Tackling the Managerial Power Problem

The Key to Improving Executive Compensation

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Executive pay continues to attract much attention from investors, financial economists, regulators, the media, and the public at large. The dominant paradigm for economists' study of executive compensation has long been that pay arrangements are the product of arm's-length bargaining—bargaining between executives attempting to get the best possible deal for themselves and boards seeking only to serve shareholder interests. According to this "official story," directors can be counted on to act as guardians of shareholders' interests. This assumption has also been the basis for corporate rules governing compensation in publicly traded firms.

But the actual pay-setting process has deviated far from this arm's-length model. Managerial power and influence have played a key role in shaping the amount and structure of executive compensation. Directors have had various economic incentives to support, or at least go along with, arrangements favorable to the company's top executives. Collegiality, team spirit, a natural desire to avoid conflict within the board, and sometimes friendship and loyalty have also pulled board members in that direction. Although many directors own shares in their firms, their financial incentives to avoid arrangements favorable to executives have been too weak to induce them to take the personally costly, or at the very least unpleasant, route of haggling with their CEOs.

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The inability or unwillingness of directors to bargain at arm's length has enabled executives to obtain pay that is higher and more decoupled from performance than would be expected under arm's-length bargaining. Indeed, there is a substantial body of evidence indicating that pay has been higher, or less sensitive to performance, when executives have more power over directors. Executives have less power over directors when shareholders are larger or more sophisticated and thus can more easily exert influence over the board. Not surprisingly, executive pay is lower and better tied to performance when there is a large outside shareholder or a greater concentration of institutional owners. Conversely, executive pay increases significantly after the adoption of anti-takeover provisions that give managers more power. Executive pay is also higher when the compensation committee chair has been appointed under the current CEO and may feel some obligation or gratitude toward that CEO.

One of the main constraints on executives' ability to extract even more value from boards is fear of shareholder outrage. Boards thus aggressively "camouflage" the amount and performance-insensitivity of executive pay in an attempt to reduce such outrage. Before 1992, for example, firms were required to disclose executive pay but were not told how they had to disclose it. Many firms thus chose to provide shareholders with long, dense narratives in which any dollar amounts were spelled out rather than expressed in numbers. A shareholder would need to spend a considerable amount of time just to find the dollar amounts, and there was generally not enough information provided to accurately add up the executive's total compensation. In 1992, the SEC required firms to disclose most compensation elements in a standardized, easy-to-read "Summary Compensation Table." Firms responded to the new disclosure requirements by coming up with pay arrangements, such as Supplemental Executive Retirement Plans (SERPs), that did not have to be reported in the table. In 2006, the SEC revised disclosure requirements to better capture the value of such "stealth compensation." But history has shown that compensation designers will try to develop other schemes to deliver pay to executives under shareholders' radar screens.

The desire to camouflage executive pay can explain the widespread practice of backdating executives' option grants, which came to light a few years ago. Most firms grant options to executives that are at-the-money: the exercise price is set to the grant-date stock price. The executive profits to the extent that the sale-date stock price exceeds the exercise price. It turns out that thousands of firms covertly backdated option grants to dates when the stock price was lower. This backdating secretly lowered the exercise price on executives' stock options and boosted the value of their option grants. Backdating also enabled firms to report lower compensation for executives than they actually received.

The existing flaws in compensation arrangements impose substantial costs on shareholders. First, there is the excess pay that managers receive as a result of their power—that is, the difference between what managers' influence enables them to obtain and what they would get under arm's-length contracting. The excess amounts paid to executives come directly at shareholders' expense, and these amounts are not mere pocket change. Second, and perhaps more important, executives' influence leads to compensation arrangements that dilute and distort executives' incentives. In particular, the decoupling of pay from performance reduces executives' incentives to make value-creating decisions and may even lead them to take steps that generate short-term gains at the expense of long-term shareholder value. In our view, the reduction in shareholder value caused by these inefficiencies—rather than that caused by excessive managerial pay—could well be the biggest cost arising from managerial influence over compensation.

