billion a year under an outstanding CEO. If the terrible CEO makes $1 million a year, an average CEO is worth far more than 1.2 times the terrible CEO, because he or she created an additional $200 million in profits. An outstanding CEO worth far more than 1.17 times an average CEO. A 20% difference in firm performance does not correlate to a 20% increase in the CEO's value. Whether CEOs have such an impact is obviously debatable, but if shareholders believe they do, shareholders would be entirely rational in paying an average CEO many times what they are paying the terrible one, even though the difference in firm performance is only 20%.

[155]ALFRED MARSHALL, PRINCIPLES OF ECONOMICS (abridged paperback ed. 1997) (1890); ALFRED MARSHALL & MARY PALEY MARSHALL, THE ECONOMICS OF INDUSTRY (reprint ed. 1996) (1879).

makers, who were assumed to play a fairly minimal role in the process.[156] The Great Depression brought about a vision of large businesses as entrenched behemoths whose destinies were largely independent of anyone's individual actions.[157] The academic view largely mirrored that of the general public, which was that large businesses in the 1950s were faceless bureaucratic organizations where the guiding principle was not individual initiative but conformity at all costs,[158] and the leaders of such enterprises, when not actively involved in stifling creativity among their subordinates, were buffoons.[159] The structure-conduct-performance model, usually associated with Harvard and Joe Staten Bain, holds that performance of firms can largely be explained by industry structure.[160] Under the later resource-based view of the firm, firms win competitive advantages not by brilliant decision making but by holding resources that are valuable, rare, inimitable, and non-substitutable.[161] In all of these models, the character and individual decision-making ability of the CEO are much less important than other industry and firm-specific factors.

Beginning in the 1980s, however—probably with the striking success of Chrysler's Lee Iacocca[162]—the cult of leadership began to take center stage. CEO/entrepreneurs like Sam Walton, Bill Gates, and Michael Dell seemed to prove that the genius of a single visionary leader will create

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[156] *See, e.g.*, JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE 89 (1978) (finding that individual decisions are less important than outside factors because "the organization responds to what it perceives and believes about the world [which] is largely determined by the existing organizational and informational structure of the organization").

[157] Probably the two most prominent works in this vein are EDWARD HASTINGS CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (8th ed. 1962) (1933); JOAN ROBINSON, THE ECONOMICS OF IMPERFECT COMPETITION (1969) (1933).

[158] Typical of the era are SLOAN WILSON, THE MAN IN THE GRAY FLANNEL SUIT (paperback ed. 2002) (1955); WILLIAM H. WHYTE, JR., THE ORGANIZATION MAN (paperback ed. 2002) (1956).

[159] The obvious example is SHEPHERD MEAD, HOW TO SUCCEED IN BUSINESS WITHOUT REALLY TRYING (paperback ed. 1995) (1952), subsequently turned into a hugely successful Broadway musical and film by Frank Loesser. In a typical film like *Executive Suite* (1954), one might root for the noble, family-oriented William Holden to gain the CEO spot instead of the scaly, blackmailing Frederic March, but one does not get the sense that ultimate choice will have any great effect on how much furniture the giant firm winds up selling.

[160] *See generally* JOE S. BAIN, BARRIERS TO NEW COMPETITION (1956) (theorizing that the structure of industries is so important to performance that individual firm decisions have relatively little impact on what happens).

[161] *See, e.g.*, Kathleen R. Conner, *A Historical Comparison of Resource-Based Theory and Five Schools of Thought Within Industrial Organization Economics: Do We Have a New Theory of the Firm?* 17 J. MGMT. 121 (1991).

[162] The story led to a phenomenal business best-seller, LEE IACOCCA & WILLIAM NOVAK, IACOCCA (1984).

spectacular amounts of wealth for shareholders.[163] Conglomerate builders like Sandy Weill, Warren Buffett, Bernie Ebbers, and Dennis Kozlowski turned tiny enterprises into corporate giants, making thousands of people wealthy, at least for a while.[164] Whatever the reasons—and they are debatable—"the idea took root that if a firm was doing poorly or well, it was because of the CEO."[165] The idea of CEO as competent executive had changed to that of CEO as visionary leader.[166] Thus, for example, the tremendous success of General Electric over the past two decades seems to be credited almost solely to its CEO, Jack Welch, with the other 300,000 employees, the hundreds of divisions and subsidiary companies, all generally playing merely walk-on parts in the production.[167] The firm founded by Thomas Edison and run for ninety years by a succession of great managers became "The House that Jack Built."[168] Books which seek to distill the wisdom and leadership style of Welch are a substantial industry in their own right.[169]

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[163]*See* JEFFREY A. TIMMONS, NEW VENTURE CREATION: ENTREPRENEURSHIP FOR THE 21ST CENTURY 6, 28 (5th ed. 1999).

[164]Stories of these individuals abound, but a good sample include ROGER LOWENSTEIN, BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST (1996); AMY STONE & MIKE BREWSTER, THE KING OF CAPITAL: SANDY WEILL AND THE MAKING OF CITIGROUP (2002); Daniel Eisenberg, *Dennis the Menace*, TIME, June 17, 2002, *available at* http://www.time.com/time/archive/preview/from_search/0.10987.1101020617-260699,00.html; Mark Lewis, *The Rise and Fall of Bernie Ebbers*, FORBES, Apr. 30, 2002, *available at* http://forbes.com/ 2002/04/30/0430wcom.html.

[165]Craig Lambert, *The Cult of the Charismatic CEO*, HARV. MAG., Sept.-Oct. 2002, at 40, 41 (quoting Rakesh Khurana).

[166]*Id.*

[167]*Id.*

[168]Sam Jaffe, *What Happens to the House That Jack Built?*, BUS. WEEK ONLINE, Nov. 29, 2000, *at* http://www.businessweek.com/bwdaily/dnflash/nov2000/ nf20001129_285.htm.

