

# EXPLAINING PAY WITHOUT PERFORMANCE: THE TOURNAMENT ALTERNATIVE

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## INTRODUCTION

After only a brief hiatus in the wake of the stock market downturn of 2000, Chief Executive Officer (CEO) pay levels have resumed their upward trajectory.<sup>1</sup> In response, many influential shareholders and academics are asking the question: Are the executive compensation arrangements we observe examples of optimal contracting between CEOs and the boards of directors of the firms they manage, according to which executives are rewarded for enhancing shareholder value? Or do such arrangements indicate a corporate governance failure, whereby CEOs exercise so much influence over boards that managers are effectively setting their own pay?

The foregoing accounts—“optimal contracting” and “managerial power,” respectively—dominate current explanations of how executive pay is structured. In this Article, I demonstrate that neither explains adequately observed executive pay arrangements. Instead, I turn to the paradigm of tournament theory—in which CEO pay is a prize awarded to the winner of a competition to get to the top of the corporate ladder—to illuminate the structure of executive pay. Introducing tournament theory into the mix of how firms motivate their CEOs can explain features of CEO pay that are either inconsistent with, or deemed inefficient by, competing theories. Because one’s view of how executive pay arrangements should be designed has significant implications for our assessment of actual executive pay practices, I argue that we should consider the role that tournaments can play in motivating executives before undertaking reforms in the executive pay arena.

“Optimal contracting theory,” in which boards of directors are assumed to be designing pay-for-performance contracts to align the interests of managers with those of shareholders, remains the dominant lens through which executive pay arrangements are analyzed. Observed executive pay contracting fails, however, to conform to the optimal contracting model. Rather than linking compensation to performance, pay arrangements for executives do not reveal a statistically significant relationship between the two. This anomaly has puzzled scholars in the executive compensation area and generated a vigorous debate over “pay without performance.”

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<sup>1</sup> See Claudia H. Deutsch, *My Big Fat C.E.O. Paycheck*, N.Y. TIMES, Apr. 3, 2005, § 3 at 1 (reporting a twelve percent increase in average CEO pay from 2003 to 2004).

The leading response to optimal contracting theory, the “managerial power approach,” espoused most recently by Lucian Bebchuk and Jesse Fried,<sup>2</sup> contends that optimal contracting theory is the appropriate framework for understanding the structure of executive compensation, but that its weak predictive power arises from a corporate governance failure—namely, the capture of boards of directors by CEOs. Accordingly, proponents of the managerial power theory contend that corporate governance measures that would make boards less dependent on managers and more dependent on shareholders will produce more “pay for performance.”

This Article takes a different approach. It argues that boards of directors of U.S. corporations may be employing a more complicated model than a pure pay-for-performance approach for compensating CEOs—namely, one that incorporates tournament theory.<sup>3</sup> According to the tournament model, compensation is not a variable reward that increases directly with absolute performance. Instead, it is designed to motivate employees to compete for promotions by providing positive wage spreads between each level of the organizational hierarchy and the next higher level.

Until now, tournament theory has been invoked primarily as an explanation for large differentials between the pay of CEOs and second-level managers. This Article contends that, in addition to explaining such gaps in pay *levels*, tournament theory provides a potentially useful scheme for *structuring* executive compensation. If this is correct, then we should expect there to be only a weak link between CEO pay and performance for reasons that are unrelated to managerial power. Moreover, corporate governance prescriptions advocated by managerial power theorists, which focus on reallocating decisionmaking authority away from boards and toward shareholders, would be misguided.

This Article proceeds as follows. Part I reviews the dominant optimal contracting model of executive compensation and the predictions for executive pay practices that it generates. It then discusses the inconsistencies between the model’s predictions and real-world observations. As Part I demonstrates, there is a substantial divergence between the two.

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<sup>2</sup> LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) [hereinafter BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE].

<sup>3</sup> Even if boards are not deliberately conducting promotion tournaments, actual executive pay practices may create “accidental tournaments” which motivate executives. I thank Jesse Fried for this suggestion.

Numerous scholars have attempted to explain the failure of the optimal contracting model to describe executive compensation arrangements. Part II focuses on the most prominent of these, the managerial power theory, which contends that executive compensation contracts do not exhibit a strong link between pay and performance largely because boards of directors are not in fact bargaining with managers at arm's length to maximize shareholder value. Rather, they are systematically favoring managers, who exert undue influence over directors through a variety of mechanisms. Part II argues that theoretical weaknesses of the managerial power approach and empirical inconsistencies make it unsatisfying.

Part III.A turns to tournament theory to explain why we might observe a weak relationship between executive pay and performance. According to tournament theory, CEO pay is a prize awarded to the winner of a contest among all lower-level managers. It is determined not necessarily to reflect the CEO's productivity as the top executive of the firm, but rather to elicit appropriate performance from all other individuals vying for that position. To be sure, a number of objections can be leveled at tournament theory, and Part III.A addresses these. It also reviews the empirical testing that has been conducted on tournament models and suggests avenues for further empirical research. Based on the available evidence, Part III.A contends that tournaments can be a valuable component of executive compensation design.

Part III.B addresses the corporate governance prescriptions of the managerial power theory, which focus on increasing the power of shareholders relative to boards of directors. It contends that we should be cautious before adopting policy changes prescribed by the managerial power model in the corporate governance area if tournament theory helps to align executive and shareholder interests. In such circumstances, not only are these changes likely to lead to undesirable consequences with respect to compensation matters, but their effect on the balance of corporate decision-making power will, as a byproduct, have more general consequences that may be objectionable.

## I. THE OPTIMAL CONTRACTING MODEL OF EXECUTIVE COMPENSATION AND ITS SHORTCOMINGS

In the optimal contracting model of executive compensation, boards of directors negotiate compensation contracts with corporate managers designed to maximize shareholder value. Part I describes the optimal contracting model and the predictions it generates for executive compensation contracts. It then

examines whether the executive pay arrangements we observe are consistent with those predictions.

### A. *The Optimal Contracting Model and Its Predictions*

The optimal contracting model underlies most scholarship in the area of executive compensation.<sup>4</sup> According to this model, boards of directors of public corporations bargain at arm's length with executives over their pay with the goal of maximizing shareholder value.<sup>5</sup> Underlying the optimal contracting model of executive compensation is the premise, central to agency theory, that shareholders, as principals, rely on managers, as their agents, to operate publicly held corporations.<sup>6</sup> Shareholders face the problem that, unconstrained, managers may pursue their private objectives, even though this reduces shareholder value.<sup>7</sup>

The conflict of interest that gives rise to the foregoing nonalignment of interests, commonly referred to as the "agency problem," arises from the separation of ownership and control in corporations with diffuse ownership.<sup>8</sup> Because managers of such corporations generally own only a small percentage of their companies' stock, they are not forced to bear the full costs of their actions.<sup>9</sup> As a result, managers are likely to trade off the private costs of their decisions against the profits that such decisions imply at a different level than shareholders would choose.<sup>10</sup> This produces "agency costs" that reduce shareholder value.

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<sup>4</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976); see also Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778–79 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 327–28 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302–03 (1983) [hereinafter Fama & Jensen, *Separation of Ownership*]. See generally STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 26–38 (2002) (discussing various economic models of business organizations); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 9–10 (1991) (discussing mechanisms for addressing the agency problem between managers and shareholders).

<sup>5</sup> See generally Jensen & Meckling, *supra* note 4, at 307–10 (providing a seminal analysis of agency costs and the theory of the firm).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 64–65 (1968).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

Because it is impractical to monitor directly the behavior of managers, contracts with managers cannot specify fully every action that managers should take. A more practical way for shareholders to control managerial behavior is through incentive contracts. Incentive contracts can condition managers' financial rewards on the creation of value for shareholders by making managers' pay depend on some measure of performance that shareholders can observe. In this way, managers can be made to bear the costs, and enjoy the benefits to shareholders, of their actions.

While incentive compensation contracts induce managers to act more closely in the interests of shareholders than compensating managers without reference to their performance, such contracts expose managers to risk by conditioning their pay on measures of performance that are not fully within their control. Requiring managers to bear this risk in their compensation arrangements involves a cost. This cost arises because risk-averse managers must be paid a premium in exchange for accepting an element of risk as part of their compensation.<sup>11</sup> Moreover, because company executives are inherently undiversified, with their physical and human capital invested disproportionately in their companies, the risk premium they charge will exceed that assessed by the financial capital markets.<sup>12</sup> This phenomenon creates a "wedge" between the cost to shareholders of paying risky compensation and the value that executives place on it.<sup>13</sup> Firms that use incentive contracts expect to recoup the amount of this wedge in the form of enhanced managerial performance.<sup>14</sup>

According to the optimal contracting model, boards will seek to enter into efficient compensation contracts with executives. An efficient compensation

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<sup>11</sup> PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION & MANAGEMENT* 187 (1992). The amount of the risk premium is a function of a manager's risk aversion, initial wealth, and diversification. See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 12 (2002).

<sup>12</sup> See Haig R. Nalbantian, *Performance Indexing in Stock Option and Other Incentive Compensation Programs*, COMPENSATION & BENEFITS REV., Sept.–Oct. 1993, at 25, 29.

<sup>13</sup> See Lisa K. Meulbroek, *Restoring the Link Between Pay and Performance: Evaluating the Costs of Relative-Performance-Based (Indexed) Options* 3, 12 (Harvard Bus. Sch., Working Paper No. 02-021, 2001).

<sup>14</sup> Performance-based compensation is generally thought to better align the interests of managers and shareholders in two distinct ways. First, it encourages managers to commit more effort to their tasks by requiring them to internalize the costs and benefits of their actions. Second, it better aligns their interests with that of shareholders with respect to engaging in risky investments. Managers possess firm-specific human capital. Without the incentive effects of risk-based compensation, managers will seek to minimize firm-specific risk, which (unlike outside shareholders) they cannot diversify away, by underinvesting in projects that increase firm risk and overinvesting in risk-reducing activities. MICHAEL C. JENSEN, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* 144–45 (2000).

contract is one that balances the gain to shareholders from enhanced performance against the incremental compensation that managers require in order to bear risk.<sup>15</sup> In the optimal contracting model of executive compensation, boards are presumed to structure compensation contracts that maximize shareholder value.<sup>16</sup>

The optimal contracting model yields important implications for designing executive compensation contracts. One of its implications is that, as the pay-performance sensitivity—that is, the link between executive pay and shareholder wealth—strengthens, the alignment of interests between executives and shareholders increases.<sup>17</sup> For example, suppose that a CEO is considering pursuing a “pet project” that she values personally at \$100,000, but that will lower the value of her firm’s equity by \$10 million. The CEO will reject the project if the pay-performance sensitivity of her compensation contract exceeds .01 (i.e., for every \$1000 change in equity value, the value of the CEO’s compensation package changes by \$10) but will pursue the project if it is less than .01. In other words, the more closely a manager’s fortunes are tied to those of shareholders, the more their respective interests converge.

The optimal contracting model also implies that the measure of performance on which executive pay depends should be as informative as possible about managerial behavior.<sup>18</sup> Managerial actions are not always observable. Because of this, a measurable proxy for those actions must be selected. The more the selected proxy reflects events over which the executive has no control, the more error there will be in setting the executive’s compensation.<sup>19</sup> Such error increases the riskiness to the executive of the compensation package. The more randomness a compensation formula incorporates in measuring an executive’s performance, the higher the discount the executive will apply when valuing his compensation, and the more total compensation he will demand.<sup>20</sup>

Once an efficient compensation contract is in place, the optimal contracting model predicts that it generally should not be renegotiated. In the context of

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<sup>15</sup> See Stephen A. Ross, *The Economic Theory of Agency: The Principal’s Problem*, 63 AM. ECON. REV. 134, 135 (1973).

<sup>16</sup> See MILGROM & ROBERTS, *supra* note 11, at 217–18.

<sup>17</sup> Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 227–28 (1990).

<sup>18</sup> Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 84–88 (1979).

<sup>19</sup> See MILGROM & ROBERTS, *supra* note 11, at 207.

<sup>20</sup> See *id.*

conventional stock options, this model implies that the option's exercise price should not be reset if the stock price falls below it. Doing so not only weakens the link between pay and performance but also rewards poor performance.

