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## RESPONSE

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### THE PARTNER-MANAGER: SOME THOUGHTS ON BEBCHUK AND FRIED

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In response to Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010).

When did corporate executives cease to be employees of their corporations and become partners with their shareholders, and senior partners at that? What were the effects of this transformation? On one hand, the answer to the first question is simple and the second question, while a bit more complex, is also not difficult to answer. On the other hand, one can see each question as having significant depth and complexity. It is my goal in this Response to begin to probe the deeper and more complex aspects of these questions.

No two scholars have done more to address the problems of executive compensation and to offer thoughtful and thorough answers than Lucian Bebchuk and Jesse Fried. Indeed Bebchuk has spent time in the trenches, consulting for the Special Master for the Troubled Asset Relief Program (TARP). They have plumbed the depths of the sources of the problem, and offered creative and comprehensive solutions to the issues they identify.<sup>1</sup> One could critique several of their suggestions—and perhaps the effectiveness of their entire reform package—on theoretical and practical grounds, but this would be nitpicking for its own sake. As a conceptual matter, it is

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<sup>1</sup> I agree with Bebchuk and Fried's assertion that the structure of executive pay has been a significant cause of managerial short-termism. See LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY 109-11 (2001) (describing how executive compensation tied to stock price sacrifices long-term strategy).

hard to argue with their conclusions. The only critique of their reforms that I will make in this Response is to note that the complexity of their proposals and the monitoring problems associated with them might lead them to work less effectively than their authors would like.<sup>2</sup> But if one takes the suggested reforms on their own terms, even though one could quibble with the details, Bebchuk and Fried's work is compelling.

So I shall not take them on their own terms. I will, instead, place Bebchuk and Fried's work in the broader context of the two questions with which I began. This exercise will reveal what I consider to be a fundamental question that remains with respect to the core of their work and regards the premise with which they begin: the partnership of senior executives with shareholders, the state of the compensation world as it is. This starting point, of course, is practical, at least if Bebchuk and Fried are to see their proposals adopted.<sup>3</sup> Few people remake the world through scholarship. But starting with the world as it is embeds a certain degree of fatalism or, perhaps, naturalism, into their work as it does into any scholarship. It disregards the broader context in which the problem arises and therefore prevents the authors from reaching arguably broader conclusions. By treating compensation in relative isolation, their proposals do not address compensation in the broader context of the changes in corporate governance they create.<sup>4</sup> Thus, I offer these thoughts as a friendly addition to their excellent work.

In particular, I will first suggest (as effectively as I can in limited space) that the problem of executive compensation is quite recent. Indeed, no corporate executive was paid more than a million dollars

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<sup>2</sup> Bebchuk and Fried acknowledge this problem with respect to their proposal to eliminate the possibility of executives hedging their restricted stock or stock options. See Lucian A. Bebchuk and Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1953 ("No matter how strong the restrictions and limitations [on hedging] are in theory, they will not do much if executives can circumvent them in practice.")

<sup>3</sup> To their great credit, they have in fact had some real impact on the way executive compensation is structured. See *Compensation Structure and Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.* 111th Cong. 32 (2009) (written testimony submitted by Lucian A. Bebchuk, Professor, Harvard Law School) (urging Congress to "tighten[] the link between compensation and long-term results"); see also Press Release, U.S. Dep't of Treasury, THE SPECIAL MASTER FOR TARP EXECUTIVE COMP. CONCLUDES THE REVIEW OF PRIOR PAYMENTS (Jul. 23, 2010), available at <http://www.ustreas.gov/press/releases/tg786.htm> (discussing Bebchuk's written testimony submitted to the House Committee on Financial Services).

<sup>4</sup> Bebchuk has addressed compensation in the context of the changes it creates in corporate governance with respect to other corporate stakeholders in financial corporate governance, but not shareholders. See Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 251 n.11 (2010).

before 1980 (after the compensation excesses of the 1930s, that is).<sup>5</sup> As Alfred Chandler so carefully details,<sup>6</sup> executives were paid as employees, which they were. It is also important to note that the era of relatively modest executive pay spanned the era of managerialism, a period in which top management was thought to have managed corporations for their own benefit, and that pay exploded only after the institutionalization of the independent monitoring board.<sup>7</sup> Finally, it is worth noting that during the era of relatively modest executive pay, the United States' gross domestic product (GDP) grew at its fastest rate in a century and more.<sup>8</sup> And this growth occurred despite the relative absence of paradigm-changing technological innovation that characterized the late nineteenth and early and late twentieth centuries. Indeed this extraordinary GDP growth preceded the era of hostile takeovers, venture capital financing, and private equity ownership,<sup>9</sup> not to mention the development of complex and supposedly more efficient financial markets.