The Need for Shareholder-Serving Directors

The problems of executive compensation arrangements are rooted in boards' failure to bargain at arm's length with executives. Greater transparency, improved board procedures, additional shareholder approval requirements, and a better understand-

ing by shareholders of the desirability of various compensation arrangements can all help improve the situation. But these remedies cannot substitute completely for effective decision making by directors striving to serve shareholder interests.

The problems of executive compensation would be best addressed by improving directors' incentives. We need to turn the "official story" of executive compensation and board governance—which portrays directors as faithfully serving shareholders' interests—from fiction into reality.

Directors who safeguard shareholder interests are needed not only to address executive compensation problems but also to tackle the myriad corporate governance problems that would continue to arise even if compensation arrangements were optimized. For example, having such directors is essential for our ability to rely on boards to prevent managers from engaging in empire building or from impeding acquisition offers that would benefit shareholders. The foundation of our board-monitoring system of corporate governance is the existence of directors who select, supervise, and compensate executives with shareholders' interests in mind. Shareholders' ability to rely on such directors is, so to speak, the Archimedean point on which this system stands. The critical question, then, is how to make directors more focused on shareholder interests.

The Limits of Director Independence

The main way that the corporate governance system has responded to perceived governance problems over the years is by trying to bolster board independence. Reforms have sought to make nominally independent directors more independent and expand the presence and role of such independent directors on the board. Strengthened director independence is now widely believed to be key to the effectiveness of the board-monitoring model. Attributing past governance problems to insufficient director independence, many believe that strengthened independence will prevent such governance problems in the future.

We agree that director independence is likely to be beneficial. But director independence cannot by itself ensure that boards properly carry out their critical role. Rules governing director independence cannot deliver nearly as much as their enthusiastic supporters claim.

A fundamental limitation of independence requirements is that they fail to provide affirmative incentives for directors to enhance shareholder value. These requirements merely reduce, and do not fully eliminate, directors' incentives and inclinations to favor executives. Thus, any residual tendency among directors to favor executives may still have a substantial impact in the absence of any countervailing incentives to enhance shareholder value. What we need, then, is to provide directors with *affirmative* incentives to focus on shareholder interests.

Invigorating Corporate Elections

In our view, the most effective way to improve board performance is to increase the power of shareholders vis-à-vis directors. We should make directors not only more independent from executives but also less independent from shareholders. The appointment of directors should substantially depend on shareholders, not only in theory but in practice. Such dependence would give directors better incentives to serve shareholder interests.

Making directors dependent on shareholders could counter some of the factors that incline directors to pursue their own interests or those of executives rather than those of shareholders. Such dependence could make the desire for re-election a positive force rather than a negative one. It could also provide directors with an incentive to develop reputations for serving shareholders. And lastly, it could help instill in directors a sense of loyalty toward shareholders, especially if institutional investors take an active role in putting directors on boards.

For all of these reasons, we support the removal of barriers that have historically insulated directors from shareholders. Because of shareholders' collective action problems, increasing shareholder power vis-à-vis directors would hardly be a perfect solution. But movement in this direction has substantial potential for improving the incentives and performance of boards.

Shareholders' power to replace directors plays a critical role in the corporation. Although this power is not supposed to be used routinely, it should provide a critical fail-safe. "If the shareholders are displeased with the action of their elected representatives," emphasized the Delaware Supreme Court in its well-known opinion in the case of *Unocal Corp. v. Mesa Petroleum Co.*, "the powers of corporate democracy are at their disposal to turn the board out."

In reality, however, this safety valve is weak. Attempts by shareholders to replace incumbents with a team that would do a better job—the kind of action referred to in the *Unocal* opinion above—face considerable impediments. To make directors more focused on shareholder interests, it would be desirable to reduce these impediments.

To begin, shareholders should get access to the corporate ballot. Under existing rules, only incumbents' nominees are placed on the corporate ballot, and outside challengers have to bear the costs of distributing and collecting proxies supporting challengers' nominees. When a significant group of shareholders wishes to run a candidate, this candidate should simply be placed on the corporate ballot.