Thus, the optimal contracting model yields clear predictions about executive compensation contracts. First, it predicts that we will observe a meaningful link between pay and performance, so that improved firm performance will translate into substantial private gain to executives. Second, it predicts that compensation will reflect executives' real contributions to corporate performance, rather than factors influencing stock performance over which executives have no control. Finally, it predicts that exercise prices of stock options should generally not be lowered when stock prices fall. And yet, as the following section illustrates, we have not typically observed these features in executive pay design.

### *B. Observed Departures from the Optimal Contracting Model*

Despite the prediction under the optimal contracting model that efficient compensation contracts should link pay to performance to reduce agency costs, executive pay arrangements have been largely performance insensitive. This has occurred despite a substantial increase in the equity-based proportion of executive compensation over the last fifteen years. As this section explains, the foregoing puzzle can be explained largely by (1) the use of equity-based instruments to tie the compensation of executives to the stock market performance of their firms, whether such performance results from CEO actions or exogenous events, and (2) insulation of executives from downward movements in equity value through option repricing.

#### *1. Weak Pay-Performance Sensitivity*

In 1990, finance theorists Michael Jensen and Kevin Murphy sounded an alarm over weak pay-performance sensitivities among U.S. CEOs.<sup>21</sup> In their influential article in the *Journal of Political Economy*, Jensen and Murphy estimated the overall pay-performance sensitivity for CEOs, including performance-based bonuses and salary revisions, stock options, and performance-based dismissal decisions, to be about \$3.25 per \$1000 change in shareholder wealth.<sup>22</sup> Thus, the pay-performance sensitivity for CEOs at the time was about .325%.

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<sup>21</sup> Jensen & Murphy, *supra* note 17, at 225.

<sup>22</sup> *Id.* at 226–27.

Jensen and Murphy argued that their results were “inconsistent with the implications of formal agency models of optimal contracting,”<sup>23</sup> which call for incentive pay to play an important role in compensation arrangements.<sup>24</sup> Although the empirical evidence presented in their paper showed that CEO pay was positively and statistically related to changes in shareholder value, the magnitude appeared to Jensen and Murphy to be too small to have any appreciable effect on managerial behavior.<sup>25</sup>

Even more pointed were the empirical results that Jensen and Murphy obtained when they filtered out industry-wide and market-wide factors beyond the control of executives.<sup>26</sup> Such filtering provided results measuring the pay-performance sensitivity of CEOs’ real contributions to firm value, free of external factors.<sup>27</sup> In these tests, there was no statistically significant relationship between pay and performance at all.<sup>28</sup>

Jensen and Murphy’s results led them to conclude that the “general absence of management incentives in public corporations presents a challenge for social scientists and compensation practitioners.”<sup>29</sup> Reacting to relatively low pay-performance sensitivity for CEOs, institutional shareholders pressed companies to tie CEO pay more closely to firm performance.<sup>30</sup> Companies responded in the 1990s with an unprecedented increase in the use of stock options in the vast majority of executive compensation packages.<sup>31</sup>

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<sup>23</sup> *Id.* at 227.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 243.

<sup>26</sup> *Id.* at 246–47.

<sup>27</sup> See *supra* notes 36–42 and accompanying text.

<sup>28</sup> Jensen & Murphy, *supra* note 17, at 247.

<sup>29</sup> *Id.* at 262.

<sup>30</sup> See Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 51 (2003) (identifying key shareholder groups calling for performance-based pay in the early 1990s); Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1888 (2001) (noting that the rise in the use of stock options to compensate executives was a response to investors’ insistence that pay be more sensitive to performance); Kevin J. Murphy, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS 2485, 2525 (Orley Ashenfelter & David Card eds., 1999).

<sup>31</sup> Estimates vary as to the precise significance of stock options as a component of total executive compensation, but experts agree that, beginning in the early 1990s, stock options became an increasingly important component of executive compensation. See, e.g., Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847 (2002) (reporting that during the 1990s median total compensation of CEOs almost tripled from \$2.3 million to over \$6.5 million and that the increase in CEO pay over this period largely reflected an increase in stock options, which rose from 27% to 51% of total compensation).

Paradoxically, however, the stock option explosion of the last decade left executive compensation largely decoupled from executive performance. A study by Charles Himmelberg and R. Glenn Hubbard, for example, found an overall CEO pay-performance sensitivity of 1.87%.<sup>32</sup> This increase from Jensen and Murphy's sensitivity of about .325% found ten years earlier is not surprising given the sharp increase in stock option grants that took place during this period. But increases in the use of conventional stock options do not necessarily create powerful incentives. What is crucial to motivating managers to act in the interests of shareholders is the impact that their own performance has on their compensation. Tying an executive's pay to market or industry-wide fluctuations over which he has no control does nothing to link that executive's pay to his own managerial performance. A more accurate measure of pay-performance sensitivity from the point of view of incentive compensation design is one that eliminates these external factors. When Himmelberg and Hubbard eliminated such factors, they found an overall pay-performance sensitivity of only .39%<sup>33</sup>—about the same relationship that Jensen and Murphy criticized in their earlier study as being too weak to affect managerial behavior.<sup>34</sup>

Why, it seems fair to ask, did the widespread response by public companies over the last decade to calls for increased incentive compensation not improve managerial incentives? As the next section describes, changes in compensation structure during this period produced weak incentive effects because the primary device used to align managerial and shareholder interests—conventional stock options—is largely ineffective in doing so.

## 2. *The Near Nonexistence of Relative Performance Evaluation in Executive Compensation Arrangements*

Most executive pay packages are composed of four basic components: (1) a base salary, (2) an annual bonus tied to accounting performance, (3) long-term

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<sup>32</sup> Charles P. Himmelberg & R. Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* 19 (Oct. 8, 2000) (unpublished manuscript, available at <http://www.columbia.edu/~cph15/papers/ceo.pdf>).

<sup>33</sup> *Id.*

<sup>34</sup> See Jensen & Murphy, *supra* note 17, at 243; see also Joseph G. Haubrich, *Risk Aversion, Performance Pay, and the Principal-Agent Problem*, 102 J. POL. ECON. 258, 263–66 (1994) (noting that, in the presence of managerial risk-aversion, even low pay-performance sensitivities can provide meaningful incentives, but finding that for most plausible risk aversion parameters, meaningful pay-performance sensitivities are greater than the values observed by Jensen and Murphy).

incentive plans, and (4) stock options.<sup>35</sup> The first category, base salary, represents the fixed component of executive salaries, and is generally not considered to be an element of incentive pay.<sup>36</sup> The second component of executive pay, an annual bonus plan, awards an executive a bonus based on the achievement of a performance threshold, generally consisting of some accounting measure.<sup>37</sup> Long-term incentive plans, the third element of executive pay, include restricted stock plans and multiyear accounting-based performance plans, as well as retirement programs. Finally, conventional stock options reward executives for stock price appreciation.

Although the first three components of executive pay described above represent a substantial percentage of CEO pay, the fourth component, stock options, accounts for the majority of the pay-performance sensitivity of CEO compensation.<sup>38</sup> Conventional stock options are, however, a relatively poor way to motivate executives to act in the interest of shareholders. They, like many other forms of equity-based grants, reward managers for absolute increases in a firm's stock price. Stock options give managers the right to purchase (through the "exercise" of the option) a stipulated number of shares of the company's stock at a stated price (the "exercise" or "strike" price) over a specified period of time (the "exercise period") based on stated eligibility requirements ("vesting" requirements).<sup>39</sup> For example, suppose an executive is granted options to purchase 100,000 shares of her company's stock at an exercise price of \$20 per share that vest in equal installments over four years and that could be exercised for seven years from the grant date. Thus, each year, the executive will acquire the right to purchase 25,000 shares at \$20 per share at any time before the options expire. If, after one year, the executive exercises 25,000 options and sells the stock when the stock is trading at \$25 per share, her pretax profit is \$125,000.

Although a company's stock price may reflect the performance of its managers, there are many circumstances in which it may not. Broad macroeconomic factors, such as fluctuations in interest rates, can substantially affect stock prices.<sup>40</sup> Similarly, stock price movements may result from

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<sup>35</sup> See Murphy, *supra* note 30, at 2491.

<sup>36</sup> *Id.* at 2498.

<sup>37</sup> *Id.* at 2498–99.

<sup>38</sup> *Id.* at 2531.

<sup>39</sup> BRUCE R. ELLIG, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* 357 (2002).

<sup>40</sup> See VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 1153 (2d ed. 1979) (surmising that one-third to one-half of fluctuations in stock prices are attributable to market-wide influences).

industry-specific economic shocks, such as changes in oil prices. In each of the foregoing instances, the value of conventional stock options is affected by factors over which executives have no control.

If introducing the general market and industry-wide risks inherent in conventional stock options into executive pay were necessary to align managers' interests with those of shareholders, then the prevalence of conventional options in executive compensation packages might be understandable. Stock market prices can, however, be normalized for changes in value attributable to macroeconomic or industry-specific factors beyond managerial control.<sup>41</sup> Doing so captures firm-specific fluctuations in share price, more accurately reflecting management's role in producing them.<sup>42</sup>

Indexed options, for example, use relative performance evaluation to measure a firm's performance relative to the average performance of an index of other companies in the same industry as the firm.<sup>43</sup> Because the companies selected for inclusion in the index can be expected to face the same macroeconomic and industry-wide factors as those that face the firm, the extent to which the firm performs better or worse than the index isolates the portion of change in stock price that is firm-specific. Indexed options therefore reward executives based on managerial performance as opposed to overall company performance to a greater extent than do conventional stock options.

Returning to the example given above,<sup>44</sup> assume that an appropriate peer group of companies has been identified for the firm. Then, if the peer group's average trading price rises ten percent during the first year, the exercise price of the executive's stock options would rise to \$22 ( $\$20 + (.10) \times (\$20)$ ). If the executive exercises the 25,000 options that have vested after one year and sells the stock at its then-market price of \$25 per share, her pretax profit would be \$75,000, or \$50,000 less than in the example in which the executive was awarded conventional stock options.

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<sup>41</sup> See Haig R. Nalbantian & Wei Zheng, *Relative Performance Evaluation and the Selection of Peers*, in RESPONSIBLE EXECUTIVE COMPENSATION FOR A NEW ERA OF ACCOUNTABILITY 172 (Peter T. Chingos ed., 2004) (discussing various ways to measure relative performance).

<sup>42</sup> Meulbroek, *supra* note 13, at 3 (stating that by filtering out performance that derives from factors outside managerial control, such as industry-wide or market-wide gains or losses, relative-performance-based compensation tightens the link between managerial effort and compensation).

<sup>43</sup> See *id.* at 1.

<sup>44</sup> See *supra* notes 33–34 and accompanying text.

The optimal contracting model predicts that incentive compensation should filter out the impact of events that are exogenous to CEO decisions. This is a direct implication of the “informativeness” principle, which holds that the measure of performance on which executive pay depends should be as informative as possible about managerial behavior.<sup>45</sup> By making compensation depend on relative performance, firms can shield executives from market and industry risk for which executives demand a premium. They can therefore provide the same incentives to executives at a lower cost to the firm.<sup>46</sup>

While the theoretical case for relative performance evaluation is strong, there have been only a few empirical studies of its effectiveness. Studies that bear on how relative performance evaluation functions have been conducted at the individual level, with respect to professional sports.<sup>47</sup> Researchers studying the performance of players on the Professional Golf Association (PGA) golf tour and drivers in National Association for Stock Car Auto Racing (NASCAR) and International Motor Sports Association (IMSA) races found that the major theoretical prediction of relative performance evaluation is borne out; that is, average performance rises with stronger relative performance evaluation.<sup>48</sup> Similar results have emerged in laboratory experiments on the effects of relative performance evaluation.<sup>49</sup>

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<sup>45</sup> See *supra* note 18 and accompanying text.

