

University of Pennsylvania Carey Law School

## Penn Carey Law: Legal Scholarship Repository

---

Faculty Scholarship at Penn Carey Law

---

2006

### Supersize Pay, Incentive Compatibility, and the Volatile Shareholder Interest

William W. Bratton

*University of Pennsylvania Carey Law School*

Follow this and additional works at: [https://scholarship.law.upenn.edu/faculty\\_scholarship](https://scholarship.law.upenn.edu/faculty_scholarship)



Part of the [Business Administration, Management, and Operations Commons](#), [Business Law, Public Responsibility, and Ethics Commons](#), [Business Organizations Law Commons](#), [Economic Theory Commons](#), [Law and Economics Commons](#), [Securities Law Commons](#), and the [Work, Economy and Organizations Commons](#)

---

#### Repository Citation

Bratton, William W., "Supersize Pay, Incentive Compatibility, and the Volatile Shareholder Interest" (2006). *Faculty Scholarship at Penn Carey Law*. 866.

[https://scholarship.law.upenn.edu/faculty\\_scholarship/866](https://scholarship.law.upenn.edu/faculty_scholarship/866)

This Article is brought to you for free and open access by Penn Carey Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship at Penn Carey Law by an authorized administrator of Penn Carey Law: Legal Scholarship Repository. For more information, please contact [PennlawIR@law.upenn.edu](mailto:PennlawIR@law.upenn.edu).

# VIRGINIA LAW & BUSINESS REVIEW

---

VOLUME 1

SPRING 2006

NUMBER 1

---

## SUPERSIZE PAY, INCENTIVE COMPATIBILITY, AND THE VOLATILE SHAREHOLDER INTEREST

William W. Bratton<sup>†</sup>

INTRODUCTION .....	56
I. MODELING THE SHAREHOLDER .....	60
A. Speculation versus Investment .....	61
B. Noise Trading versus Fundamental Value Investment .....	62
C. Short Term versus Long Term .....	64
D. Dumb Money versus Smart Money .....	65
E. Summary: Shareholders and Fundamental Value .....	67
II. THE VOLATILE SHAREHOLDER INTEREST AND INCENTIVE COMPENSATION .....	68
A. Stock Option Plans: Prevailing Practice and Critique .....	68
B. Investment Policy .....	71
C. Quality of Financial Reports .....	76
D. Payout Policy .....	81
E. Bonuses and Exit Payments .....	83
F. Summary .....	88
III. THE VOLATILE SHAREHOLDER INTEREST AND THE DEBATE OVER SUPERSIZE PAY .....	89
A. Power and Rents .....	90
B. Defensive Tactics .....	94
CONCLUSION .....	99

---

<sup>†</sup> Professor of Law, Georgetown University Law Center.

## INTRODUCTION

THE compensation of chief executive officers increased by a factor of six over the last two decades,<sup>1</sup> with the overwhelming share of the increase coming not as salary but as “incentive pay,” mostly in the form of stock options and cash bonuses triggered by performance metrics.<sup>2</sup> Observers from outside the corporate governance arena perceive a social problem and question the magnitude of this raise. They worry about the fact that executives in the United States are by far the world’s best paid.<sup>3</sup> On the domestic level, observers also worry about a growing inequality of income: the average CEO of an S&P 500 company made thirty times more than the average American production worker in 1970, but 210 times more in 1996.<sup>4</sup> Inside the world of corporate governance, the question is different, because the level of compensation is not by itself seen as a problem.<sup>5</sup> Tournament economics provides a widely accepted justification for supsize amounts. The tournament sweeps in the entire set of aspiring executives, who then compete for a small number of top-tier jobs. High-powered competition ensues among executives, which is thought to result in better management.<sup>6</sup>

1. See Bengt Holmström & Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?* 10 (ECGI Finance Working Paper No. 23/2003, 2003), available at <http://ssrn.com/abstract=441100>.
2. Average total remuneration of executives of S&P 500 companies (adjusted for inflation) went from \$850,000 in 1970 to \$14 million in 2000, falling with the stock market to \$9,400,000 in 2002. At the same time, average base salaries merely doubled, going from \$850,000 to \$2,200,000. 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* 24-25 (Harv. NOM Working Paper No. 04-28, 2004), available at <http://ssrn.com/abstract=561305> [hereinafter Jensen & Murphy 2004].
3. See Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171 (2004) (suggesting reasons to justify the transnational pay gap).
4. Kevin J. Murphy, *Executive Compensation* 51 (Apr. 1998) (unpublished manuscript), available at <http://ssrn.com/abstract=163914> [hereinafter Murphy 1998].
5. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 5, 70-74 (Harv. Univ. Press 2004).
6. See, e.g., Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845, 846, 857 (1981); see also Edward P. Lazear, *Output-Based Pay: Incentives, Retention or Sorting?* (IZA Discussion Paper No. 761, Apr. 2003), available at <http://ssrn.com/abstract=403900> [hereinafter Lazear 2003]. Citing the absence of downside penalties, Lazear rejects the notion that performance incentives have anything to do with observed executive pay practices. He argues that equity-based pay ameliorates information asymmetries. The executive, an informational insider, trades less-risky cash compensation for riskier equity compensation in order to reassure outsiders. This leads to the prediction that equity-based compensation is more likely to appear when the firm’s production function is little understood. Lazear 2003 at 2-3.