[169]In addition to the autobiography, WELCH & BYRNE, *supra* note 90, the genre includes STUART CRAINER, BUSINESS THE JACK WELCH WAY: 10 SECRETS OF THE WORLD'S GREATEST TURNAROUND KING (1999); ROBERT HELLER, JACK WELCH (2001) ("Business Mastermind"); JEFFREY A. KRAMES, THE JACK WELCH LEXICON OF LEADERSHIP (2001) ("the Legendary Leader"); JANET C. LOWE, JACK WELCH SPEAKS: WISDOM FROM THE WORLD'S GREATEST BUSINESS LEADER (1998); ROBERT SLATER, THE GE WAY FIELDBOOK: JACK WELCH'S BATTLE PLAN FOR CORPORATE REVOLUTION (2000); ROBERT SLATER, GET BETTER OR GET BEATEN: 29 LEADERSHIP SECRETS FROM JACK WELCH (2d ed. 2001); ROBERT SLATER, JACK WELCH & THE GE WAY: MANAGEMENT INSIGHTS AND LEADERSHIP SECRETS OF THE LEGENDARY CEO (1999); ROBERT SLATER, 29 LEADERSHIP SECRETS FROM JACK WELCH (abridged 2d ed. 2003) ("the visionary leader"); ROBERT SLATER & JACK WELCH, THE NEW GE: HOW JACK WELCH REVIVED AN AMERICAN INSTITUTION (1992); MARK THOMPSON & RICHARD WILSON, ONE ON ONE WITH JACK WELCH (Audio Book 2002); NOEL M. TICHY & STRATFORD SHERMAN, CONTROL YOUR DESTINY OR SOMEONE ELSE WILL: "HOW JACK WELCH IS MAKING GENERAL ELECTRIC THE WORLD'S MOST COMPETITIVE CORPORATION" (1993); JAMES W. ROBINSON, JACK WELCH AND LEADERSHIP: EXECUTIVE LESSONS OF THE MASTER CEO (2001). One negative treatment of Welch is THOMAS F. O'BOYLE, AT ANY COST: JACK WELCH, GENERAL ELECTRIC, AND THE

All of this celebrity has worked its way into the boardroom, where boards are routinely told how important the job is and how critical their choice will be.[170] That view became widely accepted over the past decade. Interestingly, as Khurana shows, the general view of the CEO's importance was only inflated as boards become more and more independent during the 1990s, and as they put greater focus on shareholder value. During the 1980s, boards (at the behest of powerful institutional investors) fired up to 50% of the CEOs at America's largest companies. In search of greater shareholder profits, these boards got caught up in what Khurana calls "messianic mania,"[171] turning away from competent but dull insiders to motivating, flamboyant leaders who would lead the firm to spectacular growth. New CEOs like Jamie Dimon of Bank One were lavished with enormous compensation packages by boards looking for a star to turn sagging share prices around.[172] Does it work? In Dimon's case, the value of Bank One soared 30% in the week following his hiring[173]—more than $10 billion in shareholder wealth—a figure that dwarfs the total amount of his compensation package, which included "a $1 million base salary, plus a $2.5 million bonus," a guaranteed $7 million in annual stock options, and two years' pension credit for each year worked.[174] This may have been irrational, as Khurana argues—Dimon's tenure at Bank One does not at this writing look markedly more successful than his predecessor's—but examples like that were not lost on other boards.

c. *Increase in Free Agency*

The growing perceived value of CEOs might have been constrained had the tradition of promotion from within held. If senior executives are trapped in their current companies (as ballplayers were under the old reserve clause system) most of the value they produce can be captured by the owners. Their compensation will not be less than their reserve wage—the amount they could make by quitting and doing something other than being a CEO—but absent some form of undue influence it will not be much higher. But once there is an active market for CEOs, the upper

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PURSUIT OF PROFIT (1998), which details the devastation done to GE's research and development arm, and the losses suffered by the downsized workers and their communities. It is out of print.

[170] *See generally* WACKERLE, *supra* note 88 (examining the problems with the CEO selection process).

[171] Lambert, *supra* note 165, at 40.

[172] *See* KHURANA, *supra* note 30, at 16-18.

[173] *Id.* at 17.

[174] *Id.* at 16.

compensation bound for CEOs becomes the maximum value of their performance. Thus, in the AT&T example noted above, shareholders presumably should have been willing to pay a substantial slice of that $4 billion to get a CEO who would have a similar effect.

Did free agency among CEOs increase during the past decade? The answer seems to be yes, although the magnitude isn't clear. One study finds that 15% of new CEO hires come from outside the firm,[175] while others estimate the figure as high as a third.[176] Some search consultants argue that internal candidates are at a disadvantage compared to external candidates, because of the pressure on them that detracts from their daily work at the firm.[177] Bringing in talented free agents at a level below the CEO, with intent to give them experience in the firm before taking the reins, is regarded as a good practice.[178] There is widespread perception among directors that executives are more mobile and less likely to make careers at one firm.[179] Some consultants, explicitly using a sports metaphor, have said that free agency means most firms should not waste time on developing executive talent, but should simply hire who they need from other firms: "Companies should think twice about spending a lot of time and money on someone who may walk out the door anyway. A healthier attitude today may be to consider the world as your bench."[180]

All of this suggests that the same factors responsible for the growth of ballplayer salaries are also at play in the field of CEO compensation. The dollars at stake for shareholders in firms have grown with the size of those firms. Boards, whether rightly or wrongly, view the CEO as perhaps the most critical element in the success of the firm, a view that is a marked departure from past thought. And the increasing mobility of executives means that companies will be bidding for their services, not merely to attract new top candidates but to keep their own. After all, free agency raises the salaries not only of those who switch companies, but of those who stay as well.

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[175]Drake Beam Morin, *supra* note 82, at 14.

[176]Lambert, *supra* note 165, at 41.

[177]WACKERLE, *supra* note 88, at 119-20.

[178]Jay W. Lorsch & Rakesh Khurana, *Changing Leaders: The Board's Role in CEO Succession*, HARV. BUS. REV., May-June 1999, at 96, 100 (reporting comments of Alfred Zeien, former CEO of Gillette and director of several public companies).

[179]*Id.* at 103 (reporting comments of G.G. Michelson, a director of GE, among other noted accomplishments).

[180]CAREY & OGDEN, *supra* note 97, at ix-x (quoting consultant Robert Felton).

IV. BEYOND MANAGERIAL DOMINANCE

The proof of the managerial power pudding, say its creators, is in its ability to explain certain features of executive compensation that have "long puzzled" other writers on the subject.[181] If this were true, it would be a compelling reason to rely on that model. But given the nature of a board's goals, the information constraints under which it operates, and the bargaining power inherent in a CEO's position, these features are likely to be present even in situations where the CEO does not dominate the board.

In fact, if we accept a number of propositions—most of which are accepted by Bebchuk, Fried, and Walker and the remainder of which seem relatively uncontroversial—then the features that Bebchuk, Fried, and Walker examine are much less puzzling. In fact, most of the results that those authors see as requiring us to postulate managerial dominance turn out to be consistent with a less sinister explanation. There may be large amounts of self-dealing among American CEOs, but we do not need to assume it to explain their lofty compensation packages.

A. *Some Propositions*

I will take as a given certain propositions about how boards and CEOs act (or are supposed to act), and about the relative power dynamics between the two.