<sup>46</sup> Murphy, *supra* note 30, at 2535; Nalbantian, *supra* note 12, at 26. Both conventional and indexed options provide risk-averse managers with incentives to invest in riskier, higher return projects that increase shareholder value. Saul Levmore has suggested that indexed options may encourage executives to go beyond this point and increase risk that does not increase expected returns in order to differentiate their firms' performance from that of the applicable benchmark. See Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1930–31 (2001). The potential adverse incentive effects of excessive risk-taking can, however, be mitigated by penalizing managers for such behavior. Another reason that excessive risk-taking by managers may not be a significant problem is that stock options (whether conventional or indexed) may not always encourage managers to increase the risk of the activities they undertake on behalf of the firm. In particular, once an option is in the money, introducing the potential for downside risk, a risk-averse manager will avoid increasing the risk of an option's payoff, and this effect counteracts the desirability to the manager of an increase in the option's payoff. Thus, as an option is further in the money, the manager will pursue less risky projects. See Jennifer N. Carpenter, *Does Option Compensation Increase Managerial Risk Appetite?*, 55 J. FIN. 2311, 2327 (2000); Richard A. Lambert et al., *Portfolio Considerations in Valuing Executive Compensation*, 29 J. ACCT. RES. 129, 137–38 (1991).

<sup>47</sup> See, e.g., Brian E. Becker & Mark A. Huselid, *The Incentive Effects of Tournament Compensation Systems*, 37 ADMIN. SCI. Q. 336 (1992); Ronald G. Ehrenberg & Michael L. Bognanno, *The Incentive Effects of Tournaments Revisited: Evidence from the European PGA Tour*, 43 INDUS. & LAB. REL. REV. 74-S (1990).

<sup>48</sup> Becker & Huselid, *supra* note 47, at 347; Ehrenberg & Bognanno, *supra* note 47, at 86-S.

<sup>49</sup> See, e.g., Clive Bull et al., *Tournaments and Piece Rates: An Experimental Study*, 95 J. POL. ECON. 1, 21–22 (1987); Haig R. Nalbantian & Andrew Schotter, *Productivity Under Group Incentives: An Experimental Study*, 87 AM. ECON. REV. 314, 332–33 (1997).

A test of the use of relative performance evaluation in executive compensation arrangements would ask whether, other things being equal, companies that rely on relative performance assessments to determine executive compensation outperform those that link pay to absolute performance measures. In the late 1990s, Mercer Human Resource Consulting, Inc., a leading compensation consulting firm, conducted a simple test of this proposition.<sup>50</sup> Using data from its annual top executive compensation surveys, Mercer examined performance patterns among companies that differed in the degree to which they used relative performance in determining executive pay. Companies were divided into “absolutists,” for which CEO pay tracked closely changes in stock price, and “relativists,” for which CEO pay tracked closely stock price movements relative to the Standard & Poor’s 500 Index.

The two groups separated clearly at the extremes of high and low performance. Among the high performers, relativists delivered higher returns, and among the low performers, they exhibited less pronounced losses.<sup>51</sup> Admittedly, these are only rough comparisons that do not account for the multiple factors beyond relative performance evaluation that might explain performance differences. Nevertheless, the findings add to the weight of evidence suggesting that relative performance evaluation can improve the effectiveness of rewards.

Despite strong theoretical and emerging empirical evidence that firms can benefit from incorporating some form of relative performance evaluation in incentive contracts, it is almost never a feature of executive compensation arrangements.<sup>52</sup> Instead, executives are typically rewarded based on absolute share price fluctuations. The widespread failure to provide executives with efficient incentives has led Kevin Murphy to observe that “the paucity of RPE [relative performance evaluation] in options and other components of executive compensation remains a puzzle worth understanding.”<sup>53</sup>

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<sup>50</sup> Nalbantian & Zheng, *supra* note 41, at 177.

<sup>51</sup> *Id.* at 178.

<sup>52</sup> *Id.* at 173 (noting that “few companies incorporate relative performance criteria in their stock option plans”); *see also* Meulbroek, *supra* note 13, at 38 (stating that only one U.S. firm had an indexed option plan as of the author’s 2001 publication date); Murphy, *supra* note 31, at 2537 (“Although stock options could theoretically be indexed to industry or market movements, indexed options are virtually nonexistent in practice.”).

<sup>53</sup> Murphy, *supra* note 30, at 2539.

### 3. *Undermining Precommitment Strategies Through Option Repricing*

Another prediction of the optimal contracting model that is not reflected in executive compensation practice is that once an executive compensation contract is selected, it should be renegotiated only if doing so would be efficient. In other words, renegotiation is viewed as a voluntary act that should benefit both the principal and the agent. Accordingly, we should observe renegotiation only if it becomes feasible to achieve mutual improvement relative to the original contract.

With the foregoing principle in mind, we can analyze the efficiency of repricing “underwater” stock options. An underwater stock option is an option to purchase stock at an exercise price that is above the stock’s market price.<sup>54</sup> Although a firm may award an option with any exercise price relative to the market price of the stock on the date of the grant, exercise prices for stock options are typically set at the then-current market price (“at-the-money” options).<sup>55</sup> Such at-the-money options go underwater when the market price of the underlying stock declines following the grant.

Firms with underwater stock options confront incentive and retention issues.<sup>56</sup> When stock options go underwater, the options are more likely to expire worthless.<sup>57</sup> An executive whose options are severely underwater may believe that no amount of effort will bring the options back into the money, effectively severing the link between pay and performance as to those options.<sup>58</sup> In addition, if the executive holds underwater options that remain unvested, his financial incentive to remain with his current employer diminishes.<sup>59</sup> To restore the benefits of stock options, companies often reset the exercise prices of underwater stock options to the new, lower market price of the underlying stock.<sup>60</sup>

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<sup>54</sup> Gary N. Sutton & Jeffrey P. Donohue, *Repricing Underwater Stock Options*, VENTURE CAP. J., Nov. 1, 2001, at 18, 19.

<sup>55</sup> See Hall & Murphy, *supra* note 30, at 50.

<sup>56</sup> See Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 267–68 (1999).

<sup>57</sup> See Hall & Murphy, *supra* note 30, at 58–59.

<sup>58</sup> See Viral V. Acharya et al., *On the Optimality of Resetting Executive Stock Options*, 57 J. FIN. ECON. 65, 66–67 (2000).

<sup>59</sup> See Sutton & Donohue, *supra* note 54, at 18.

<sup>60</sup> Until recently, it was common for companies simply to reduce the exercise prices, or “reprice,” stock options to preserve their value to employees. See Menachem Brenner et al., *Altering the Terms of Executive Stock Options*, 57 J. FIN. ECON. 103, 110–11 (2000). Effective July 1, 2000, however, any options that a company offered to reprice after December 15, 1998, became subject to “variable accounting,” which requires

Although repricing underwater stock options renews incentives for managers, doing so has an adverse impact on initial incentives, referred to as a “feedback” effect.<sup>61</sup> The feedback effect describes the impairment to initial incentives that results when managers no longer regard their contracts as credible. If managers suffer no consequences when a firm’s stock price falls, they are unlikely to have as strong an incentive to work to increase it when their options are initially awarded.<sup>62</sup> Perversely, managers may even have an incentive to drive down their firm’s stock price pending a possible repricing. To eliminate the negative feedback effect, the principal must precommit to an incentive contract, which rules out repricing.<sup>63</sup>

Another argument in favor of repricing is that underwater options weaken the retention power of managers’ unvested options.<sup>64</sup> When managers leave a firm, they typically forfeit their unvested options. The greater the value of such unvested holdings, the greater the incentive the manager has to stay at the firm.

The competing effects of repricing—positive “re-incentive” and retention effects, on the one hand, and a negative feedback effect, on the other hand—imply that repricing should occur only when the former effects dominate the latter effect. Although it is difficult to generalize about the competing effects, repricing should occur more frequently in settings where stock prices go underwater due more to factors beyond managerial control than to lack of managerial diligence. If poor performance is due to industry-wide or market-wide factors, then failing to reprice options penalizes executives for factors beyond their control and reduces the retention power of their unvested options. Alternatively, if poor stock price performance is due to poor managerial

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the company to “mark-to-market” all options included in the repricing offer at the end of each quarterly reporting period. As a result, instead of the compensation expense of the option being measured on the grant date, any increase in the stock price over the exercise price as of each quarterly measurement date while the option is outstanding results in a compensation expense to the company. Companies wishing to reduce the exercise prices of their options without subjecting the options to variable accounting must insert a six-month waiting period between the dates the underwater options are cancelled and the replacement options are issued. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: SHARE-BASED PAYMENT 10–11 (2004), available at <http://www.fasb.org/pdf/fas123r.pdf>. Commentators have referred to this practice as “backdoor repricing.” Brian J. Hall & Thomas A. Knox, *Managing Option Fragility* 3 (Harvard NOM, Research Paper No. 02-19, 2002), available at <http://ssrn.com/abstractid=316576>.

<sup>61</sup> See Acharya et al., *supra* note 58, at 67 (2000).

<sup>62</sup> See Li Jin & Lisa Meulbroek, *Do Underwater Executive Stock Options Still Align Incentives?: The Effect of Stock Price Movements on Managerial-Incentive Alignment* 9–10 (Harvard Bus. Sch., Working Paper 02-002, 2001).

<sup>63</sup> See Acharya et al., *supra* note 58, at 67.

<sup>64</sup> Sutton & Donohue, *supra* note 54, at 19.

performance, then repricing options eliminates a penalty for poor performance and provides perverse retention effects.

By specifying how a firm should dynamically respond to conditions that shift the degree of managerial incentive alignment on which the original contract was based, incentive contracts can minimize the negative feedback effect. P. Jane Saly has described a contracting model in which this principle is incorporated.<sup>65</sup> The model specifies how the firm will respond to two different economic environments, one normal and the other signifying an economic downturn.<sup>66</sup> If the normal state of the world occurs, the agreed-upon contract is implemented.<sup>67</sup> Otherwise, the contract is reset.<sup>68</sup> Instead of implementing such contracts, however, studies of repricing events suggest that repricing tends to occur in response to poor firm-specific performance, rather than poor overall industry or market performance.<sup>69</sup> These studies provide yet another basis for the argument that, inconsistent with the optimal contracting model, boards too often reward managers for good performance outside their control and fail to punish them for poor performance within their control.<sup>70</sup>

In addition to compensating managers in ways that exhibit weak pay-performance sensitivity, rewarding good luck rather than superior performance, and failing to penalize executives for poor performance, there are numerous other features of executive pay practices that are inconsistent with conventional principal-agent theory. These include “golden hellos,”<sup>71</sup> deferred compensation arrangements,<sup>72</sup> and substantial retirement benefits,<sup>73</sup> all of which are examples of performance-insensitive compensation. According to the optimal contracting model, such pay structures should not persist. Instead, firms should redesign their compensation contracts to pay executives in ways that reward them for enhancing shareholder wealth. The failure of executive compensation contracts to conform to predictions of the optimal contracting

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<sup>65</sup> P. Jane Saly, *Repricing Executive Stock Options in a Down Market*, 18 J. ACCT. & ECON. 325, 328–29 (1994).

<sup>66</sup> *See id.* at 328.

<sup>67</sup> *See id.*

<sup>68</sup> *See id.*

<sup>69</sup> *See* Jin & Meulbroek, *supra* note 62, at 10–11.

<sup>70</sup> *Id.* at 11.

<sup>71</sup> “Golden hellos” refer to large initial payments often used to recruit CEOs from their current positions, generally including a large cash component. *See generally* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2, at 130–31.

<sup>72</sup> *See id.* at 102–107.

<sup>73</sup> *See id.* at 95–111.

model and the resulting loss to shareholders confront us with a puzzling inconsistency between theory and practice.

## II. THE MANAGERIAL POWER RESPONSE AND ITS LIMITATIONS

The failure of the optimal contracting model to predict observed practices in executive compensation contracting has led legal scholars to explore alternative explanations of executive pay practices.<sup>74</sup> Of the competing accounts that have been offered to explain observed inefficiencies in executive compensation contracting, the managerial power theory has become the most prominent. The managerial power account of executive compensation contracting relies on managerial influence over weak boards of directors to explain inefficiencies in the structure of executive compensation contracts.<sup>75</sup> Part II describes and critiques the managerial power approach's attempt to solve the executive compensation puzzle.

### A. *The Theory*

The managerial power explanation for why we observe inefficiencies in executive compensation arrangements is that, simply put, managers exert undue influence over boards in negotiating their pay packages.<sup>76</sup> According to the managerial power approach, the absence of arm's length bargaining between the two parties results in compensation arrangements that are systematically structured to favor managers.<sup>77</sup> Adherents of this view contend that because risk-averse managers prefer guaranteed salary over risky arrangements, we observe pay structures that do not align incentives of managers and shareholders as predicted by the optimal contracting model.<sup>78</sup>

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<sup>74</sup> See, e.g., *id.* (advancing the "managerial power explanation" that managers effectively set their own compensation because of the undue influence they exert over boards of directors); Levmore, *supra* note 46 (offering a social norms explanation for the use of conventional options in managerial compensation packages); Murphy, *supra* note 30 (contending that favorable accounting treatment has misled boards to perceive the cost of conventional options as artificially low and therefore grant too many conventional stock options to executives); David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. PA. L. REV. 1941, 1942-43 (2001) (suggesting the tax deductibility of conventional options as a possible explanation for their use).