Considered this way, one has to question the acceptance of current levels of executive compensation as somehow normal or inevitable, and the degree to which it leads senior executives to serve society by running their corporations as efficiently as possible. In order to do that, one needs to look at the new corporate governance model such compensation has generated, one in which what I shall call the "partner-manager" is central. Indeed, one has to wonder whether the incentives of the partner-manager inevitably lead her to work for herself to the potential disadvantage of the corporation and its shareholders. Ultimately, this raises the question of whether Bebchuk and Fried's

<sup>5</sup> See Harwell Wells, "No Man Can Be Worth \$1,000,000 A Year": *The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 761 (2010) (noting that no compensation package exceeded one million dollars from the 1940s through the 1970s).

<sup>6</sup> See generally ALFRED D. CHANDLER JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

<sup>7</sup> Compare Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469 (2007) (arguing that independent directors maximize shareholder value by enhancing fidelity, reliability of public disclosure, and responsiveness), with Lawrence E. Mitchell, *The Trouble with Boards*, in PERSPECTIVES ON CORPORATE GOVERNANCE 17, 20 (F. Scott Kieff & Troy A. Paredes eds., 2010) (reading history to tell a "darker story" and positing that independent boards arose to protect directors from liability and avoid fiduciary obligations).

<sup>8</sup> *Gross Domestic Product Percent Change from Preceding Period*, BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE (Sept. 30, 2010), <http://www.bea.gov/national/xls/gdpchg.xls>.

<sup>9</sup> Whatever else one might say about venture capital and private equity financing, both clearly embrace a model of partner management in the context of privately owned enterprises and carefully negotiated arrangements.

reforms, persuasive as they are, are sufficient to address the problem rather than a symptom.

#### THE RISE OF THE PARTNER-MANAGER

The sweep of American corporate history shows an interesting evolution from entrepreneurial managers to partner-managers. During the latter half of the nineteenth century, American industrial corporations were run by the men who had created them.<sup>10</sup> There was no public market to speak of, except in the case of some railroads and banks, and entrepreneurs like Carnegie, Havemeyer, Harriman and Rockefeller took their wealth as controlling partners and shareholders of closely-held firms.<sup>11</sup> Their compensation was less for their services than, as with all entrepreneurs, their risk, and their rewards were often rich, commensurate with the risks they took.<sup>12</sup>

As Chandler demonstrates, even as these entrepreneur managers were building and profiting from their businesses, another class of managers was developing.<sup>13</sup> The unique circumstances of the railroads led to the development of the first class of employee managers who were hired to run the details of businesses as they grew larger and ever more complex.<sup>14</sup> These managers were not entrepreneurs. Their compensation wasn't based on risk, for the risks they took were not those of entrepreneurs but of ordinary employees. Quite literally, they were paid to keep the trains running on time.<sup>15</sup>

As the market for industrial and other securities exploded at the end of the nineteenth century, entrepreneurs either sold their stock in the giant public combinations (often retaining stock in the newly public companies) or sold some or all of their stock on the market.<sup>16</sup>

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<sup>10</sup> See EDWARD CHASE KIRKLAND, *INDUSTRY COMES OF AGE* 195-216 (1961) (noting that under this arrangement, there existed "a widespread belief that . . . the managers, since they had a genuine stake in an enterprise, would be more energetic, efficient, and prudent in the conduct of its affairs").

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

<sup>12</sup> *Id.*

<sup>13</sup> See CHANDLER, *supra* note 6, at 9-10, 87, 95, 415-16 (explaining that the increased use of such managers, particularly common among the railroads, was necessary as companies merged or otherwise increased in size and expertise in coordinating complex operations).

<sup>14</sup> *Id.* at 87.