The corporate governance question is whether compensation mechanisms within the winner's circle should be subject to exacting standards of incentive compatibility. Critics of prevailing practices argue that large payoffs to managers should be strictly conditioned on the creation of shareholder value.<sup>7</sup> According to critics, prevailing arrangements fail to impose such conditions because the bargaining framework is skewed in management's favor.<sup>8</sup> Defenders of the prevailing practice answer that the governance framework is effective, if not perfect. To support this view, they point to rational risk/return trade-offs embodied in the contracts.<sup>9</sup>

This article intervenes in the debate to assert that an evaluation of compensation practices should concern more than the attributes of the bargaining space. The discussants all posit the maximization of shareholder value as the firm's objective and agree that such value can be enhanced by aligning management's interests with those of the shareholders. A follow-up question rarely arises: How should the shareholder-beneficiary be modeled for the purpose of designing incentives? This Article unpacks the notion of the shareholder, introducing a more particularized account in which the unitary model of the shareholder disintegrates into a differentiated cast of characters made up of investors, speculators, noise traders, fundamental value investors, short-term holders, long-term holders, dumb money, and smart money. The model is not only fragmented, but is also volatile, for different shareholder types predominate in different firms and in different stock markets. A normative question emerges concerning the design of equity

- 
7. Professors Lucian Bebchuk and Jesse Fried are the leading critics. *See generally* BEBCHUK & FRIED, *supra* note 5. They build on a large antecedent literature. Before their appearance, the leading critic was Professor Charles Elson, who for many years has been describing pay practices as a function of board capture. *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651 (1995); Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 156-64 (1996). A management-influence hypothesis has also appeared in the economic literature. *See* Marianne Bertrand & Sendil Mullainathan, *Agents With and Without Principals*, 90 AM. ECON. REV. 203 (2000); Marianne Bertrand & Sendil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901 (2001).
  8. BEBCHUK & FRIED, *supra* note 5, at 6, 9.
  9. For a theoretical showing along these lines, see Benjamin E. Hermalin, *Trends in Corporate Governance* 13-20 (Sep. 3, 2003) (unpublished manuscript), *available at* <http://ssrn.com/abstract=441360>. In Hermalin's model, stepped-up board monitoring causes pay to increase in equilibrium. The insight is that stepped-up monitoring decreases the executive's expectations of job security and induces greater effort, because the executive wants to induce a retention decision from the monitoring board. This reduces the executive's utility, causing the executive to negotiate for higher pay.

incentive compensation: What kind of a shareholder do we wish the incentivized manager to be?

Most will agree that compensation should be designed to encourage managers to take the view of a long-term, fundamental value investor, rather than a short-term speculator sensitive to market moods. Yet prevailing compensation practices align management interests with those of speculative, short-term shareholders. Three possible perverse effects result, all well-known in the compensation literature:<sup>10</sup> first, speculatively inclined managers can rationalize investments in projects that decrease the long-term value of the firm; second, speculative incentives encourage aggressive accounting and distorted corporate reporting; and, third, speculative incentives skew payout policy away from dividends toward open-market repurchases of firm stock, with possible adverse consequences. Long-term restraints on the alienation of equity awards, whether purchased through the exercise of stock options or granted outright, would ameliorate all three problems. These are not seen in practice because they diminish the value of equity grants by impairing liquidity and inhibiting the reduction of risk by means of diversification.