<sup>75</sup> See *infra* Part II.A.

<sup>76</sup> See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2, at 62.

<sup>77</sup> See *id.*

<sup>78</sup> See *id.* at 64.

Lucian Bebchuk and Jesse Fried, leading exponents of the managerial power explanation, illustrate the managerial power perspective in their book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*.<sup>79</sup> Assume that the board of directors of a public company is considering two pay arrangements for the company's CEO. In the first, the CEO would receive \$5 million in fixed salary. In the second, the CEO would receive the same \$5 million, but only if the firm were to meet certain performance targets. For the firm to meet these targets, the CEO would have to exert effort and make managerial decisions that are personally distasteful to him, such as firing unproductive employees, spinning off unrelated assets, or abandoning a pet project. Even though the CEO can reasonably expect to earn \$5 million under both packages, the authors argue, the CEO will use his influence in negotiations to obtain the fixed-salary contract. This maximizes the CEO's utility because it does not require the CEO to act against his personal interests. However, it does not maximize shareholder value because it gives the CEO little incentive to attain the performance targets.<sup>80</sup>

The managerial power approach to executive compensation predicts that managers will succeed systematically in structuring their pay in ways that are unrelated to performance. Their ability to do so is attributed to numerous strategic advantages that executives enjoy in the pay-setting process, including: (1) influence by CEOs over the director nomination process; (2) the ability of the CEO to direct economic benefits to board members or their favored causes; (3) social and psychological forces encouraging directors to "go along" and "get along" with management; (4) the small personal costs to directors of cooperating with management; and (5) time and informational limits on directors.<sup>81</sup>

Although, in theory, external forces could discipline managers' ability to obtain self-serving pay arrangements, proponents of the managerial power explanation conclude that they do not. In particular, managerial power theorists contend that the ability of shareholders to constrain managerial power over compensation matters through litigation, voting against stock option plans, or shareholder resolutions is limited.<sup>82</sup> Similarly, they argue that market forces, including the fear of a hostile takeover or proxy contest, do not result in

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<sup>79</sup> *See id.*

<sup>80</sup> *Id.* at 63.

<sup>81</sup> *See id.* at 23–44.

<sup>82</sup> *See id.* at 45–52.

efficient contracts because the market for corporate control is insufficiently strong.<sup>83</sup>

The only real constraint on managers' opportunism in obtaining favorable pay arrangements, according to managerial power theorists, is "outrage." Outrage refers to negative reactions by outsiders to manager-favorable compensation arrangements.<sup>84</sup> The costs that such reactions impose on managers and directors are termed "outrage costs." "When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favor."<sup>85</sup>

In the managerial power model, executives' desire to minimize outrage costs also causes them to try to obscure, or "camouflage," the level of their compensation by favoring inefficient compensation structures that harm company performance.<sup>86</sup> For example, until recently, one way for managers to obscure their compensation has been to take a substantial percentage of their salary in stock options. Stock options in the past have been given favorable accounting treatment.<sup>87</sup> A company that issued executive stock options where the number and exercise price per share of stock underlying the options were known on the grant date (subject only to the contingency that the options vest over time) had to recognize a compensation expense on its income statement equal only to the difference, if any, between the market price of the stock on the date of the grant and the option's exercise price.<sup>88</sup> The net result was that there was no charge to company earnings for "at-the-money" options. Thus, the idea of camouflage suggests that managers sought to receive in the form of stock options pay that might have provoked outrage if dispensed in some other form.<sup>89</sup>

To summarize, the managerial power explanation for why we observe executive compensation contracting that is inconsistent with the optimal contracting model is that management has captured the board of directors. The

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<sup>83</sup> See *id.* at 55–56.

<sup>84</sup> *Id.* at 65.

<sup>85</sup> *Id.*

<sup>86</sup> See *id.* at 67–68.

<sup>87</sup> See Murphy, *supra* note 31, at 859–60.

<sup>88</sup> *Id.*

<sup>89</sup> Note that explaining the inefficient use of stock options through the idea of camouflage is distinct from Murphy's "perceived cost" explanation. The perceived cost explanation for the overuse of stock options contends that boards are granting stock options based on a perceived cost that is far below their true economic cost. See *id.* at 859. In contrast, the managerial power explanation attributes such overuse to the managers' undue influence over boards. See BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2, at 147–50.

outcome of managers' influence over their own compensation arrangements results in pay structures that favor managers at the expense of shareholders. Accordingly, managerial power adherents recommend reforms designed to reduce the insulation of boards of directors from shareholders.<sup>90</sup>

### *B. Limitations of the Managerial Power Explanation*

Managerial power theorists view opportunistic managers as having captured the pay process, subject only to the limitation of public "outrage." The result, they claim, is that we observe inefficient compensation contracts that fail to incentivize managers to run corporations on behalf of shareholders. Part II.B critiques the theoretical basis of the managerial power approach to executive compensation and assesses the level of empirical support that exists for it.

#### *1. Theoretical Objections*

At the heart of the managerial power approach to executive pay is the premise that directors, as a result of managerial influence, serve the interests of managers to the detriment of shareholders. While the managerial power view sheds light on certain aspects of executive pay, such as the importance of the board's role in formulating executive pay arrangements, it does not adequately explain the phenomenon for which it was developed—namely, the structure of executive pay.<sup>91</sup> In particular, the presence of managerial power seems, at best, a very partial explanation for why we do not observe more pay for performance.

The managerial power theory accepts as its basic framework the conventional principal-agent model, in which arm's-length contracting between the board and management *would* produce efficiently structured compensation contracts that minimized agency costs *if* it took place. According to the managerial power account, the reason that we do not observe such contracts is that executive compensation negotiations are not conducted at arm's length because managers exert undue influence over boards. As a result, managers are able to obtain more favorably structured compensation contracts than they would under optimal contracting.<sup>92</sup>

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<sup>90</sup> See BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2, at 189–216.

<sup>91</sup> See *id.* at 8 ("We would accept compensation at current or even higher levels as long as such compensation, through its incentive effects, actually serves shareholders.")

<sup>92</sup> See *id.* at 62.

One theoretical weakness of the managerial power approach is that it assumes that CEO influence over the compensation process translates into inefficient compensation contracts. This assumption ignores, however, the fact that in the principal-agent model firm performance is itself a function of the compensation contract. In other words, by specifying a more efficient compensation contract, the incomes of both shareholders and executives can be increased.

As an example, take the alternative compensation schemes that Bebchuk and Fried use to illustrate their managerial power perspective described in Part II.A above. In that example, a board of directors is considering two pay arrangements for the company's CEO: \$5 million in fixed salary or a scheme contingent on performance targets under which the CEO can obtain \$5 million but only if he makes some personal sacrifice. The authors postulate that a CEO with influence over the board will use that influence to secure the fixed salary because it does not require him to fulfill the contingency.

But suppose that we extend the example to permit bargaining over the structure of the contract. If the CEO discounts the contingent contract by fifteen percent, then the board must pay the CEO a premium of something more than \$750,000 to induce him to agree to it. The board will do so if it expects to more than recoup this expense in the form of enhanced performance. Importantly, so long as the CEO is compensated for agreeing to the performance-based contract, that contract is in the interest of both parties.

Take another example, one in which an executive compensation scheme inefficiently incorporates conventional options. Recall that the informativeness principle directs us to minimize randomness in evaluating performance because such error increases the riskiness, and hence lowers the value to the executive, of the compensation package. We should therefore expect both the executive and the board to seek to restructure the compensation scheme to substitute indexed options for conventional options. Again, here, they can then share the resulting gains.

In the foregoing examples, the more efficient contract increases shareholder value, and consequently, the potential amount available to pay managers. Accordingly, it is in both parties' interests to agree to it. We should therefore expect managers to use their influence to obtain more efficient pay structures—a result precisely the opposite of that generated by the managerial power theory—and then attempt to secure for themselves a portion of the gains.

Once the dependence of firm performance on compensation contracts in the agency model is recognized, it should be apparent that, with respect to the structure of executive compensation, managers' and shareholders' interests are aligned *toward* maximizing shareholder value.<sup>93</sup> Given an initial level of fixed (nonperformance-based) compensation, a manager would be willing to bear the risk of shifting some of his compensation to performance-based pay in exchange for an offsetting increase in the expected value of his total pay.<sup>94</sup> The additional amount required to induce a manager to do so is the risk premium associated with accepting the risk-based income.<sup>95</sup> Both firms and managers should favor performance-based pay up to the point at which the incentive benefits from the performance-based pay no longer outweigh the risk premium that managers require to bear the increased uncertainty in their incomes.<sup>96</sup>

The managerial power model offers the valuable insight that boards of directors do not appear to be engaging in optimal contracting with corporate executives. However, its explanation for why we do not observe such compensation arrangements is ultimately at odds with its own theoretical underpinnings. According to Part II.B.1, the managerial power theory is based on agency theory, which predicts that the decoupling of pay from performance will be suboptimal not only for shareholders but also for managers. Thus, although the managerial power theory makes the point that boards may not be entering into efficient compensation contracts with managers, it fails to provide us with a convincing reason for why they are not doing so. As discussed in Part II.B.2 below, the managerial power theory also enjoys little empirical support.

## 2. *Empirical Evidence*

The managerial power theory generates the testable prediction that increases in managerial power will be negatively associated with shareholder value. This result arises from agency theory's premise that managers' interests are not naturally aligned with those of shareholders. According to agency theory, compensation mechanisms that link executive pay to executive performance are an important way to induce managers to take actions that are personally costly to them but enhance shareholder value. The managerial

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<sup>93</sup> See Murphy, *supra* note 31, at 855.

<sup>94</sup> MILGROM & ROBERTS, *supra* note 11, at 209.

<sup>95</sup> See Murphy, *supra* note 30, at 2513.

<sup>96</sup> MILGROM & ROBERTS, *supra* note 11, at 207.

power theory contends that managers induce directors to adopt performance-insensitive compensation arrangements. Thus, it predicts that as managerial power increases, executive pay structures become less effective at disciplining managers. As a result, firm performance is adversely affected.

To test the foregoing hypothesis, it is necessary to identify an observable proxy for managerial power. Empirical studies have generally turned to two indicia for measuring managerial power. One approach is to assume that managerial influence over compensation is positively related to the relative proportion of inside to independent directors on a firm's board or, even more relevant, its compensation committee.<sup>97</sup> As the relative proportion of inside to independent directors increases, managers should encounter less resistance in promoting their desired pay packages.<sup>98</sup> In these circumstances, the various means by which executives can shape board decisionmaking should operate as strongly as possible.

An alternative proxy that has been used for managerial power is whether any outside shareholder owns a large equity stake in the firm.<sup>99</sup> Managerial power proponents argue that because a "large shareholder has more incentive than dispersed shareholders to monitor management," the presence of such a shareholder should be negatively correlated with managerial power.<sup>100</sup> In other words, they argue that large outside shareholders should constrain managers' ability to obtain self-serving pay arrangements.

There is a significant difficulty with using the presence of a large outside shareholder as a proxy for low managerial power, however, that makes the proxy unhelpful in testing the managerial power theory. Specifically, a positive relationship between the presence of a large outside shareholder and

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<sup>97</sup> For a summary of empirical studies adopting this approach, see Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 386–88 (2002), and Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 235–38 (2002).

<sup>98</sup> See William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1084 (1999).

<sup>99</sup> See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 920–26 (2001) (testing for evidence of more pay-for-luck at firms without a large outside shareholder); Donald C. Hambrick & Sydney Finkelstein, *The Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises*, 16 STRATEGIC MGMT. J. 175 (1995) (examining the relationship between pay-performance sensitivity for firms with and without a large outside shareholder); Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351 (2003) (studying the relationship between institutional ownership concentration and pay-for-performance sensitivity).