First, the board, in designing CEO compensation, is really trying to align the CEO's interests with those of the shareholders. This is the classic assumption of the optimal contracting approach, and it is the approach Bebchuk, Fried, and Walker suggest that boards should be taking. Let us assume that board members are trying to act in shareholders' best interests.

Second, the board has no way to determine precisely how much value the CEO will create for shareholders, and has few ways to evaluate it other than by the performance of the firm itself. The board believes that a truly exceptional CEO will return to shareholders many times the value of the compensation package, no matter how greedy the CEO. Bebchuk, Fried, and Walker do not explicitly make this assumption, but it seems reasonably uncontroversial.[182] It is estimated that a CEO's wealth changes from \$3.25 to \$11 for every \$1,000 change in shareholder wealth,[183] so a

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[181]Bebchuk et al., *supra* note 12, at 795.

[182]"A several million dollar change in CEO wealth appears very small when divided by the annual change in market value of a Fortune 500 company . . . ." Brian J. Hall & Jeffrey B. Liebman, *Are CEO's Really Paid Like Bureaucrats*?, 113 Q. J. ECON. 653, 656 (1998).

[183]Bebchuk et al., *supra* note 12, at 775 n.57.

board might reasonably believe that the compensation paid to a CEO is vastly less important than the CEO's competence. A small difference in performance (e.g., raising the value of a $20 billion firm to a $21 billion firm) can dwarf even the most lavish compensation package. There may be a dispute over whether the board's belief is rational, but there can be little dispute of what is, in fact, believed.

Third, the board also believes that *this* individual is, or will be, an exceptional CEO, or it would not have selected him or her.[184] In situations where the CEO is an incumbent and has selected the board members, they will also obviously be predisposed to regard him or her as exceptional. In situations where the board believes that the incumbent or the prospective candidate is clearly superior to other candidates, the board will feel considerable pressure to retain or attract the desired individual and to make him or her happy. Again, Bebchuk, Fried, and Walker do not make this assumption, perhaps because they conflate all pressure on the board with improper influence.

Fourth, the CEO selection process is highly disruptive to the firm and requires an enormous investment of time and money on the part of directors and other employees. The board will generally be reluctant to go through this process. Bebchuk, Fried, and Walker do not address this issue, but it seems uncontroversial.

Fifth, a CEO (like a pitcher or a law professor) is more interested in maximizing his or her own utility than the utility of the business owners (the stockholders). The CEO thus has no particular incentive to align his or her interest with those of the owners, but is willing to do so to the extent that it does not interfere with the CEO's own utility. The CEO is usually risk-averse; a very high percentage of his or her wealth is, or will be, tied up in salary and firm stock. The CEO prefers the scheme that gives him or her the highest likelihood of getting the largest amount of money possible. The CEO wants as many birds in the hand as possible, and to the extent they are in the bush, the birds should be large, slow, and sitting on low branches. Bebchuk, Fried, and Walker, of course, share this assumption; the whole concept of the managerial power approach posits that CEOs have different preferences than boards.

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[184]This is an outcome of the "Lake Wobegon" effect: the general perception that the individual being selected for any job is above average. The business people who have invested time and effort in hiring the person tend to overestimate his or her capabilities, just as they tend to be overly optimistic about other aspects of their business. *See, e.g.*, Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 139-41 (1997) (arguing that executives are too optimistic about their business prospects and this leads to unintentional though reckless fraud).

Sixth, the CEO's compensation package must be negotiated. Boards (even those entirely independent of management) do not *set* compensation, they *negotiate* it. No CEO compensation package can be set unless the CEO agrees to it. Given that the CEO's goals are different from those of the owners, there is no reason to believe that the owners' optimal results will be acceptable to the CEO. Bebchuk, Fried, and Walker do not recognize this problem, except to include it in the general description of management rent-seeking.

Seventh, those negotiations at least in the case of incumbent CEOs will not involve arm's-length dealings. Even parties of equal bargaining strength do not normally use an arm's-length model when negotiations occur in the context of long-term relationships. This means that the parties will tend not to rely on the letter of contracts when situations change significantly, and will frequently readjust obligations in light of new circumstances.

With these propositions in mind, we can turn to the specific aspects of CEO compensation that Bebchuk, Fried, and Walker argue are explained best by the managerial power approach.

B. *The "Puzzling" Features of CEO Compensation*

Bebchuk, Fried, and Walker identify several puzzling features of CEO compensation that they conclude are better explained by the managerial power approach than by conventional means. They argue that these features are difficult to explain in ordinary optimal contracting terms, and provide powerful evidence in favor of the managerial power approach. If we look at the evidence they marshal, however, it is much less convincing than it appears, and is to a large extent explainable by the propositions just put forth.

1. Uniform Exercise Prices and "At the Money" Options

Virtually all stock options granted to CEOs are granted at the money; that is, with the exercise price set at the market price at the time of issuance.[185] Here, Bebchuk, Fried, and Walker see two issue. First, there is the "puzzle of one size fits all"—the fact that the vast majority of options issued are of the same type, at the money, regardless of the length of the vesting period, the status of the executive, or the situation of the firm.[186]

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[185]Options whose exercise price is below the market price are said to be "in the money" while those whose exercise price is above the current market price are "out of the money."

[186]Bebchuk et al., *supra* note 12, at 817.

> It is highly unlikely, however, that a single design would be optimal for nearly all companies and all executives. Option values and the incentives they create depend on a stock's volatility, the grantee's stock holdings, and the grantee's general level of risk aversion. Moreover, the shape of the desired incentive will depend on a firm's growth opportunities, debt load, and other factors. These variables will differ from firm to firm, and even among executives within the same firm. Thus, there is no reason for the optimal exercise price to be the same for almost all companies.[187]

Second, because the stock market as a whole rises and falls, at the money options can potentially reward CEOs for general market rises unrelated to firm-specific performance. Bebchuk, Fried, and Walker find this inexplicable:

> From shareholders' perspective, an option plan should be designed to maximize incentives given the amount of dollars spent, or to achieve a certain amount of incentives at the lowest possible cost. When managers are rewarded for market- and sector-wide price movements that have nothing to do with their efforts, the money is poorly spent. This raises the possibility that the firm could either create the same incentives for less money or use the same amount of money to create even more powerful incentives.[188]

It should be noted first that there is, in fact, a solid case to be made that at the money options in general do provide the optimum level of incentive for top executives.[189] And the evidence is decidedly mixed that the kind of market-indexed options Bebchuk, Fried, and Walker advocate are, in general, superior for shareholders.[190] Firms where managerial interests are more closely aligned with those of owners should, all things being equal, create more wealth for shareholders.[191] Yet shareholders in the few firms which index options, or which provide for vesting based on performance criteria, do not seem to have received more wealth than those

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[187] *Id.* at 817-18 (footnotes omitted).
[188] *Id.* at 798.
[189] *See* Murphy, *supra* note 25, at 862-63.
[190] *See* Bebchuk et al., *supra* note 12, at 795-99.
[191] *Id.* at 799.

of firms that do not.[192] More important, indexed options can be skewed to be even more favorable to management than ordinary at the money options, as some shareholders have now discovered to their chagrin.[193]

But we can for the moment assume that indexed options are optimal from a shareholder perspective. And we can agree that the reason they are not used is that "managers are not seeking exercise prices that are value-maximizing for shareholders. Rather, managers are interested in exercise prices that are value-maximizing for managers . . . ."[194] Managers, in other words, prefer at the money options because they have a higher likelihood of yielding profit. The latter point is probably self-evident—there is no reason to believe that CEOs are more self-effacing than most airline pilots, teamsters, or law school professors, all of whom we usually expect to maximize their own values rather than those of their institutions.