Strict incentive compatibility, then, decreases the compensation value of equity grants. A question accordingly arises concerning the appropriate mediation of this conflict between compensation value and incentive effects. Economic theory holds out no calculative solution; there is no general theory of optimal incentive contracting with respect to corporate managers.<sup>11</sup> Pending such a theory's appearance, three alternative approaches can be suggested. First, the imposition of alienation restraints can be offset by an increase in the number of shares awarded, leaving the present value of compensation unaffected. Here a question arises respecting the amount paid, for at some point the value of the concession becomes unreasonably large. Second, a decrease in value for the sake of incentive compatibility could be deemed non-compensable as a normative proposition: Why should shareholders have to pay more for correctly aligned incentives? In this case, the problem lies in the tournament payoff, because at some point a pay cut hurts the firm by dulling incentives. The third approach, which recognizes the problems just noted, deems the matter ill suited to rule-based resolution and

---

10. See, e.g., Randall Thomas & Thomas Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 40-46 (2000).

11. If we had such a theory, there would be nothing to dispute except the level of pay. See Patrick Bolton, José Scheinkman & Wei Xiong, *Pay for Short-Term Performance: Executive Compensation in Speculative Markets* 33 (ECGI Finance Working Paper No. 79/2005, Apr. 2005), available at <http://ssrn.com/abstract=691142>.

leaves it to case-by-case negotiation. Here, the problem lies in the flawed bargaining context.

Although there is no theoretical template that correctly determines trade-offs between compensation and incentive compatibility, economic theory does hold out normative guidance. Equity grants make no sense when viewed as pure compensation. If a supersize pay-package were the sole objective in view, the shareholders would get more bang for their buck by paying cash. Equity grants accordingly can be justified only to the extent that they hold out positive incentive effects, effects that can be maximized only by imposing retention constraints that detract from compensation value. An ordering of priorities is implied. Incentive compatibility should come first, with the level of compensation being set only in an incentive-compatible framework. So long as corporate boards treat incentive-alignment and compensation as coequal objectives, trade-offs will follow, and equity compensation schemes will continue to hold out perverse incentives.

Part I describes behavioral variations in the shareholder population. Inevitable uncertainty about valuation causes the shareholder in the shareholder-value-maximization norm to fragment into diverse behavioral types. The shareholder types are presented in a two-sided taxonomy that distinguishes the speculative element (made up of noise traders, short-termers, and dumb money) from the investment element (made up of fundamental value holders, long-termers, and smart money).

Part II looks at stock option and bonus plans to see what kind of shareholder they usher into corporate headquarters. Speculators emerge in significant numbers, with negative implications for investment policy, corporate reporting, and payout policy. Realigning incentives means placing painful constraints on the liquidity of management stockholdings, and results in a trade-off problem for the design of incentive compensation.

Part III shows that this Article's analysis holds negative implications for both sides of the debate over executive pay. The critics look for a cure in shareholder empowerment without pausing to ask about the incentives of the interest holders thus empowered. Shareholder demands are volatile in time, and the shareholder interest cannot always be relied upon for productive instructions. The defenders justify the prevailing practice as a fair and rational risk/return trade-off between the manager and the firm. In so doing, however, they model the shareholder-manager no differently than the holder of shares in a diversified mutual fund, and so fail to confront incentive problems wrought into the contracting pattern.

## I. MODELING THE SHAREHOLDER

To value a share is to project returns and then find a factor with which to discount them.<sup>12</sup> The appraiser studies facts presently ascertainable about the company, the industry, and the economy,<sup>13</sup> and then takes out a crystal ball. Valuations are just guesses, albeit some better-calculated than others. That being the case, it comes as no surprise that financial economics has never managed to come up with a robust asset-pricing model.<sup>14</sup> Absent such a model, which would provide a means to verify present prices, there is much room for behavioral variation, diversity of approach, and opinion among shareholders on matters of valuation. And nearly all matters of concern to shareholders ultimately come down to matters of value. Behaviorally speaking, then, there is no unitary, empirical shareholder. One only can describe a series of binary alternatives:

<b>Speculation</b>	<b>Investment</b>
Noise trading	Fundamental value investment
Short term	Long term
Dumb money (smart money)	Smart money (dumb money)

It follows that when the shareholder interest is called on to provide a normative benchmark (whether to better align the incentives of executives or for some other purpose), the shareholder must be modeled. Modeling means choosing among the different shareholder types above. The choice proceeds under constraint: one can mix and match characteristics from the various rows and from either column, but if one includes too many characteristics from both columns at once, a model providing a coherent normative instruction will not emerge.