<sup>15</sup> *Id.* at 105-06. Of course, these managers were also expected to maintain track and rolling stock, manage finances, and the like. *Id.*

<sup>16</sup> See LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY* 90-112 (2007) (describing the increasing importance of the stock market in American life at the turn of

Although some would retain a measure of control for a considerable period of time, others left their businesses to the care of the investment bankers who brought them to market and to the professional managers they hired. Thus began the separation of ownership and control that Thorstein Veblen observed in 1904,<sup>17</sup> and the observation for which Berle and Means were celebrated following their 1932 publication.<sup>18</sup> While later commentators have overstated the fact of separation,<sup>19</sup> it is nonetheless clear that by the time Berle and Means wrote, professional management ruled both board and company. And while the evidence suggests that during this age of managerialism, corporate executives owned significant amounts of stock in their corporations, their compensation largely was paid in the form of cash salary, like that of other employees—and in relatively moderate amounts at that.<sup>20</sup>

The 1970s' attack on managerialism broke up the insider board (which in fact typically had some number of outside directors) and led to the rapid development and acceptance of the monitoring board. By 1985, it was clear that a corporate board dominated by insiders was a board at greater risk of legal liability than a board com-

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the twentieth century); *see also* NAOMI R. LAMOREAUX, *THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895-1904*, at 120-26 (1985) (detailing the common practice of smaller firms being sold to larger, multiplant firms); Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 29 *BUS. HIST. REV.* 105, 116-38 (1955) (explaining the liquidity-enhancing effect of stock market listing in the late nineteenth century); Marian V. Sears, *The American Businessman at the Turn of the Century*, 30 *BUS. HIST. REV.* 382, 411-17 (1956) (detailing the increased attention to and spreading of ownership that resulted from stock market listing at the turn of the century).

<sup>17</sup> *See* THORSTEIN VEBLÉN, *THE THEORY OF BUSINESS ENTERPRISE* 266-67 (1904) (discussing the transfer of business decisionmaking authority from owners to managers).

<sup>18</sup> *See* ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 66 (Harcourt, Brace & World, rev. ed. 1967) ("As the ownership of corporate wealth has become more widely dispersed, ownership of that wealth and control over it have come to lie less and less in the same hands.")

<sup>19</sup> *Cf.* MITCHELL, *THE SPECULATION ECONOMY*, *supra* note 16, at 272-74 (explaining that complete separation between ownership and control is an inaccurate observation since managers tended to invest heavily in the stock of their own corporations).

<sup>20</sup> *Id.* *See also* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 25 (Eur. Corp. Governance Inst., Finance Working Paper No. 44/2004, 2004), *available at* <http://papers.ssrn.com/abstract=561305> (showing that the rapid increase in executive compensation is largely the result of stock option issuance); Carola Frydman & Raven E. Saks, *Historical Trends in Executive Compensation 1936-2003* 16-17 (Nov. 15, 2005) (unpublished manuscript), *available at* <http://faculty.chicagobooth.edu/workshops/AppliedEcon/archive/pdf/FrydmanSecondPaper.pdf> (noting that nearly all executive compensation was in the form of cash prior to the 1980s).

posed largely of independent directors.<sup>21</sup> And as Melvin Eisenberg so persuasively argued in the late 1960s and early 1970s, only a board of independent directors could perform the central task that was the proper province of directors anyway: monitoring the management of their corporations.<sup>22</sup> The creation of the independent monitoring board appeared perfectly designed to redress the perceived problems of managerialism. Whether it was effective in improving corporate performance is an issue beyond the scope of this Response.<sup>23</sup>

But the general acceptance of the independent monitoring board created a different corporate governance problem. While the managerial board had intimate knowledge of the corporation's business and affairs, the independent monitoring board—a board composed of fully-employed members who had little time to commit to the affairs of the corporation—had to develop monitoring tools that fit the time available for their work and fulfilled their basic monitoring responsibilities. Stock price came to be the most easily accessed metric and—in an era in which markets were said to be highly efficient—appeared to serve as a reasonable proxy for corporate performance. Stock also became a logical way to compensate employee managers since this type of payment would direct their efforts toward the improvement of corporate performance as manifested by stock price.

At the same time, the independent monitoring board created a power vacuum. Where at one point manager-directors had relatively equal access to information, the new board model with its part-time directors left the lion's share of corporate information—and certainly the most significant, intangible information—in the hands of the CEO. All well-designed bureaucratic structures are designed to channel information to the top.<sup>24</sup> The top of the new corporate gover-

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<sup>21</sup> See Mitchell, *supra* note 7, at 51-53 (describing corporate America in the mid-1980s as being “thick in the boom of hostile takeovers, insider-trading scandals, the proliferation of junk bonds, and renewed Congressional attention,” which contributed to the desire of corporations to minimize legal risks by having boards of independent directors).