The problem is that Bebchuk, Fried, and Walker ignore the fact that compensation is a contract, and that two parties have to agree to the contract. The board of directors (and shareholders) presumably prefer that CEOs be paid as little as possible, and that such pay be so structured as to kick in only when the CEO's own efforts provide a demonstrable benefit to shareholders.[195] But we are assuming here (as do Bebchuk, Fried, and Walker) that the CEO has very different preferences. He or she prefers compensation to be very high, paid in cash, and paid regardless of how the

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[192]Bebchuk, Fried, and Walker can find only one publicly traded firm (Level 3 Communications) that indexes its options, and only a handful (including Monsanto and Citigroup) that condition vesting on some kind of performance standard. For this, these companies have been "widely praised by the business press and by prominent market personalities like Warren Buffett." But there is little evidence of any shareholder benefit. *Id.* at 802.

[193]At Level 3 Communications, it appears that the particular index formula adopted is actually resulting in massive additional compensation to management even though the share price plummeted from $132 to less than $2. If the stock should climb back to 10-20% of its former price, management will be rewarded with options equal to 20% of the firm, and shareholders are not happy. *See Level 3 Communications Inc.: Mgm't's Proposal to Issue Additional Shares—And Why We're Voting Against It*, OUTSTANDING INVESTOR DIGEST, OID.com Special Edition (2002), *at* http://www.oid. com/public/html/02level3/02level3_specialreport.pdf. The point seems to be that indexing is particularly beneficial to management when the underlying stock is highly volatile relative to the chosen index.

[194]Bebchuk et al., *supra* note 12, at 820.

[195]In this sense, boards are no different than the purchasers of any other service. All things being equal, buyers prefer to pay as little as possible and, in a perfect world, would prefer not to pay at all unless they have received some tangible benefit. Some practical implications of this for those who design compensation plans are discussed in Thomas Gilroy et al., *The Compensation Committee Report, Performance Graph, and Other Executive Compensation Disclosure Requirements*, 916 PRACTISING LAW INST. CORP. LAW & PRAC. COURSE HANDBOOK, Series 121, at 184-86 (1996).

firm performs.[196] (Banks and colleges, after all, do not index mortgage and tuition payments to the performance of the CEO's firm.) The CEO has no reason to agree to highly contingent compensation that carries any substantial downside risk, and the deal cannot be struck without CEO agreement.

In this regard, the firm's board of directors is in no different position than the owner of a baseball team. From the owner's perspective, player compensation should also, to use Bebchuk, Fried, and Walker's phrase, "be designed to maximize incentives given the amount of dollars spent, or to achieve a certain amount of incentives at the lowest possible cost."[197] That would suggest that team owners would set compensation based on performance. Players could be paid based on a combination of individual performance (hits, home runs, wins, innings pitched, etc.) and team performance (wins). This system would probably provide optimal incentive to players. But we do not generally see this kind of contingent compensation in player contracts. Most player compensation is in the form of salary and fixed bonuses, and is based neither on player nor team performance.[198] Why? Not because the players dominate team compensation setting, not because they have selected the owners and the team president, but because the players will not agree to highly contingent compensation. And if the other party won't agree, there will be no deal.

All things being equal, the CEO prefers cash.[199] If the board insists on making some portion of the compensation contingent, the CEO will prefer alternatives with the highest likelihood of paying off. Those would be options issued in the money. But those have some unpleasant side effects: they must be charged against the firm's earnings and (more important in the CEO perspective) they are immediately taxable as income to the CEO.[200] The next best things are options issued at the money. They aren't taxable when issued and they are likely to be valuable because the

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[196]"Because executives are risk averse, they would prefer to receive the expected value of these incentive instruments in cash. Indeed, they might prefer to receive an amount of cash that is significantly less than the expected value of the incentives." Bebchuk et al., *supra* note 12, at 825.

[197]*Id.* at 798.

[198]For example, the contract of baseball's highest-paid player, Alex Rodriguez, calls for salary and guaranteed bonus compensation of approximately $23 million a year. The contract contains a number of incentives which, added together, total perhaps $5 million.

[199]Murphy, *supra* note 6, at 739 (noting that "[e]xecutives shifting from salaries to performance-based compensation will demand a premium for bearing more risk, resulting in higher pay levels").

[200]*See* 26 U.S.C.A. § 422(b)(4) (2003); Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 208 & n.233 (2000).

market usually rises over the long run.[201] This makes them the most palatable form of contingent compensation, and thus the one that CEOs are most likely to demand. Given the powerful bargaining position of the CEO, this is likely to be the best set of incentives the board can get.

Bebchuk, Fried, and Walker appear to assume that any deviation from the compensation level that shareholders would find ideal must be due to the CEO's domination of the board. But this would be the case only if the board had the power to dictate the terms of the CEO's compensation, and as we have already seen the CEO is in an exceptionally powerful bargaining position even when he or she does not dominate the board. If the owner of the Texas Rangers cannot impose highly contingent incentive pay on a journeyman ballplayer,[202] there is no reason to believe that the owners of General Electric can impose it on a CEO, whose bargaining power is at least as great.

Two other factors also help explain the widespread use of at the money options. First, Bebchuk, Fried, and Walker underestimate how difficult it would be to craft a system that filters out everything except the CEO's performance. They conclude that the ideal mix should not only vary among firms but among executives in the same firm. Even if it could be done to the satisfaction of the CEO and the board, the transactional costs of doing that are probably pretty high. To simply say that the effort involved in crafting a properly indexed compensation system that filters out market movements would be "trivial" because companies already collect data about financial performance,[203] is to beg the questions: Exactly which companies are "peers" of General Electric? Microsoft? Wal-Mart? Does the CEO of Dynergy get a big bonus because it outperformed Enron? The problem is not whether data is available, it is whether that data can be used

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[201]The practical aspects of the disparate tax treatment is discussed in Steven D. Grossman et al., *A Comparative Analysis of Stock-Based Incentives for Executives*, 37 TAX EXECUTIVE 257, 259 (1985).