<sup>100</sup> BEBCHUCK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2, at 82.

pay for performance does not necessarily support the managerial power approach. The impact that such shareholders have on public corporations occurs through their influence over boards of directors. Consequently, large outside shareholders constrain directorial, rather than managerial, behavior. Part III of this Article presents a theory for why companies may not rely exclusively on performance-sensitive compensation arrangements for reasons entirely unrelated to the influence of managers. Thus, evidence that the presence of a large outside shareholder increases pay-performance sensitivity does not discriminate between the managerial power theory and alternative theories of board behavior that do not depend on managerial power.

Accordingly, this section views the proportion of independent directors as the better proxy for whether managerial power exists. To be sure, the managerial power explanation correctly points out that even independent directors are susceptible to the influence of the CEO.<sup>101</sup> Such influence begins with the CEO's involvement in the director nomination process. Although revisions to the listing standards of the NYSE and the NASDAQ require that director nominees be selected by an independent nominating committee or, in the case of the NASDAQ, a majority of the independent directors of the board,<sup>102</sup> as a practical matter, director nominees generally enjoy the support of the CEO.<sup>103</sup> In addition, CEOs generally control both the agenda of and the information disseminated to the board in connection with board meetings.<sup>104</sup> Exacerbating this informational asymmetry, board culture discourages directors from openly criticizing the CEO except in the most extreme circumstances.<sup>105</sup> In sum, the managerial power approach depicts even independent directors as weak monitors, no more effective than insiders at curbing managerial opportunism.

Despite the foregoing arguments underlying the view that independent directors are powerless to control management, there are plausible reasons to

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<sup>101</sup> See *id.* at 28–29.

<sup>102</sup> N.Y. STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.04(a) (2004), available at <http://www.nyse.com/listed/listedcomanual.html>; NASD MANUAL § 4350(e)(3) (2004), available at <http://nasd.complinet.com/nasd/display/index.html>.

<sup>103</sup> See Walter J. Salmon, *Crisis Prevention: How to Gear Up Your Board*, HARV. BUS. REV., Jan.–Feb. 1993, at 68, 71; Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1831 (1999).

<sup>104</sup> See, e.g., Tom Giles & Katherine Reynolds Lewis, *Qwest Directors Outlined 'Credibility' Gap for Nacchio in 2001*, BLOOMBERG NEWS, Oct. 2, 2002 (reporting results of survey of Qwest directors in which comments about former CEO Joseph Nacchio included references to “haphazard” information flows and inability of board to “perform basic governance responsibilities”).

<sup>105</sup> See BEBCHUCK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2, at 31–33.

believe that independent directors do in fact constrain opportunistic managerial behavior. First, independent directors typically hold multiple directorships.<sup>106</sup> According to the “reputation capital” theory, these directors are professional monitors of managerial actions who have made substantial investments in establishing their reputations.<sup>107</sup> Consequently, independent directors have an incentive to act as effective monitors because being directors of a well-performing company signals their value to the external labor market, which rewards them with directorships on the boards of other firms.<sup>108</sup>

Another reason for why independent directors should be more effective monitors of management than their inside counterparts relates to how they are compensated. There is a growing trend of compensating independent directors with some form of equity ownership.<sup>109</sup> If independent directors own equity, they will have a direct incentive to monitor managerial actions and to oppose unprofitable managerial initiatives. While such initiatives might serve the personal interests of managers, they do not inure to the benefit of directors. Accordingly, it is reasonable to believe that independent directors’ financial interests are more closely aligned with those of shareholders than are those of inside directors.

Thus, unlike insiders, independent directors have meaningful incentives to discipline managers. If independent directors do, indeed, effectively constrain agency costs, then the managerial power theory predicts a positive relationship between the proportion of independent directors on the board or its compensation committee and firm performance. Yet, most empirical studies that have examined the issue have rejected a relationship between the two.

Early studies did not confirm a positive correlation between the proportion of independent directors serving on a board and various performance measures.<sup>110</sup> More recently, Sanjai Bhagat and Bernard Black found an *inverse* correlation between board independence and firm performance.<sup>111</sup> Further testing by the authors led them to conclude that poor performance

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<sup>106</sup> See ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 212 (1995) (citing a survey of Fortune 1000 directors indicating that more than twenty percent of the respondents served on four or more boards as an outside director).

<sup>107</sup> See Fama & Jensen, *Separation of Ownership*, *supra* note 4, at 315–16.

<sup>108</sup> *Id.*

<sup>109</sup> Andrew Countryman, *Directors’ Ownership Stakes Gain New Worth: Investors Want Interests Aligned*, CHI. TRIB., July 11, 2004, § 5 at 1 (observing more emphasis being placed on the equity component of director pay).

<sup>110</sup> See *supra* notes 106–109 and accompanying text.

<sup>111</sup> Bhagat & Black, *supra* note 97, at 248.

induced firms to adopt more independent boards,<sup>112</sup> but that increasing board independence did not lead to improved firm performance and possibly reduced it.<sup>113</sup>

Kam-Ming Wan studied the relationship between pay-performance sensitivity for CEOs and the proportion of inside directors on corporate boards.<sup>114</sup> As discussed above, CEOs are likely to exert relatively more influence over inside directors than over independent directors.<sup>115</sup> The managerial power approach predicts that CEOs prefer their pay to be decoupled from performance.<sup>116</sup> Thus, if the managerial power approach is an accurate account of the dynamics of compensation setting, we would expect Wan to find a statistically significant relationship between board composition and pay-performance sensitivity. To the contrary, however, he found no evidence that more independent boards are associated with increased pay-performance sensitivity.<sup>117</sup>

In another study of CEO compensation, researchers including Catherine Daily examined the relationship between CEO compensation and the makeup of compensation committees, to which boards of directors delegate responsibility for overseeing the compensation of executive officers.<sup>118</sup> The authors tested the hypothesis that a higher proportion of inside directors leads to higher levels of noncontingent, as compared to contingent, CEO compensation. Again, if the managerial power approach holds, there should be an identifiable correlation between inside representation on the compensation committee and CEO-favorable compensation structures, such as compensation packages containing higher proportions of noncontingent pay. However, the authors' findings did not suggest any correlation between compensation committee composition and contingent pay.<sup>119</sup>

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<sup>112</sup> *Id.* at 249.

<sup>113</sup> *Id.* at 252.

<sup>114</sup> Kam-Ming Wan, *Independent Directors, Executive Pay, and Firm Performance* (2003) (unpublished manuscript, available at <http://ssrn.com/abstract=392595>).

<sup>115</sup> See *supra* notes 101–09 and accompanying text.

<sup>116</sup> See *supra* text accompanying notes 80–81.

<sup>117</sup> Wan, *supra* note 114, at 3, 23.

<sup>118</sup> Catherine M. Daily et al., *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 *ACAD. MGMT. J.* 209, 209 (1998).

<sup>119</sup> See *id.* at 218. But see Harry A. Newman & Haim A. Mozes, *Does the Composition of the Compensation Committee Influence CEO Compensation Practices?*, 28 *FIN. MGMT.* 41, 41 (1999).

Many more empirical studies have examined relationships bearing on the influence of managerial power on executive compensation.<sup>120</sup> A substantial number of these, however, focus on the level, rather than the structure, of executive compensation. As already noted, the level of CEO compensation alone does not bear on the efficiency of a given compensation scheme. Higher levels of compensation could be desirable if those levels were the product of powerful incentive compensation structures.

In sum, limited evidence exists to support the claim that managers exert influence over boards of directors to decouple their pay from their performance. If managers effectively set their own compensation, there should be a negative correlation between managerial power and firm performance. There should also be a negative correlation between managerial power and pay-performance sensitivity. In fact, the evidence indicates neither relationship. These results cast considerable doubt on the managerial power explanation for pay without performance.

### III. A TOURNAMENT EXPLANATION OF CEO COMPENSATION AND ITS CORPORATE GOVERNANCE POLICY IMPLICATIONS

If the weak link between pay and performance in executive compensation arrangements is not satisfactorily explained by undue managerial influence over boards, how can we explain its persistence? Part III suggests that boards may be designing CEO pay arrangements using more elaborate approaches to motivating top executives than varying compensation with absolute performance. This Part focuses on the use of the CEO pay package as a prize awarded to the executive who wins the competition, or “tournament,” for the CEO job. In the tournament model, CEO pay incorporates a reward for prior effort that is fixed in advance. For that reason, it may not be correlated tightly with the CEO’s performance.<sup>121</sup> Part III.A analyzes tournament theory and the

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<sup>120</sup> See Martin J. Conyon & Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and United Kingdom*, 110 *ECON. J.* F640, F652 (2000); John E. Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 *J. FIN. ECON.* 371, 372–73 (1999); Richard A. Lambert et al., *The Structure of Organizational Incentives*, 38 *ADMIN. SCI. Q.* 438, 441–42 (1993).

<sup>121</sup> Another part of the story of weak pay-for-performance sensitivity at the CEO level is that firms may be paying their CEOs “efficiency wages.” Efficiency wages are wages that are set above the market-clearing level to create incentives for workers to remain in their jobs (thereby reducing the employer’s recruiting and training costs) and to work harder (by giving them more to lose if they are terminated). See George A. Akerlof, *Labor Contracts as Partial Gift Exchange*, 97 *Q.J. ECON.* 543, 544 (1982) (describing a “norm-gift-exchange” model in which employers make a “gift” to their employees of above-market wages and workers reciprocate by making a “gift” to their employers of effort in excess of the minimum standard); David Charny

empirical support for it as an explanation of CEO compensation practices. It then considers the evidence on whether tournament theory can serve as an effective incentive scheme, and, if so, under what conditions. Part III.B sets forth the contrasting corporate governance policy implications that flow from both the managerial power theory and tournament theory, the potential consequences of which reach well beyond the realm of executive compensation. These differences caution us to pause before embarking on the managerial power theory's prescriptions for reform in this area.

### A. A Tournament Theory of CEO Compensation

Tournament theory has been invoked to explain large differentials between the level of CEO pay and the pay of lower-level managers,<sup>122</sup> as well as the pay gap that exists between U.S. and foreign CEOs,<sup>123</sup> but it has not been fully elaborated as an explanation of how CEO pay is structured. Specifically, it has

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& G. Mitu Gulati, *Efficiency-Wages, Tournaments, and Discrimination: A Theory of Employment Discrimination Law for "High-Level" Jobs*, 33 HARV. C.R.-C.L. L. REV. 57, 60–61 (1998) (making the argument that both efficiency wages and tournaments are likely to be observed as equilibrium solutions in contexts in which high-level jobs are scarce and monitoring employees is difficult); *see also* EDWARD P. LAZEAR, *PERSONNEL ECONOMICS* 70 (1995); MILGROM & ROBERTS, *supra* note 11, at 250–52 (describing the "efficiency wage" model); David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581, 1636 (1998). Commentators also have suggested that tournaments may cause participants to reveal otherwise difficult to observe, subjective attributes, such as judgment, fairness, collegiality, and integrity, which may be important to the employer. *See* Scott Baker et al., *The Rat Race as an Information Forcing Device* 1–3 (N.Y. Univ. Law Sch. Law and Econ. Research Paper Series, Research Paper No. 04-034, The Univ. of N.C. Law Sch. Legal Studies Research Paper Series, Research Paper No. 05-01, and Georgetown Univ. Law Center Law and Econ. Research Paper Series, Research Paper No. 649083, 2005); *see also* George P. Baker, *Incentive Contracts and Performance Measurement*, 100 J. POL. ECON. 598, 600 (1992); Bengt Holmström & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. (SPECIAL ISSUE) 24, 25–26 (1991). *But see* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons From the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 302–03 (2004) (surmising that character counts in promotion decisions but cautioning that opportunities for would-be CEOs to circumvent fair play norms are substantial).

<sup>122</sup> *See* Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841, 847 (1981); *see also* LAZEAR, *supra* note 121, at 25–37 (1995); Lorne Carmichael, *Firm-Specific Human Capital and Promotion Ladders*, 14 BELL J. ECON. 251, 257 (1983); Ronald G. Ehrenberg & Michael L. Bognanno, *Do Tournaments Have Incentive Effects?*, 98 J. POL. ECON. 1307, 1308–10 (1990); James A. Fairburn & James M. Malcomson, *Rewarding Performance by Promotion to a Different Job*, 38 EUR. ECON. REV. 683, 684 (1994); James M. Malcomson, *Work Incentives, Hierarchy, and Internal Labor Markets*, 92 J. POL. ECON. 486, 487–89 (1984); Barry J. Nalebuff & Joseph E. Stiglitz, *Prizes and Incentives: Towards a General Theory of Compensation and Competition*, 14 BELL J. ECON. 21, 26 (1983); Mary O'Keefe et al., *Economic Contests: Comparative Reward Schemes*, 2 J. LAB. ECON. 27, 34 (1984).