<sup>22</sup> See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 172-77 (1976) (detailing the ways in which permitting a corporation's executives to sit on the board is “inconsistent with the board's advice and function”).

<sup>23</sup> *But see, e.g.,* Sanjai Bhagat & Bernard Black, *Independent Directors*, in 2 *NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 283 (Peter Newman ed., 1998) (“[S]tudies of overall firm performance have found no convincing empirical evidence that firms with majority-independent boards achieve better performance than other firms.”).

<sup>24</sup> See ANTHONY DOWNS, *INSIDE BUREAUCRACY* 24-25 (1967) (defining, in part, bureaucracies as organizations that are large enough that, in general, highest ranking members know less than half of all other members because of efficient communication); MAX WEBER, *ECONOMY AND SOCIETY* 956-57 (Guenther Roth & Claus Wittich

nance model was the CEO, who now had the ability to determine the quality and amount of information available to the independent directors. Among this information was, of course, the CEO's performance.<sup>25</sup> Compensation committees had perhaps better information than did the independent directors more generally, and the compensation consultant business began to boom,<sup>26</sup> but the imperial CEO had been created and was firmly in control.

Thus began the third phase of the development of executive compensation, the partner-manager phase, and it is this phase of the development of executive compensation that Bebchuk and Fried address. It is in the early stages of this phase that the separation of ownership and control perhaps was more complete than in any other era, despite the growing power of institutional investors. A logical corporate governance corollary of this reality was to tie the executive's interests more closely to those of the corporation's shareholders. Supported firmly by academics, Congress enshrined this principle in a 1993 amendment to the Internal Revenue Code.<sup>27</sup> The rest, as they say, is history.

This brief historical survey should make it clear that the development of a corporate economy in which executive compensation is largely composed of such large amounts of stock, representing a non-negligible percentage ownership of the corporation's shares, was hardly inevitable and only of quite recent vintage.<sup>28</sup> The amounts of stock paid to and owned by top executives in fact make them partners with shareholders in the business, albeit partners without the mutual agency obligations and unlimited liability that characterize partners in

eds., 1978) (describing characteristics of modern bureaucracy, including a model of administrative efficiency of information and actions).

<sup>25</sup> See Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1346 (2005) (noting that the elimination of board ties to corporate insiders led to increased dependence on the chief executive for information).

<sup>26</sup> See Brian Cadman et al., *The Incentives of Compensation Consultants and CEO Pay*, 49 J. ACCT. & ECON. 263, 279 (2009) ("[W]e find that 755 of 880 firms in our initial sample retain compensation consultants, suggesting that the use of consultants is widespread."); Kevin J. Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants*, 49 J. ACCT. & ECON. 247, 260 (2009) (finding that compensation consultants increasingly work exclusively with compensation committees).

<sup>27</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified as amended at 26 U.S.C. § 162(m) (2006)) (detailing restrictions to deductions on "excessive employee remuneration").

<sup>28</sup> Managerial stock ownership of exchange-listed corporations rose from thirteen percent in 1935 to twenty-one percent in 1995. Clifford G. Holderness et al., *Were the Good Old Days That Good? Changes in Managerial Stock Ownership Since the Great Depression*, 54 J. FIN. 435, 436 (1999).

the legal form.<sup>29</sup> The incentive of relatively unrestrained partners is to maximize their own wealth—if necessary at the expense of others—and it is clear that top corporate executives in the age of partner-managers have done precisely this, as Bebchuk and Fried show. Bebchuk and Fried have done an excellent job of designing restraints for these incentives. The question remains whether restraints alone, without altering incentives, will be fully effective. The governance problem created by modern executive compensation is not a problem of compensation alone; it is a broader one that goes to the heart of the nature of the modern, public corporation.