[202]The opening-day 2003 salaries for the eleven pitchers on the Texas Rangers totaled more than $32 million. *See Baseball Salaries*, SPORTS ILLUSTRATED, SI.COM (2003), *available at* http://sportsillustrated.cnn.com/baseball/2003/salaries/rangers.html (visited June 11, 2003). As these words are being written, in June 2003, several of these opening-day pitchers are not currently pitching for the Rangers, although several are still being paid. The Rangers have tried twenty-one different pitchers—all of whom are paid by salary—who have combined to allow more than six runs a game, worst in the major leagues. *See 2003 Regular Season Statistics*, ESPN.COM, *available at* http://sports.espn.go.com/mlb/statistics (visited June 11, 2003). Given this dreadful performance, contingent compensation would have vastly deceased the amount of money the Rangers paid their pitchers—but we nevertheless do not observe it in practice. This suggests that owners cannot, in fact, dictate that employees take contingent compensation even when those employees do not control the firm.

[203]Bebchuk et al., *supra* note 12, at 803.

to craft an accurate measure that will filter out non-firm-specific effects.[204] This is the problem that many advocates of indexed options choose to ignore.[205] The experience of Level 3 Communications, where indexed options apparently will allow management to reap larger windfalls than would have been available under a non-indexed plan, suggests that it is much more difficult to come up with an indexed plan that works well under all future scenarios than might be expected.[206]

Second, Bebchuk, Fried, and Walker do not fully consider that people generally value cash in hand more than they value an equal dollar amount of contingent compensation. Contingent option compensation is much less valuable to a risk-averse recipient than cash, even when the value to a risk-tolerant observer would be identical. Thus, executives systematically discount by a substantial amount the value of their option package. If those people have a say in their compensation (which they do, because they must agree to it) option compensation will be more expensive than cash compensation. And the more contingent the option compensation, the more dollars needed.[207] It is thus not true that "the firm could either create the same incentives for less money or use the same amount of money to create even more powerful incentives."[208] Shareholders may indeed get better incentives, but they will have to pay

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[204]One study shows that superior-performing executives would have earned more money under indexed options than they earned in ordinary non-indexed option compensation. *See* Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance*, HARV. BUS. REV., Mar.-Apr. 1999, at 91, 93-94 (explaining that superior performing executives would have earned more money under indexed options than they earned in ordinary non-indexed option compensation).

[205]*See, e.g., id.* 93-94. Rappaport notes that indexing options to the general market is a problem because it "ignores the special factors that affect the company's industry," and thus "[i]t is better to judge management's contribution using a peer group index." *Id.* But then he concedes that "many companies have diversified into a wide range of products and markets, [and thus] it is sometimes difficult to identify a group of peers." *Id.* at 94. He then goes on to ignore those points in arguing that boards nevertheless ought to come up with some kind of indexed option plan. *Id. See also* Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J. L. BUS. & FIN. 31, 48 (1997) (suggesting that if firms cannot identify a peer group "then an index must be comprised of companies with similar market capitalizations"). But indexing the performance of, say, car maker General Motors to online auctioneer Ebay and burger retailer McDonald's simply on the grounds that their market capitalizations are (at the time of this writing) very similar seems odd.

[206]*See Level 3 Communications*, *supra* note 193, at 3.

[207]*See generally* Lisa K. Meulbroek, *The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options* (Harvard Business School, Working Paper No. 00-056, 2000), *available at* http://222.hbs.edu/research/facpubs/workingpapers/papers2/9900/00-056pdf (identifying and measuring the deadweight costs accompanying equity-linked compensation plans).

[208]Bebchuk et al., *supra* note 12, at 798.

more for them.

There is one final problem with using the managerial power approach to explain the absence of indexed options. As the example of Level 3 Communications shows, it is possible to tailor an indexed plan in such a way that it receives substantial applause in the financial press,[209] but still allows management to siphon off even more wealth than a non-indexed plan would.[210] Given such an advantage over non-indexed options, the managerial power approach suggests that they should be much more popular than they are.

2. Resetting Option Prices

When a firm's stock price falls to a level below the exercise price of the stock options, those options become far less valuable. For several years it was fairly common for companies whose employee options had fallen far out of the money to reset the option prices, often to the market price on the reset date.[211] This allowed executives owning options to make enormous amounts of money if the stock crawled back to even a quarter of its previous value, even while shareholders lost billions. Resetting option prices has all but disappeared in the wake of accounting changes that require firms to charge the value of these resets against earnings.[212] But the practice persists in another way: issuing large new blocks of options at the lower price as a tacit means of making the employee whole. [213] I will for present purposes refer to all of these kinds of practices as "resets."

On the surface, the issue of resetting is the strongest piece of evidence for the managerial power approach. If the point of incentive compensation is to reward results, resetting option prices removes that incentive and even rewards poor performance. The parties have a deal, and to renegotiate a deal after one side has lost turns incentive pay into a heads-I-win-tails-we-reset game. Shareholders whose own shares do not come with reset provisions are obviously upset. To them, this looks like the rankest kind of self-dealing. It also undercuts the whole point of the incentive: if employees know *ex ante* that the options will be reset if they fall in value, they will feel less motivated to work hard.[214]

But it is not that simple. First, there is substantial evidence that

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[209] *Id.* at 802.

[210] *See Level 3 Communications*, *supra* note 193, at 3.

[211] Murphy, *supra* note 25, at 861-62.

[212] *Id.* at 861-62.

[213] *Id.*

[214] Bebchuk et al., *supra* note 12, at 822.

parties in long-term relational contracts frequently reset prices based on changed circumstances.[215] This is so even where parties have equal bargaining power, because the perception is that preserving the relationship and the good will of the other party is more valuable than the amount to be gained by insisting on the terms of the original deal.[216] There is also evidence that business people routinely overestimate their firm's likelihood of success.[217] Where the price of the firm's stock has dramatically decreased, the parties may see circumstances as changed. A substantial portion of the CEO's compensation, which the parties thought would be worth a particular amount, is now worth considerably less.[218] That changes the nature of the deal considerably in a way that, oddly enough, a *rise* in market price would not. The parties to the agreement expect the price to rise, and that it will rise a great deal. Thus a rise in market price will not be a changed circumstance for the parties, but an unexpected decline will. In such cases, relational contract theory would suggest that we would see some resetting even in situations where bargaining power is equal.