<sup>123</sup> *See* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1209–13 (2004).

yet to be deployed in explaining why CEO pay does not exhibit stronger pay-performance sensitivity.<sup>124</sup> I suggest that tournament theory does, however, provide a plausible account for the observed decoupling of CEO pay and performance.

In general, tournament theory implies a compensation structure for the hierarchy of labor within the firm. In contrast to optimal contracting, in which employees are rewarded at any given level of the corporate ladder in proportion to their absolute performance, the tournament model describes a reward system in which (1) compensation at each job level is set in advance—that is, it is not designed to reflect the performance of, for example, the CEO as CEO—and (2) there is a positive spread between each rung of the corporate ladder and the next highest one.

At each position on the job ladder, employees face a probability between zero and one of being promoted to the next level. The move to the next level rewards workers with both a higher salary and the chance to compete for future promotions. The decision whom to promote is based on relative performance. In other words, employees are promoted based not on how well they perform in an absolute sense, but rather on who performed the best. Common examples of internal labor market tournaments arise in a variety of settings. Students may be graded according to a curve. Baseball players with the best minor league records are awarded the chance to play in the major leagues. Salespersons who achieve specified targets are rewarded with excursions. In each case, the tournament plays a role as an incentive mechanism.

Workers are motivated to perform in the tournament model because the probability of winning the contest depends on the amount of effort that they exert. In other words, compensation is not set to reflect an employee's productivity in his current job. Instead, compensation is designed to induce all individuals to perform appropriately when they are in more junior positions.<sup>125</sup> Thus, the problem for the firm is to choose a series of wage spreads between levels of the firm's organizational hierarchy that maximizes profits, subject to the constraint that employees maximize their expected utility by increasing effort up to the point at which the cost to them of doing so no longer justifies the value to them of increasing their probability of winning the contest.

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<sup>124</sup> See LAZEAR, *supra* note 121, at 32 (acknowledging that how to motivate the CEO is an open question under tournament theory).

<sup>125</sup> Lazear & Rosen, *supra* note 122, at 847.

In the context of the managerial hierarchy within a corporation, where there is only one CEO position and where executive positions at lower levels are also limited in number, tournaments take the form of a ladder competition in which contestants vie to increase their probabilistic chances of winning promotions. In these contests, an employee's likelihood of securing a promotion is not random; random rewards, such as a lottery, do nothing to encourage any particular behavior. Nor are these contests based on absolute performance, which is not rewarded under tournament theory except insofar as it increases an employee's likelihood of winning the contest. Instead, a manager's odds of being promoted depend on how well he performs relative to his peers.

As the foregoing discussion suggests, both agency theory and tournament theory seek to design compensation arrangements that maximize shareholder value. They simply adopt alternative methods for eliciting performance from employees. In this regard, there are several theoretical reasons why employing tournaments might be superior to applying only individualistic rewards tied to absolute productivity in the context of executive pay. First, pay-for-performance schemes require that the firm be able to measure accurately some observable indicator of an employee's performance. Interdependence among the efforts of team members in producing joint outputs, however, makes it difficult to isolate the contributions of any one individual to a given performance measure. As a result, it may be difficult or costly to measure an employee's effort level.<sup>126</sup>

Where the verifiability of individual performance is a problem, firms will be reluctant to motivate employees through pay schemes based on absolute performance. Instead, they may offer rewards based on an individual's performance relative to others. Relative comparisons can provide performance incentives without the need to monitor the absolute performance of all employees. All that is necessary is for the firm to choose to promote those employees that performed best among their peers.

To be sure, it remains necessary to monitor the top few individuals who are the most likely candidates for the job at the next highest tier. Employers can generally weed out most unsuitable employees quickly, leaving only a limited number of competitors whose work must be more carefully scrutinized. Even

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<sup>126</sup> Note that in jobs in which performance is highly variable and an employee's contribution can be readily observed, basing wages on performance is likely to be efficient. See KATHERINE V. W. STONE, FROM WIDGETS TO DIGITS 112–13 (2004).

at this point in the tournament, however, it is not necessary for the firm to determine with precision the productivity of each competitor, as measuring productivity involves inherently subjective evaluation. Instead, the firm need only rank the competitors' performances. Edward Lazear and Sherwin Rosen make the point that tournaments can provide incentives to employees at lower information costs in the following way:

If it is less costly to observe rank than an individual's level of output, then tournaments dominate [performance] standards. On the other hand, occupations for which output is easily observed save resources by using the piece rate or standard, or some combination, and avoid the necessity of making direct comparisons with others as the tournament requires. . . . [C]orporate executives, whose output is more difficult to observe, engage in contests.<sup>127</sup>

Thus, in a complex business organization, conducting tournaments should be less costly than monitoring individual productivity.

In addition to reducing information costs, tournaments may also reduce the risk to employees, relative to pay-for-performance schemes, that their compensation will be influenced by general uncertainties beyond their control. For example, two managers, each running a different division of a corporation, may experience poor results in a given quarter, not for lack of diligence, but because of poor overall economic conditions. These conditions will affect both individuals similarly, and therefore be irrelevant to an evaluation of their performance if they are being judged relative to one another. While relative performance evaluation in the context of pay-for-performance schemes can also filter out general macroeconomic effects on performance measures, doing so depends on being able to identify a suitable peer group for a given firm, which can be a difficult task.

If tournaments can provide less risky compensation to employees than pay-for-performance schemes, then it is less costly to a firm to provide employees with what, in their calculation, is an equivalent amount of pay. As described earlier, risk-averse employees will apply a discount to pay that is subject to risk that they cannot eliminate.<sup>128</sup> Thus, by implementing a tournament model, the firm can save compensation expense with respect to risks that are common to all employees within a particular peer group.

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<sup>127</sup> Lazear & Rosen, *supra* note 122, at 848.

<sup>128</sup> See *supra* notes 11–12 and accompanying text.

Finally, conducting internal promotion tournaments has an advantage over pay-for-performance schemes in encouraging employees to make firm-specific human capital investments when it is difficult for employees to verify their own performance. Firm-specific human capital investments are investments that are nontransferable outside the workplace and thus are not recoverable.<sup>129</sup> These include investments in acquiring specialized knowledge, skills, and relationships unique to the firm. For example, a product manager must invest firm-specific human capital in the form of developing detailed knowledge of unique products under her supervision. Such an investment is unlikely to be of much value outside her firm.

Margaret Blair and Lynn Stout have addressed the problem of inducing firm-specific human capital investments by employees in the context of team production theory, in which each member of the corporate “team” contributes unique resources to the enterprise.<sup>130</sup> Investing in doing so, however, leaves any one member of the team vulnerable to exploitation by the other team members.<sup>131</sup> Once one team member has made a firm-specific investment, another team member with control over the corporation can use that power to keep all the rents exceeding the minimum amount necessary to keep the first team member involved in the enterprise.<sup>132</sup> Thus, each team member will fear making any firm-specific investment, raising the possibility that the venture will never be formed.<sup>133</sup>

When employees cannot practically verify their own absolute performance, firms will be tempted to claim that performance was lower than it actually was.<sup>134</sup> Using pay-for-performance compensation arrangements in these circumstances thus discourages employees from making firm-specific human capital investments in their jobs. Tournaments can induce employees to do so, however, by allowing firms to credibly commit themselves *ex ante* to attaching a higher wage to jobs that employees will attain if promoted.<sup>135</sup> These higher wages serve to compensate employees for their investments.<sup>136</sup> Employees, in

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<sup>129</sup> See MILGROM & ROBERTS, *supra* note 11, at 328.

<sup>130</sup> Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 286 (1999).

<sup>131</sup> *Id.* at 276.

<sup>132</sup> *Id.* at 272.

<sup>133</sup> *Id.*

<sup>134</sup> See Carmichael, *supra* note 122, at 251.

<sup>135</sup> See *id.* at 252; Canice Prendergast, *The Role of Promotion in Inducing Specific Human Capital Acquisition*, 108 Q.J. ECON. 523 (1993).

<sup>136</sup> See Carmichael, *supra* note 134, at 252; Prendergast, *supra* note 135, at 523–34.

turn, can verify whether the firm awards the higher-level wage. A hierarchical wage structure within the firm can thus encourage firm-specific human capital investments by employees.

In sum, tournament based compensation systems offer numerous potential advantages over their pay-for-performance counterparts—namely, reduced monitoring costs, lower compensation risk to employees from common uncertainties, and the ability to induce employees to make firm-specific human capital investments. On the other hand, tournament theory has weaknesses that need to be addressed before it can be appraised as a theory of executive pay structure. In particular, conducting tournaments within firms raises three important questions. First, interfirm mobility is a key feature of the modern labor market. Does filling CEO openings through external hiring rather than through internal promotions undermine tournament theory? Second, at the top of the hierarchy—the CEO position—there are no more promotions left to win. In the absence of relative comparisons at the top, how do companies provide motivation? Third, how does a tournament framework deal with the potential for uncooperative behavior that may arise in a competition-based pay system? The remainder of this section addresses these questions, in turn, before reviewing the empirical evidence on tournament theory.

There is an apparent contradiction between tournament theory and the trend over the past thirty years toward filling CEO vacancies by hiring external candidates.<sup>137</sup> While in the 1970s, outside hires accounted for fifteen percent of all CEO replacements, by the 1990s that figure had risen to twenty-six percent.<sup>138</sup> Because external hiring diminishes the probability that a would-be CEO will win the “CEO prize,” this trend would appear to diminish the incentives that a tournament provides to its participants.

On closer analysis, however, the power of tournaments as a mechanism for motivating lower-level executives need not be diminished by increased external hiring. In tournament theory, participants are motivated to perform because the probability of winning the contest depends on the amount of effort exerted. This feature remains true in the face of a more fluid labor market. What external hiring does imply for employees, however, is that their *expected* reward from competing in the tournament (which consists of the probability of

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<sup>137</sup> Kevin J. Murphy & Ján Zábajník, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 AM. ECON. REV. 192, 192 (2004).

<sup>138</sup> *Id.* at 193.

winning multiplied by the value of the prize) falls.<sup>139</sup> To maintain the expected reward at the desired level when there is a significant likelihood of lateral hiring, firms must increase CEO pay. Escalating CEO pay is, of course, exactly what we have observed.<sup>140</sup>

Another question that confronts tournament theory is how it motivates a CEO, who sits atop the firm's pay hierarchy and therefore cannot be promoted any further internally. Tournament theory, which originated to provide an account of hierarchical wage structures within firms, fizzles out at this point.<sup>141</sup> It implies a pay differential between CEO compensation and the compensation of subordinate managers, but that pay differential motivates only would-be CEOs, not the victorious CEO who has won the prize. At this point, an approach other than internal labor market contests is needed to influence CEO behavior.

One possibility for how CEOs are motivated after internal promotion opportunities have been exhausted is to include CEO positions at other, larger firms in the universe of jobs in the tournament. Several studies have found a strong positive statistical relationship between firm size and CEO compensation.<sup>142</sup> The justification for this relationship is that larger firms generally require CEOs of greater ability, who command higher pay. CEOs who seek to run larger firms can establish their abilities by successfully managing smaller firms. Thus, recognizing that tournaments may also occur in interfirm labor markets provides a valve for CEO promotion and therefore a means of motivating CEOs.<sup>143</sup>

Alternatively, CEOs can be motivated to perform through "on-the-job discipline . . . achieved by demotion, retirement, or outright separation of a poorly performing CEO from the corporation."<sup>144</sup> The possibility of direct

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<sup>139</sup> See Lazear & Rosen, *supra* note 122, at 845.

<sup>140</sup> See Murphy, *supra* note 31, at 847.

<sup>141</sup> See LAZEAR, *supra* note 121, at 32 (acknowledging that the question of how to motivate the CEO is an open question under tournament theory).

<sup>142</sup> The "elasticity" of pay and size is approximately 0.3, implying that pay increases by about one-third as firm size doubles. George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 609 (1988).