Beyond providing shareholders with easier access to the corporate ballot, additional measures to strengthen electoral threats

should be adopted. Under existing rules of corporate law, incumbents' "campaign" costs are fully covered by the company—providing them with a great advantage over outside candidates, who must pay their own way. To lower the financial barrier for challengers, companies should be required to reimburse reasonable costs incurred by such nominees when they garner sufficient support in the ultimate vote.

Such reimbursement arrangements could be opposed, of course, on grounds that they would be costly to shareholders. But an improved corporate elections process would be in the interests of both companies and shareholders. The proposed measures would not expend corporate resources on nominees whose initial support and chances of winning are negligible; the limited amounts expended on serious challenges would be a small and worthwhile price to pay for an improved system of corporate governance.

Incumbent directors are currently protected from removal not only by the substantial cost to challengers of putting forward a competing slate, but also by staggered boards. In a staggered board, only one-third of the members come up for election each year. As a result, no matter how dissatisfied shareholders are, they must prevail in two annual elections in order to replace a majority of the incumbents and take control away from current management. A substantial fraction of public companies have such an arrangement.

The entrenching effect of staggered boards is costly to shareholders. Companies with a charter-based staggered board have a significantly lower value than other companies, controlling for relevant differences. Legal reforms that would require or encourage firms to have all directors stand for election together could thus contribute significantly to shareholder wealth.

Another way to reduce directors' ability to ignore shareholder interests is to remove the board's veto power over changes to the company's basic governance arrangements. These arrangements are set forth either in the rules of the state in which the company is incorporated or in the company's charter. Under longstanding corporate law, only the board—not a group of shareholders, however large—can initiate and bring to a shareholder vote a proposal to change the state of incorporation or to amend the corporate charter.

Federal securities laws give shareholders the power to express their sentiments in precatory shareholder resolutions, but these resolutions are nonbinding. In recent years, shareholders of companies with staggered boards have increasingly initiated proposals recommending annual election of all directors. However, boards often choose to ignore these proposals, even when they attract a majority of the shareholder vote.

Directors' control over the corporate agenda is often justified on grounds that the U.S. corporation is a completely "representative democracy," in which shareholders can act only through their representatives, the directors. In theory, if shareholders could easily replace directors, that power would be sufficient to induce directors not to stray from shareholders' wishes on major corporate issues.

As we have seen, however, the removal of directors is rather difficult under existing arrangements. It would be far from easy even under a reformed system of corporate elections. Furthermore, shareholders may be pleased with management's general performance but still wish to put in place governance arrangements that restrict management's power or discretion in certain ways. Shareholders should be able to make a change in governance arrangements without concurrently having to replace the board.

The absence of shareholder power to initiate and approve changes in firms' basic corporate governance arrangements has, over time, tilted these arrangements excessively in management's favor. As new issues and circumstances have arisen, firms have tended to adopt charter amendments that address these changes efficiently only when the amendments were favored by management. Additionally, states seeking to attract incorporating and reincorporating firms have had incentives to give substantial weight to management preferences, even at the expense of shareholder interests.

Giving shareholders the power to initiate and approve by vote a proposal to reincorporate or to adopt a charter amendment could produce, in one bold stroke, a substantial improvement in the quality of corporate governance. Shareholder power to change governance arrangements would reduce the need for intervention from outside the firm by regulators, exchanges, or legislators.

Indeed, if shareholders had the power to set the ground rules of corporate governance, they could use it to address some of the problems we have discussed above. Shareholders could establish rules that dismantle staggered boards or invigorate director elections. Shareholders could also adopt charter amendments that improve the process by which executive pay is set or place whatever limits they deem desirable on pay arrangements.

Executive pay problems reflect underlying flaws in corporate governance. To fix these problems, the structure of corporate governance arrangements must be reformed. The power of the board and the weakness of shareholders are often viewed as an inevitable corollary of the modern corporation's widely dispersed ownership. But this weakness is partly due to the legal rules that insulate management from shareholder intervention. Changing these rules would reduce the extent to which boards can stray from shareholder interests and would much improve corporate governance—including flawed executive pay arrangements.

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