Second, the managerial power approach has its own problems with option resets. Bebchuk, Fried, and Walker discount the usual explanation for resets, noting that they are necessary to retain employees whose large option holdings are now virtually worthless. An employee who has a million options exercisable at $100 each while the current price is $5 can either stick around and wait for the stock price to climb, or jump to a new firm and get a new batch of options at that firm's current market price. Resetting allows firms to retain and motivate employees.[219] Bebchuk, Fried, and Walker are understandably dubious about this. After all, if the point is to retain employees and create incentives for them, those incentives should be crafted so as to be forward-looking; resetting merely changes the terms of the former deal instead of creating new incentives.

But a surprisingly large number of companies reset options for employees and exclude the CEO and other top executives.[220] Under the

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[215]*See, e.g.*, Hillman, *supra* note 110, at 7-8. "Adjustments often may be precisely what the parties expect." *Id.* at 7.

[216]*See id.* at 8.

[217]*See, e.g.*, Langevoort, *supra* note 184, at 139-41.

[218]*See* Murphy, *supra* note 25, at 864 ("Options that fall out of the money are perceived to be nearly worthless to undiversified recipients.").

[219]*See* Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1906 (2001) (noting that an "employee who was promised *X* in salary plus *Y* in (the expected value of) options per month might otherwise find offers from competing firms more attractive because these competing offers will take current market prices into account").

[220]*See* Daniel A. Rogers, Avoiding the "bad hit": Executive stock option repricing in the casino gaming industry 12 (May 3, 20000), *at* http://www.cba.neu.edu/~drogers/ REPRICE.PDF (finding that eleven of nineteen option repricing events excluded the CEO from participation).

managerial power approach this should not happen. If the CEO shared the reset, we could plausibly claim that resetting options for lower-level employees is mere camouflage. But there is nothing to camouflage if the CEO does not share in the largesse, so there is nothing to be gained from a managerial power explanation. If the primary driver of option resets is the greed of top management, option resets that exclude top management should be nearly impossible. But they occur with some frequency.[221] We therefore need an alternative to the managerial power approach to explain this phenomenon. The most likely candidate is the conventional one: such resets are genuinely believed (rightly or wrongly) to be necessary to retain and motivate employees. And once we assume that boards really believe lower-level employees are motivated by resets, it is equally reasonable to assume that resets also motivate the CEO.[222]

Moreover, the managerial power approach would suggest that resetting would be most common in situations where the CEO has the greatest influence over the board, such as when most of the board is appointed after the CEO takes office. But a recent study suggests exactly the opposite—the more board members appointed after the CEO takes office, the less likely the firm is to reset options. [223] This may be because directors who owe their appointment to the CEO are more sensitive about the appearance of self-dealing than other directors. Whatever the reason, it directly conflicts with the premises of the managerial power approach.

3. Freedom to Unwind Incentives

Two more features that Bebchuk, Fried, and Walker find consistent with the managerial power approach and inconsistent with optimal contracting are the freedoms that CEOs have to (i) unwind their incentive packages by exercising their options and selling their stock, and (ii) use financial instruments to hedge their investments. There is substantial evidence that this is done routinely; some companies even cut out the middleman and simply pay employees the difference between the market price and the exercise price. If options are designed to make CEOs behave like owners, goes the argument, then permitting CEOs to sell their shares

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[221] *See id.* at 12-13.

[222] Note that the opposite is not necessarily true. That some CEOs do not participate in resets suggests that the particular parties do not believe that those CEOs need resets to be motivated. But this does not imply that resets have no motivational value; some CEOs may be motivated by them while others are not.

[223] *See* Timothy G. Pollock et al., *The Role of Politics in Repricing Executive Options*, ACAD. MGMT. J. 1,8, 16-17 (forthcoming 2001), *available at* http://www.bus.wisc. edu/research/ hfischer/ AMJ%20final%20version.pdf.

after they vest (or hedge the risk through various financial devices) undercuts the motivational aspect of the options. Murphy suggests that the extent of this unwinding is probably "overstated,"[224] but it is certainly common.

The point of granting stock options is to make managers think like owners. It is not clear, however, that permitting CEOs to sell their shares makes them different from all other shareholders, who always have the power to sell their shares. Bebchuk, Fried, and Walker note that, in a sampling of forty large companies, the average exercise period for options with a 10-year expiration is 5.8 years,[225] and CEOs do not normally exercise in-the-money options immediately on vesting.[226] Indeed, it is likely that the vesting period for the options received by the average CEO will be longer than the period the average owner has held the stock.[227] CEOs who intend to sell options as soon as they vest have an incentive to boost the business in the short and medium terms, which aligns the CEO's interest with that of investors who own the stock for the short or medium term. CEOs who hold options for a very long time may be aligned with long-term investors, but that is likely to be only a small subset of the firm's owners. CEOs who regularly receive and subsequently sell options may be more similar to most of their investors than CEOs who hold stock for twenty years.

The problem with the managerial power approach of unwinding is already getting familiar; it focuses on the interests of the shareholders rather than the mutual interests of the parties. Bebchuk, Fried, and Walker note that if the CEO is free to sell the options, and does, shareholders must either grant new options, which costs more money, or face the fact that the CEO has lower incentives.[228] This is certainly true, but this benefit to the shareholders imposes significant costs on the CEO. Bebchuk, Fried, and Walker recognize this cost, but nevertheless conclude that:

> [t]here is no reason to assume that the optimal contract would always give the executive the ability to unwind options and

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[224]Murphy, *supra* note 25, at 865.

[225]Bebchuk et al., *supra* note 12, at 827 (citing Jennifer N. Carpenter, *The Exercise and Valuation of Executive Stock Options*, 48 J. FIN. ECON. 127, 139 (1998)).

[226]*Id.* at 827 n.186 (citing Kathy B. Ruxton, *Executive Pay, 1998: Chief Executive Officer Compensation at S&P Super 1,500 Companies as Reported in 1998*, at 16 (Investor Responsibility Research Center 1999)).

[227]*See* FREDERICK F. REICHHELD & THOMAS TEAL, THE LOYALTY EFFECT—THE HIDDEN FORCE BEHIND GROWTH, PROFITS, AND LASTING VALUE 24 (1996). It has been estimated that half of the shareholders of an average public firm turn over every year.

[228]Bebchuk et al., *supra* note 12, at 826.

> restricted stock as soon as they vest. Nevertheless, we observe virtually no attempts by firms to prevent executives from unwinding options and restricted shares immediately after they have vested.[229]

A fundamental problem with this argument is the assumption that it is optimal in some cases to have options vested but not exercisable. But Bebchuk, Fried, and Walker do not elaborate on this. Vested but unexercisable options are of limited value to the risk-averse CEO, who cannot cash in when the price is high, but who stands to lose them all if the price drops. If the goal is to require the CEO to create incentives for future performance, options obviously need to be held for some period. But that is precisely what vesting schedules already do. It is hard to see why a CEO would work harder to increase the stock price for a vested option, unexercisable for two years, than he or she would for an unvested option that will vest in two years and be immediately exercisable. The additional motivation provided in the former situation seems trivial.