<sup>143</sup> See Donald Vandegrift & Paul Brown, *Task Difficulty, Incentive Effects, and the Selection of High-Variance Strategies: An Experimental Examination of Tournament Behavior*, 10 LAB. ECON. 481, 482 (2003).

<sup>144</sup> HAROLD DEMSETZ, *Management Compensation and Tournament Theory*, in THE ECONOMICS OF THE BUSINESS FIRM 110, 114 (1995); see also Eric L. Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* 22–23 (Univ. of Southern Cal. Law Sch. Law and Economics Working Paper Series No. 4, 2004) (finding evidence that increased monitoring and incentive compensation are

monitoring of CEOs seems reasonable given that the CEO exerts observable decision-making authority over major corporate decisions and that the consequences of these decisions are likely to be reflected in firm performance. Moreover, studies have identified a statistically significant relationship between the probability of job loss by the CEO and the poor quality of firm performance.<sup>145</sup> Thus, it may be that direct monitoring of CEOs can influence CEO behavior. In these circumstances, pay for performance is not needed to control agency costs.<sup>146</sup>

In addition, some social scientists have suggested that financial incentives may not improve the performance of individuals who are intrinsically motivated toward high achievement.<sup>147</sup> This is most likely to be true of CEOs who, by the time they achieve their position, have survived multiple rounds of weeding out of individuals with any appreciable taste for slack and have self-selected or become acculturated to hard work.<sup>148</sup> Even those who acknowledge that money may be a general motivator question whether financial incentives have any substantial impact on executives who already possess substantial wealth.<sup>149</sup> To the extent monetary compensation serves as an incentive for CEOs, it may do so only as a status symbol and not as a performance incentive.<sup>150</sup> These findings suggest that a substantial tournament

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substitutes).

<sup>145</sup> See IRA T. KAY, CEO PAY AND SHAREHOLDER VALUE: HELPING THE U.S. WIN THE GLOBAL ECONOMIC WAR 16 (1998) (citing examples of major companies who replaced under-performing CEOs). More recently Carly Fiorina, the former CEO of Hewlett-Packard, was fired by the company's board following poor performance under her watch. See John Markoff, *When + Adds Up to Minus*, N.Y. TIMES, Feb. 10, 2005, at C1.

<sup>146</sup> The threat of job loss is especially potent where high or "efficiency" wages serve as incentives for CEOs to maintain their positions and there is a queue for the job among lower-level managers. See Wilkins & Gulati, *supra* note 121, at 1636; see also LAZEAR, *supra* note 121, at 70 (describing the requirement of a queue for efficiency wage theory to hold); MILGROM & ROBERTS, *supra* note 11, at 250–52 (describing the "efficiency wage" model).

<sup>147</sup> Researchers have, for example, found that traits such as concern for excellence, status with experts, and the regard of peers are independent from the motive to acquire money. See Richard E. Snow & Douglas N. Jackson III, *Individual Differences in Conation: Selected Constructs and Measures*, in MOTIVATION: THEORY AND RESEARCH 71, 81 (Harold F. O'Neil, Jr. & Michael Drillings eds., 1994); Douglas N. Jackson et al., *Is Achievement a Unitary Construct?*, 10 J. RES. PERSONALITY 1, 18 (1976).

<sup>148</sup> See Melvin A. Eisenberg, *The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations*, in CORPORATE GOVERNANCE INSTITUTE 103, 112–14 (ALI-ABA Course of Study).

<sup>149</sup> See DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 39, 244 (1993).

<sup>150</sup> See Tyler Cowen, *Nice Work if You Can Get It*, WALL ST. J., Dec. 23, 2004, at D8 (reviewing BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 2) (suggesting that ego is the primary driver of CEO behavior, with money playing a secondary role except as an indicator of status).

prize is sufficient to satisfy a CEO and that additional rewards are not central to inducing him to perform.

Finally, it may be desirable to use pay for performance as a device to motivate the CEO.<sup>151</sup> I am not suggesting in this Article that performance-based pay cannot serve as one of multiple strategies for aligning managerial and shareholder interests. Rather, my claim is that good CEO compensation design likely should not be limited to pay for performance.

Another objection that has been leveled at tournament theory is that contests may produce uncooperative behavior among participants that is costly to the firm. Such behavior is likely to arise whenever one's success in a tournament is a direct function of others not performing as well.<sup>152</sup> Uncooperative behavior undermines the efficiency of tournament-style pay structures.

The dangers that flow from possible uncooperative behavior in tournament play can, however, be mitigated. First, organizational measures can be taken to minimize the ability of competitors to interfere with one another's efforts. Edward Lazear described a real world example of a firm that chose its president from among the ranks of the presidents of its subsidiary operating companies.<sup>153</sup> These subsidiaries were in separate regional geographic locations. Lazear postulated that one reason for selecting presidents from field offices is that doing so prevented competition among vice-presidents at the head office.<sup>154</sup> Cooperation among vice-presidents is highly desirable. While cooperation among regional presidents might also be desirable, it is less important to the organization. Thus, Lazear suggested that individuals not be pitted directly against one another when their cooperation is important to a firm.<sup>155</sup>

Another avenue to consider to diminish the negative behavior that competition can induce is the use of tournaments to elicit information about whether an employee has attributes that are consistent with a firm's "culture."

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<sup>151</sup> See LAZEAR, *supra* note 121, at 32.

<sup>152</sup> See Wilkins & Gulati, *supra* note 121, at 1614. Randall Thomas makes the additional point that tournament losers may leave the firm altogether if the wage gap is too big, thereby increasing turnover. He argues that where retention and cooperation are important to a firm's success, boards of directors should consider carefully the impact of substantial wage dispersion on firm value. Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437, 457-58 (2003).

<sup>153</sup> See LAZEAR, *supra* note 121, at 36.

<sup>154</sup> *Id.*

<sup>155</sup> *Id.* at 37.

Many workplaces emphasize the importance of compatibility with their firms' cultures when screening new hires and in the course of periodic reviews. Fitting into a firm's culture may involve possessing traits such as integrity, loyalty, and "being a team player," which are difficult both to observe and measure. Tournaments can "force" such information from participants by creating the kind of environment—namely, stressful competition—that is most likely to cause them to reveal it.<sup>156</sup> Thus, tournaments may in fact assist firms in checking uncooperative behavior in the workplace.

In sum, tournament theory provides an attractive theoretical possibility for explaining pay without performance in executive compensation design. Rather than addressing agency problems through pay for performance, tournaments among managers provide the mechanism for doing so. Firms that rely on competition, rather than just absolute performance, to compensate employees can potentially motivate executives at a lower cost. Relative to pay-for-performance schemes, tournaments offer firms the possibility of motivating employees with lower information costs and fewer compensation risks to employees, and by encouraging firm-specific investments in human capital. Although tournament theory leaves a gap insofar as it does not fully address how to motivate the CEO and raises concerns about eliciting uncooperative behavior, there are avenues for addressing these difficulties. Tournament theory may therefore present an important part of the solution to the agency problem.<sup>157</sup>

This Part now turns to the level of empirical support that exists for tournament theory. The tournament model predicts that wage differentials should increase at higher levels within an organization. This follows from the fact that motivation in a tournament is provided by the possibility of future job slots at all subsequent levels of the organizational hierarchy. In other words, the value of being promoted is not only the prize at that level but also the opportunity to compete in future rounds. The possibility of competing in future rounds diminishes as an individual competitor ascends the corporate ladder. In the tournament model, the substitute for the loss of the option to compete in further rounds is an increasing ratio of pay in later rounds of the tournament. Thus, tournament theory predicts an especially large pay differential between the CEO and the managers at the next lower level.<sup>158</sup> This

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<sup>156</sup> See Baker et al., *supra* note 121, at 3.

<sup>157</sup> For a critique of the tournament theory of managerial compensation, see DEMSETZ, *supra* note 144, at 110–36.

<sup>158</sup> Tor Eriksson, *Executive Compensation and Tournament Theory: Empirical Tests on Danish Data*, 17

prediction is borne out in empirical testing; studies find a convex relationship between pay and organizational level.<sup>159</sup>

A second prediction of tournament theory is that, as the probability of being promoted to the next level of the corporate hierarchy diminishes, compensation should increase to offset the greater risk of losing in the tournament. The riskiness of the contest can be affected in a number of ways. It can vary in response to changes in the number of contestants competing for a promotion, with the probability of promotion decreasing as the number of contestants increases. The riskiness of the contest also increases, as mentioned above, when external hiring rises. Finally, it can be affected by the degree to which an individual's performance within the organization is subject to chance.<sup>160</sup> The more randomness is associated with performance, the less likely it is that an employee's effort will determine the outcome of the promotion decision.<sup>161</sup> As a result, workers will exert less effort. Increased wage differentials must be established to offset this tendency.<sup>162</sup> Consistent with the first prediction, researchers have found that increases in the number of

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J. LAB. ECON. 262, 265; Brian G. M. Main et al., *Top Executive Pay: Tournament or Teamwork?*, 11 J. LAB. ECON. 606, 608 (1993).

<sup>159</sup> See Lambert et al., *supra* note 120, at 447; Main et al., *supra* note 158, at 611–12. It is worth pointing out here that the use of conventional stock options in executive compensation packages is consistent with tournament theory so long as the expected value to an executive of total compensation (including options) corresponds with the executive's hierarchical position within the organization. Stock options introduce a potential inefficiency into compensation arrangements, however, because they are assigned a value by risk-averse executives that is lower than the cost that they impose on the firm. See Meulbroek, *supra* note 13, at 12. This “wedge” is accepted in an optimal contracting regime as a necessary cost of motivating managers. See *supra* notes 11–14 and accompanying text. If tournaments create efficient incentives for executives, however, the wedge represents nothing but a cost to the firm. On the other hand, there is an offset to this cost from the tax advantages accorded to certain compensation that is treated as performance-based. Specifically, Section 162(m) of the Internal Revenue Code prohibits publicly traded corporations from deducting pay over \$1 million annually per executive unless the excess compensation either consists of options or is based upon the achievement of performance goals that have been established by a compensation committee composed solely of independent directors. See I.R.C. § 162(m) (2000). The employees whose compensation is covered by this rule include the CEO or the individual acting in that capacity and the four most highly compensated officers other than the CEO, whose compensation must be reported under the Securities Exchange Act of 1934. See 26 C.F.R. § 1.162-27(c)(2) (2005) (defining the employees covered under § 162(m)). Another source of bias that has favored the use of conventional stock options in compensation contracting is that directors are unlikely to experiment with novel executive compensation schemes, even when they believe that doing so would improve incentives. Directors confront reputational penalties for bad outcomes. Because, if a bad outcome occurs but the action underlying it was consistent with approved conventional wisdom, the adverse impact on a director's reputation is mitigated, directors are likely to be reluctant to deviate from common compensation instruments, such as conventional stock options.

<sup>160</sup> LAZEAR, *supra* note 121, at 30.

<sup>161</sup> *Id.* at 29.

<sup>162</sup> *Id.* at 30.

vice presidents are positively correlated with the present value of the CEO-VP pay differential.<sup>163</sup> This author is not aware of any studies that examine the effect of lateral hiring or luck on wage differentials.

Finally, tournament theory predicts that firm performance will be positively correlated with increased wage dispersion. In other words, the tournament model implies that a large wage gap induces higher effort, which should, in turn, be reflected in better performance. Efforts to conduct empirical testing on tournament theory have related primarily to the distribution of prizes in sports tournaments, where there is usually very clear evidence on performance. As described in Part I.B.2, these studies, as well as laboratory experiments, suggest that tournament systems have considerable motivational properties.

Two implications flow from the foregoing empirical evidence. Tournament models are (1) consistent with actual pay arrangements within the managerial ranks of firms and (2) can provide meaningful performance incentives. The question remains whether tournament incentive systems dominate pay-for-performance incentive systems in the workplace, and if so, under what circumstances. As described above, tournaments have both advantages and disadvantages relative to optimal contracting arrangements. If tournaments are unlikely to improve upon optimal contracting as the sole means of motivating executives, then the puzzle of why there is not more pay-performance sensitivity in the design of executive pay survives. What is needed, then, are empirical comparisons that distinguish between the two theories.