Investment banks provide a nice example of this governance problem, even following the transformation of some into bank holding companies and the absorption of others into larger, financial conglomerates. Members of the New York Stock Exchange were prohibited from incorporating prior to 1953.<sup>30</sup> This placed natural checks on their risk taking and ability to raise capital, as well as on the compensation of their partners. Members of the New York Stock Exchange were prohibited from offering their stock to the public prior to Donaldson, Lufkin, and Jenrette's (DLJ) defiance of the rule in 1970.<sup>31</sup> Thereafter, almost every major investment bank fell into line and became publicly held.<sup>32</sup> This of course allowed them to raise considerably

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<sup>29</sup> It is, I believe, well recognized that fiduciary duties provide only modest restraints, and perhaps less so in the area of executive compensation than in other dimensions of the corporation's business. See, e.g., William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 61-64 (2010) (anticipating the Supreme Court's recent holding in *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1426 (2010), establishing a standard whereby investment advisers face liability for fiduciary breaches when charging fees that are "disproportionately large"); Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 425-35 (2010) (discussing the influence of Bebchuk and Fried in the field of executive compensation and detailing several critiques thereof); Wells, *supra* note 5, at 736-37 (illustrating courts' unwillingness to cap executive compensation).

<sup>30</sup> See *NYSE Votes Permissive Incorporation*, CHRISTIAN SCIENCE MONITOR, Mar. 6, 1953, at 14 (reporting on the 1953 amendment making the corporate form available).

<sup>31</sup> See JOHN BROOKS, *THE GO-GO YEARS* 316 (1973) (discussing W.H. Donaldson's remarks on "the impermanence of Wall Street capital" prior to DLJ's actions forced the rule to change).

<sup>32</sup> See Michael Hayes, *The Vanishing Partnership*, REGISTERED REP. Jan. 2000, available at [http://registeredrep.com/mag/finance\\_vanishing\\_partnership/](http://registeredrep.com/mag/finance_vanishing_partnership/) (discussing the rapid and lasting changes at the NYSE motivated by DLJ's actions); Andrew von Nordenflycht, *The Demise of the Professional Partnership? The Emergence and Diffusion of Publicly-Traded Professional Service Firms 20-25* (Nov. 2008) (unpublished draft), available at <http://www.law.georgetown.edu/LegalProfession/documents/vonNordenflychtPaper.pdf> (recounting DLJ's move to reform ownership requirements and its support by Merrill Lynch).



greater amounts of capital and take greater risks with shareholders' money now that monitoring management became a meaningful issue.

But while their form was corporate and their capital structure public, these investment banks largely retained the trappings of partnerships. Look, for example, at the percentages of earnings investment banks pay in compensation compared to the balance retained for their public shareholders. For instance, in the first quarter of 2010, Goldman Sachs had net revenues of \$12.75 billion, net earnings of \$3.4 billion, and paid compensation and benefits (deducted from net revenue) of \$5.5 billion, leaving \$3.3 billion for its common shareholders.<sup>33</sup> On net revenue of almost \$8 billion in the second quarter of 2010, Morgan Stanley paid \$3.9 billion as compensation, with \$1.6 billion going to the shareholders.<sup>34</sup> The story is easily repeated with respect to JP Morgan Chase, Merrill Lynch, and the late Bear Stearns.<sup>35</sup> In no other industry is the partner-manager so obviously institutionalized. Yet what is true in investment banks has also become true (although in numbers less extreme) with respect to top management of nonfinancial corporations, and it is only constrained space that prevents me from adding additional examples.

Tying compensation to performance is a worthy effort. But the partnership model of corporate management raises broader questions of corporate governance and performance, questions that Bebchuk and Fried do not address because they take the current compensation model as their starting point. It also raises questions regarding the relationship of executive compensation to real economic growth. The answers may all be positive, but the question needs to be addressed at a deep economic level. While it is the last refuge of academic scoundrels to do so, I plead an inability to even begin to address these broader problems in a note of this nature. With deep respect for Bebchuk and Fried's work, I simply raise the questions for another day.

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<sup>33</sup> Goldman Sachs Group, Inc., Quarterly Report (Form 10-Q) (May 10, 2010).

<sup>34</sup> Morgan Stanley, Quarterly Report (Form 10-Q) (Aug. 9, 2010).

<sup>35</sup> See Bear Stearns Cos., Annual Report (Form 10-K, Ex. 13) (2007) (reporting compensation of \$4.3 billion with \$2 billion for common shareholders on net revenue of \$9.2 billion); JP Morgan Chase & Co., Annual Report (Form 10-K) (Feb. 24, 2010) (reporting \$27 billion in compensation with \$8.8 billion for common shareholders on net revenue of \$100 billion); Merrill Lynch & Co, Annual Report (Form 10-K) (Feb. 25, 2008) (reporting \$15.9 billion in compensation on net revenue of \$11.2 billion).

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