Interestingly, the managerial power approach proves too much. If CEO greed is the driving factor and CEO dominance dictates the outcome, why are there vesting schedules at all? Why doesn't the CEO simply issue himself or herself fully vested options that are immediately exercisable? This would be much more to the CEO's advantage, both because the options will already have vested in the event he or she is fired, and because it permits the CEO, like every other investor, to take advantage of very short term spikes in the firm's price.

Moreover, various types of hedging portions of the CEO's shareholdings may actually bring the CEO's interests into closer alignment with shareholders and save money for the firm. An "undiversified manager," such as a CEO who has the bulk of his or her investment in the firm, "is exposed to the total volatility of the firm, whereas [the normal] diversified investors bear only the . . . firm's [systematic] risk."[230] This imposes substantial costs on the CEO, which can be ameliorated by use of the sort of financial engineering mechanisms that Bebchuk, Fried, and Walker identify.[231] If the CEO cannot offload some of this risk, the firm will have to pay more to compensate the CEO for those additional costs. It may well be in the firm's interest to allow managers to engage in such activities as a means of lowering compensation costs.

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[229] *Id.* at 826-27.

[230] Meulbroek, *supra* note 207, at 2-3.

[231] *See id.* at 28.

4. Differences Between Executives With More or Less Power

Bebchuk, Fried, and Walker find that CEOs who exercise more power within their firms receive higher compensation than those who exercise less power. If true, this is a major finding that buttresses the managerial power approach. Evidence of this is decidedly mixed, however, and requires us to draw some questionable inferences from what evidence there is. Bebchuk, Fried, and Walker here lump together several different bits of evidence upon which they base their claims.

Anti-takeover protections. CEOs in companies with anti-takeover provisions, it is said, earn more than those in firms without such provisions.[232] Because it is axiomatic that anti-takeover provisions in a firm entrench incumbent management, Bebchuk, Fried, and Walker conclude that this fact supports the managerial power approach.[233] But this does not follow. The evidence on the impact of anti-takeover devices on compensation is actually mixed, with some studies finding that CEO compensation becomes more performance-based *after* adoption,[234] which is inconsistent with the managerial power thesis. Given that greedy CEOs are (as Bebchuk, Fried, and Walker acknowledge) more than capable of extracting extremely lucrative golden parachutes in the event of a takeover,[235] and the presence of anti-takeover devices themselves add fuel to potential shareholder outrage,[236] the managerial power approach does not seem to give us any particular reason to believe that executives should prefer such devices.

Larger boards. CEO compensation, argue Bebchuk, Fried, and Walker, is higher in firms with larger boards. At first blush this would seem to contradict the managerial power approach, because conventional wisdom suggests that the smaller board is more likely to be dominated by insiders. Bebchuk, Fried, and Walker come to the opposite conclusion by theorizing that larger boards are "less cohesive" and thus less capable of

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[232] *See* Bebchuk et al., *supra* note 12, at 837-38 (citing Kenneth A. Borokhovich et al., *CEO Contracting and Anti-Takeover Amendments*, 52 J. FIN. 1495, 1503-13 (1997)).

[233] Bebchuk et al., *supra* note 12, at 837-38.

[234] *See* John C. Coates, IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 307 (2000) (concluding that conflicting evidence "should make one cautious about concluding that actual pills do influence compensation decisions").

[235] Bebchuk et al., *supra* note 12, at 834 (noting that "golden parachutes and similar arrangements [may be] driven by optimal contracting or managerial opportunism").

[236] Shareholder anger at poison pills in the 1980s was a major factor in sparking the shareholder activist movement in the first place. *See* James Kristie, *The Institutional Investor Richard Koppes: "It took companies a while to figure out we were not going away."; A Life in Governance*, DIRECTORS & BOARDS, Fall 2001, at 30.

standing up to the CEO.[237] But to the extent they are correct that larger boards are less cohesive, CEOs should be less able to achieve the kind of sycophantic harmony that the managerial power approach describes. Indeed, Bebchuk, Fried, and Walker appear to be rationalizing here; if a study had come up with the opposite result, the theory would likely explain that smaller boards are easier for the CEO to dominate.

Older and more experienced directors. Compensation is higher in firms whose outside directors are older and serve on five or more boards.[238] Again, this seems to contradict the managerial power approach, because independence should increase with age, experience, contacts outside the firm, and the availability of multiple income sources. Bebchuk, Fried, and Walker suggest that it is, on the contrary, consistent with the managerial power approach because such directors are "likely to be relatively distracted." Again, this is a rationalization. After all, if a study found that compensation is higher in firms whose directors were young, relatively inexperienced, and served on few other boards, the obvious conclusion would be that such weak directors are easier for the CEO to dominate.

CEO tenure and role on the board. Compensation is higher for executives with longer tenure and for those who also chair the board.[239] This finding is fully consistent with the managerial power approach. But there are some problems: First, an executive who performs the roles of CEO and chair probably should be paid more than a CEO who does not perform two jobs. Second, the number of directors appointed by the CEO probably correlates fairly well with the length of the CEO's tenure. Additionally, the length of that tenure probably correlates fairly well with the CEO's (or the firm's) success. Thus, all things being equal, we would expect longer-tenured CEOs to receive more than those who have been in office less time, even absent the dominance effect.

Directors appointed by the CEO. CEO compensation is higher in firms whose boards contain more directors who were appointed by the CEO.[240] Again, this is consistent with the managerial power approach. The same difficulty noted above arises, however, because the ability of the CEO to appoint directors is most likely correlated with the CEO's success. Moreover, there is evidence that points to the opposite conclusion. As noted above, (1) directors appointed after the CEO takes office are less likely to re-price CEO options than are those who predate the CEO and

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[237]Bebchuk et al., *supra* note 12, at 838.

[238]*Id*. at 838.

[239]*Id*. at 838-39.

[240]Bebchuk et al., *supra* note 12, at 838.

presumably helped select him or her,[241] and (2) new hires into CEO positions tend to be paid more than the incumbents they replace.[242] Each of those findings is precisely the opposite of what the managerial power approach would predict.