Frans van Dijk conducted a study in a laboratory setting in which participants worked on real tasks under different payment schemes.<sup>164</sup> Their study revealed that subjects exerted dramatically higher effort in a tournament than in a pure pay-for-performance setting.<sup>165</sup> The drawback of employing a tournament scheme, however, was that it produced larger variability of effort.<sup>166</sup> Two other experimental studies have produced similar results.<sup>167</sup>

It is worth mentioning another study that examined simultaneously all three of the pay-for-performance, tournament, and managerial power models using

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<sup>163</sup> Main et al., *supra* note 158, at 617.

<sup>164</sup> Frans van Dijk et al., *Incentive Systems in a Real Effort Experiment*, 45 EUR. ECON. REV. 187, 189 (2001).

<sup>165</sup> *Id.* at 204.

<sup>166</sup> *Id.* at 207.

<sup>167</sup> See Bull et al., *supra* note 49; Nalbantian & Schotter, *supra* note 49.

the same data set.<sup>168</sup> The authors of this study did not undertake to distinguish among the theories. Rather, they sought to test whether their data were consistent with multiple models.<sup>169</sup> Their results supported predictions generated by all three theories, suggesting that organizational incentives are most appropriately characterized by a combination of approaches.<sup>170</sup>

Given the dearth of evidence on the relative predictive power of tournaments and pay-for-performance systems, it seems clear that devising ways to address the question empirically should be an important research agenda item for those interested in executive compensation arrangements. Although it is not this Article's purpose to test the propositions generated by these alternative theories, it is worth noting some testable predictions of tournament pay systems that are not shared by their pay-for-performance counterparts and that could distinguish between the two. These include the following:

1. Firms in riskier markets will have larger wage spreads than firms in less risky markets. This hypothesis follows from the desirability in tournaments to award promotions based on relative performance, not luck. Introducing chance into the promotion decision diminishes the incentive effects of competition because competitors are less certain that their efforts will pay off. To compensate for this effect, wage spreads must increase.
2. Firms that engage in substantial lateral hiring will also have larger wage spreads than firms that promote internally. Reducing the likelihood that an employee will move up to the next rung of the corporate ladder diminishes incentives, which must be counteracted with a larger jump in pay at the next level in the hierarchy.
3. Firms subject to greater market and industry risk, or firms for which it is difficult to construct a peer group, will be more likely to employ tournaments than pay-for-performance schemes. Where exogenous factors are especially difficult to filter out, individual performance is more difficult to isolate. In contrast, tournament participants within the firm are likely to face common uncertainties, so that their relative performance will not result from factors beyond their control.

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<sup>168</sup> See Lambert et al., *supra* note 120.

<sup>169</sup> *Id.* at 439.

<sup>170</sup> *Id.* at 456–59.

4. Wage spreads will remain stable over time, subject to changes in labor market conditions. In other words, once the optimal difference in wage levels throughout the hierarchy is determined, it should change only to reflect changes in an employee's opportunity cost of joining the firm.

Understanding more fully the relative incentive effects of different compensation methods would shed light on whether firms are systematically adopting inefficient compensation arrangements, which, as the next section suggests, has significant corporate governance policy implications.

### *B. Implications for Corporate Governance Policy*

Thus far, this Article has suggested that the optimal contracting model of executive compensation fails to yield accurate predictions about executive pay practices. The managerial power theory's response to this failure is to argue that management-captured boards of directors are not bargaining over executive compensation at arm's length on behalf of shareholders. The corporate governance policy prescription that follows from the managerial power theory is straightforward: make boards more dependent on shareholders by increasing shareholder power, thereby limiting director discretion to act in ways that shareholders do not approve.<sup>171</sup> Doing so, according to managerial power theorists, would restore optimal contracting and result in boards better serving shareholder interests more generally.<sup>172</sup>

While orienting boards toward serving shareholders may be consistent with the premises of the managerial power theory, it is not a result that is implied if tournament theory is an important element of efficient executive pay design. In that case, boards can be viewed as using the tournament approach to CEO compensation to motivate lower-level employees. The justification for doing so could be that, relative to relying solely on pay-for-performance schemes,

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<sup>171</sup> The reforms that managerial power proponents advocate to make boards more dependent on shareholders include facilitating shareholder access to the corporate ballot, improving the transparency of executive compensation arrangements, requiring a shareholder vote on certain features of executive pay packages, eliminating staggered boards, and allowing shareholders to initiate and approve proposals to reincorporate or adopt charter amendments. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2, at 189–216. For an assessment of the likelihood that such reforms will be adopted in the current political environment, see William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. (forthcoming 2005) (reviewing BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2).

<sup>172</sup> See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2, at 201–02; see also Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 908 (2005) (advancing the argument that increasing shareholder power would reduce agency costs between managers and shareholders generally).

tournaments provide a lower cost means of incentivizing managers, better filters out exogenous factors, and encourages managers to make firm-specific human capital investments. Thus, tournament compensation structures may benefit shareholders.

If existing compensation practices serve shareholder interests, then reallocating decision-making power away from boards toward shareholders is unnecessary. Worse, it may be counterproductive because shareholders may use their increased influence to pressure boards of directors to rely too heavily on performance-based pay, when either a one-size-fits-all approach is misguided or when a mix of strategies is called for.<sup>173</sup>

Even assuming that it would be advantageous to more closely link pay to performance, how can we know that giving shareholders greater power in corporate governance would achieve that end? The link between shareholder power and performance-based pay depends on the assumption that CEOs earn excessive amounts of noncontingent pay because they can convince their boards to grant it to them. As I argued in Part II.B, managerial power may not be the principal driver of executive pay arrangements. If high *levels* of fixed CEO compensation are the product of other phenomena, increasing shareholder power will not address the problem. For example, one account for high CEO pay levels is that it arises naturally from competitive benchmarking, which is used by most compensation consultants.<sup>174</sup> Competitive benchmarking involves using a comparison group to set levels of pay. In order to set the compensation of their own CEOs, firms look to the pay levels of other CEOs within their peer group. Firms typically then set their CEOs' pay in the top half of the CEO peer group.<sup>175</sup> Their justification for doing so is retention. When most firms behave this way, CEO pay keeps ratcheting upward. Such institutional causes of escalating executive pay are unlikely to

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<sup>173</sup> There are indications that shareholders are jumping onto the pay-for-performance bandwagon. For example, the California Public Employees' Retirement System (CalPERS), a public pension fund long at the forefront of institutional shareholder activism, has stated that pay-for-performance is one of its top issues. *Proxy Battles Center on Pay-for-Performance Issues*, BASE & BONUS, May 2005, available at [http://www.baseandbonus.com/articles/20050510/proxy\\_battles\\_center\\_performance\\_issues](http://www.baseandbonus.com/articles/20050510/proxy_battles_center_performance_issues).

<sup>174</sup> See John M. Bizjak et al., Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation? (Apr. 2003) (unpublished manuscript, on file with author). The authors report that benchmarking is used extensively in their sample of firms.

<sup>175</sup> Thomas L. Friedman, *Learning from Lance*, N.Y. TIMES, July 27, 2005, at A23 (reporting that John Mack, as the new CEO at Morgan Stanley, initially demanded in the contract he signed that his total pay for the subsequent two years would be no less than the average pay package received by the CEOs at three specified peer group firms).

be constrained by shareholders.<sup>176</sup> In contrast, the use of tournaments could reduce overall CEO pay by deemphasizing the risky contingent element of executive compensation that risk-averse managers discount.<sup>177</sup>

Finally, even if shareholders were likely to exert any enhanced power granted to them to improve existing executive pay practices, increasing shareholder power is an overinclusive prescription, with implications extending well beyond the executive compensation arena.<sup>178</sup> For example, boards exercise discretion over corporate financing decisions, such as dividend and debt policy. They also oversee investment policy, such as what projects to pursue and whether to engage in significant acquisitions. Any changes in the distribution of power between boards and shareholders will have spillover effects on board decision making in these areas, and the effects that such changes imply have yet to be analyzed fully.<sup>179</sup> It is therefore only with caution that initiatives directed at corporate governance realignment for purposes of improving the efficiency of executive pay arrangements should proceed.

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<sup>176</sup> See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* (2002) (contending that emphasis on charisma in CEO hiring artificially limits the number of candidates considered, giving them extraordinary leverage to demand high salaries and power); Murphy & Zábajník, *supra* note 137, at 193 (explaining the trend of rising CEO pay as an equilibrium adjustment to the increasing need to attract CEOs with “general” managerial skills (i.e., skills that are transferable across companies, or even industries)).

<sup>177</sup> See *supra* notes 11–14, 164 and accompanying text.

<sup>178</sup> See Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1654 (2005) (reviewing BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2) (contending that a shift of authority from boards to shareholders is “intrinsically undesirable”). Commentators make the point that the optimal corporate governance structure must minimize overall agency costs, given that the board performs multiple functions, not just selecting executive compensation arrangements. See John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1162–63 (reviewing BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 2). For a more narrowly tailored approach to improving executive compensation processes, see Jeffrey N. Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for ‘Compensation Disclosure and Analysis’* 14–28 (Columbia Law Sch. Law & Econ. Research Paper No. 273, 2005).

<sup>179</sup> For analyses of the potentially harmful effects on reapportioning corporate governance authority away from boards of directors and toward shareholders, see Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. (forthcoming Feb. 2006); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. (forthcoming Feb. 2006); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. (forthcoming 2006) (replying to Bebchuk, *supra* note 172); Leo E. Strine, Jr., *Towards a True Corporate Republic: A Traditionalist Response to Lucian’s Solution for Improving Corporate America*, 119 HARV. L. REV. (forthcoming 2006) (replying to Bebchuk, *supra* note 172).

## CONCLUSION

According to the dominant optimal contracting model of executive compensation, boards seek to maximize shareholder value when they negotiate compensation arrangements with executives. The optimal contracting model does not, however, fit the facts well. Specifically, it predicts a meaningful relationship between executive pay and performance, but studies have not shown a convincing relationship between the two.

The managerial power theory of executive compensation has been proposed to explain why executive pay is substantially decoupled from performance. According to the managerial power approach, one of the key assumptions of the optimal contracting model—that boards serve as faithful agents of shareholders—is inaccurate. Instead, managerial power proponents argue that boards are captured by management and consequently allow managers to structure their compensation arrangements to suit themselves; that is, without regard to their performance. The only significant constraint on such opportunism in the managerial power model is public “outrage,” which arguably accounts for the widespread use of compensation devices that are hard for shareholders to value accurately and therefore “camouflaged” from them. According to the managerial power model, making boards more independent of management would go a long way toward restoring the optimal contracting model’s predictive accuracy.

This Article has argued that the managerial power theory does not explain fully the failure of the optimal contracting model to make accurate predictions about executive pay practices. First, as a theoretical matter, managers’ interests should be aligned with those of shareholders in structuring executive compensation to maximize shareholder value. Second, as an empirical matter, the managerial power theory enjoys little support.

Tournament theory offers an explanation of observed executive pay arrangements other than optimal contracting theory or managerial power theory. In tournament theory, compensation is set not to reward individuals incrementally for increases in absolute performance. Rather, it is designed to provide positive wage spreads between each level of the organizational hierarchy and the next higher level. In each round of the tournament, employees compete for the prize of the compensation attached to the immediately senior position as well as for the chance to remain in the tournament and compete for all subsequent prizes, which, internally, culminate

in the “CEO prize.” This competition can generate powerful managerial incentives.

Substantially differing policy implications flow from the managerial power theory and a view of executive compensation design that incorporates the tournament approach. Managerial power urges corporate governance reforms aimed at making directors more accountable to shareholders, with the goal of counteracting managerial influence and restoring arm’s length bargaining to executive compensation. But if firms are incorporating tournament theory in executive compensation design, then we should not expect to observe a tight link between executive pay and performance for reasons that have nothing to do with managerial power.

Any reforms aimed at changing the distribution of power between boards and shareholders with the intention of changing executive compensation arrangements necessarily presuppose a particular model of how executive compensation is set. The managerial power theory assumes that the optimal contracting model is accurate except for its assumption that boards are bargaining at arm’s length with managers in making compensation decisions. It does not, however, persuasively establish that managerial influence is responsible for pay without performance in executive compensation arrangements. The use of tournaments to motivate executives offers an alternative explanation for why pay and performance are substantially decoupled. We would be well advised to pause, therefore, and consider the implications for executive compensation, in particular, and firm decision making, in general, of the corporate governance reform prescriptions that managerial power theorists advance before proceeding to implement them.