CEO stock ownership. CEO compensation, say Bebchuk, Fried, and Walker, is higher in firms where the CEO owns a large block of the stock.[243] Though unclear, this finding suggests that increasing CEO ownership of a firm does not increase the alignment of the CEO's interests with those of the shareholders, but rather increases the likelihood that the CEO will profit at shareholder expense. (That implies that permitting CEOs to unwind options, a practice that Bebchuk, Fried, and Walker find puzzling, may be in the shareholders' interest because it reduces CEO power.) There are other reasons to suspect that some of this correlation may be benign. CEOs who own large blocks of stock are likely to be entrepreneurs/founders/CEOs whose importance to the firm is much greater than the importance of any ordinary executive.[244] Regardless, it is fair to say that this finding provides the most direct support for the claim that the CEO may be exercising undue influence over the board.

Presence of institutional investors. Executive compensation will be lower and more performance-sensitive as the level of institutional ownership of a firm rises.[245] Bebchuk, Fried, and Walker conclude that this is because these large shareholder blocks have sufficient strength to limit the power of management. But there are three problems with this conclusion. First, there is the "chicken-and-egg" difficulty—it is hard to say whether institutional investors reduce management power, or whether institutional investors simply prefer to invest in firms with lower and more performance-based compensation. The study on which Bebchuk, Fried, and Walker rely here raises at least an inference that this may be what is happening.[246] Second, Khurana marshals a good deal of evidence that

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[241] *See* Pollock et al., *supra* note 223, at 17.

[242] Murphy, *supra* note 25, at 853-54.

[243] Bebchuk et al., *supra* note 12, at 839.

[244] A recent study that supports Bebchuk, Fried, and Walker's empirical claim notes that the CEO is the largest shareholder in 26% of publicly traded companies, and in such cases the CEO's mean ownership level is 24% of the firm. *See* Richard M. Cyert et al., *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453, 462-63 (2002).

[245] Bebchuk et al., *supra* note 12, at 839.

[246] *See* Jay C. Hartzell & Laura T. Starks, Institutional Investors and Executive Compensation 8 (2000) (unpublished working paper) (noting that 58% of mutual fund decision makers are influenced in their investment decisions by the level of CEO compensation, while 71% are favorably influenced by stock-based compensation plans), *at* http://www.stern.nyu.edu/fin/workpapers/papers00/wpa00015.html.

much of the increase in CEO compensation is due to the increasing role of large institutional shareholders, with their short-term orientation and belief in "corporate savior[s]" from outside the organization.[247] This would certainly reinforce the finding that CEO compensation will be more performance-based. But as noted previously, the more performance-based the compensation, the higher it is likely to be. Third, the managerial power approach suggests that compensation should decline as institutional ownership increases, but institutional ownership has been growing steadily since the 1950s, and rose consistently through the 1990s as CEO compensation skyrocketed.[248] There is a discrepancy in the studies that must be sorted out, but the best we can say at this point is that the role of institutional investors is unclear.

Presence of a large block holder. Bebchuk, Fried, and Walker report a number of studies that suggest an inverse relationship between CEO compensation and the size of the largest outside block of stock.[249] The larger the outside block, the lower the level of CEO compensation. Apparently, this is true regardless of whether the outside shareholder's block is controlling. Although this also suffers from the "chicken-egg" problem, it is certainly consistent with the managerial power approach.

What does it mean to put all these bits of CEO power together? Some of these findings suggest that managers abuse power to get higher pay. But that is hardly controversial. We can assume that there is some undue influence by managers without assuming it is the model that explains CEO compensation generally. Given our knowledge of how insiders manipulate firms for their own advantage, it is striking that the evidence is so weak. One study relied on by Bebchuk, Fried, and Walker shows that top executives at firms with a major outside shareholder make, on average, 5% less than those in firms that lack such a shareholder—a difference that is statistically significant but practically meaningless. If active shareholder monitoring means an average 5% difference in pay, and if (as we saw earlier) an average CEO makes $6.5 million, we are talking about $325,000. When we consider that several pieces of this evidence actually support Khurana's contrary thesis that shareholders themselves are responsible for the increases, the case for the managerial power approach is further weakened.

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[247]*See* KHURANA, *supra* note 30, at 56-61.
[248]*Id.* at 57, fig. 3.2.
[249]Bebchuk et al., *supra* note 12, at 839-40.

5. Differences Between U.S. and Foreign Firms

CEOs in the United States are paid more than CEOs in other countries.[250] Bebchuk, Fried, and Walker essentially argue that this is because (1) American CEOs have more power because shareholding in the U.S. is much more dispersed than in most other countries; and (2) foreign CEOs are more likely to have outside interests which allow them to extract rents in a way that does not seem to count as CEO compensation, such as having the firm enter into favorable transactions with other CEO-controlled entities.

The first point is problematic because if true, we should to see CEO pay decreasing as ownership becomes more concentrated. But as noted, CEO pay has climbed as ownership has become more concentrated in large institutional shareholders. The problem with the second point is that it is actually inconsistent with the managerial power approach. That approach suggests the CEO will take all that he or she can get, and there is no reason to take a lesser amount of compensation just because the CEO is in a position to make more money on the side. Bebchuk, Fried, and Walker suggest that this is because taking a lower salary "might be a cost-effective means of camouflaging the overall amount of rents that [are] being extracted."[251] But this is speculation. The argument makes sense if we postulate that foreign cultures have a lower outrage factor than the United States does. But that is in reality nothing more than a statement that foreign cultures do not value CEO performance as highly as the United States does. If that is the case, we do not need to add the managerial power approach to our explanation—we need merely say that the value of CEOs varies from culture to culture.

V. CONCLUSION

Some CEOs have a great deal of control over their firm's compensation-setting processes. Their compensation may well be unduly influenced by that control, and shareholders may well suffer. Self-dealing is always a possibility in firms, and experience plainly shows that corporate insiders engage in self-dealing at the expense of shareholders. To the extent the managerial power approach draws attention to this factor, it is useful.

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[250] *Id.* at 842 (citing John M. Abowd & Michael L. Bognanno, *International Differences in Executive and Managerial Compensation*, *in* DIFFERENCES AND CHANGES IN WAGE STRUCTURES 70-72 (R. Freeman & L. Katz eds., 1995); Murphy, *supra* note 25, at 866.

[251] Bebchuk et al., *supra* note 12, at 844-45.

It is one thing, however, to say undue influence and self-dealing play a role in the process, and quite another to declare them the primary drivers of the system. There are too many factors at play. A model that uses as its primary variables greed and fear of publicity cannot accurately account for the myriad features we see in the world of CEO compensation.

Ultimately, any good explanation of CEO compensation must deal with the factors discussed here: the serious uncertainty and cognitive limitations that surround compensation decisions, the special dynamics of the bargaining in the course of an ongoing relationship, and the bargaining power inherent in the CEO's position. It will also need to look beyond the confines of the boardroom at the larger social currents whose whorls and eddies affect our perceptions of CEO value.