The shareholder is indeed modeled routinely in boardrooms and in corporate and securities law. But the more particular attributes of such shareholder constructs tend to be implicit, and often vary with the context or over time. Securities law provides an example. Historically, it has regulated from the perspective of the investment column, but has been increasingly

12. See RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 62-71 (6th ed. 2000).

13. See ZVI BODIE & ROBERT C. MERTON, FINANCE 260 (2000) (describing firm-specific risk).

14. See Jeffrey Gordon & Lewis Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 771-786 (1985).

solicitous of the speculative side during the last two decades.<sup>15</sup> Corporate law presents a contrasting case. It often models its shareholder-beneficiary so vaguely as to elide the problem of making menu choices. This is not necessarily a failing; the governance problems on corporate law's table often do not require further inquiry into the shareholders' financial and behavioral profiles. For example, when the question is whether management should be able to line its pockets with an unfair self-dealing transaction, the law may fairly assume a unitary shareholder interest in a fiduciary duty of loyalty. Sometimes, however, corporate law does model the shareholder interest more particularly. For example, it draws selectively from the investment column in articulating the law of takeover defense,<sup>16</sup> aligning the long-term shareholder with the manager against short-term speculators, so as to justify management takeover defenses.<sup>17</sup> There follows a more particular look at the columns and the categories.

#### A. Speculation versus Investment

The typology's headings come from the classic conservative treatise on finance and valuation, Graham and Dodd's *Security Analysis*.<sup>18</sup> Graham and Dodd divided stockholders into two types. On one side, they placed those who play the market looking for quick gains. Against this category of speculators, Graham and Dodd contrasted a second category of investors, which itself comprises two subsets. The more conservative subset of investors looks for safe income streams, analyzing past performance and avoiding any forward-looking projection. The less conservative subset looks for capital appreciation rather than income, and invests based on projections of future growth. They thereby resemble speculators, with the difference lying

- 
15. Prior to 1978, the Securities and Exchange Commission insisted that issuers disclose only verifiable financial information. That conservative position was much criticized. *See, e.g.,* Homer Kripke, *The SEC, the Accountants, Some Myths[,] and Some Realities*, 45 N.Y.U. L. REV. 1151, 1188-1191 (1970). The SEC eventually yielded, crafting a safe-harbor rule for issuer disclosures of projections. *See* Proposed Safe-Harbor Rule for Projections, Exchange Act Release No. 15,306 (Nov. 7, 1978); *see also* Guides for Disclosure of Projections of Future Economic Performance, Exchange Act Release No. 15,305 (Nov. 7, 1978).
  16. Compare Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002), with Lucian Bebchuk, *The Case Against the Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).
  17. *See, e.g.,* *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1155 (Del. 1989) (approving defensive tender offer on the ground of protection of long-term investment plan).
  18. BENJAMIN GRAHAM & DAVID L. DODD, *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE* 33-36 (3d ed. 1951).

in the approach taken. Investment in growth requires something “more tangible than the psychology of the purchaser,”<sup>19</sup> specifically the safety of the principal and a satisfactory return, and these goals are best achieved by thorough analysis. Such analysis has to address the quality of the company, but it cannot stop there. Quantity, in the sense of the relation of the stock price to the company’s fundamental value, matters just as much. In Graham and Dodd’s picture, the market price is not necessarily the best available evidence of the value on offer. Given a market full of speculators, it certainly will not be: the best firm in the world is the issuer of just another speculative stock if speculators have bid its price to the stratosphere.<sup>20</sup>

Investment, said Graham and Dodd, is “good for everybody and at all times.”<sup>21</sup> But speculation is not always bad, depending on who does the speculating and the prevailing conditions.<sup>22</sup> Unfortunately, speculation often turns out badly. The failure properly to distinguish between the two activities, they said, brought about the disaster of 1929.<sup>23</sup>

## B. Noise Trading versus Fundamental Value Investment

The essence of Graham and Dodd’s distinction between speculation and investment shows up in the contemporary noise-trading theory of stock market pricing.<sup>24</sup> The noise theorists, looking to behavioral psychology, divide the market into two types of shareholders: noise traders and fundamental value investors.<sup>25</sup> The fundamental value investors closely resemble the less-conservative subset of Graham and Dodd’s investors. These actors know that value lies in hard cash flows and invest into those flows even as they look for growth. Their timelines tend to be longer, and their information sets include only facts respecting the investee and the economy (so-called “fundamental value information”), rather than the latest word from Wall Street. Market trends and daily noise do not impress them.

---

19. *Id.* at 37.

20. *Id.* at 38-39. Contemporary observers term their approach “value investing.” Warren Buffett, a student of Graham and Dodd, is a famously successful exemplar. *See* ROGER LOWENSTEIN, *BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST* 36-59 (1995) (describing Buffett’s relationship with Graham).

21. GRAHAM & DODD, *supra* note 18, at 34.

22. *Id.*

23. *Id.*

24. *See, e.g.*, Andrei Shleifer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP., Spring 1990, 19, 19-22, 23-26 (1990).

25. For a leading model, see Joseph Lakonishok et al., *Contrarian Investment, Extrapolation, and Risk*, 49 J. FIN. 1541, 1542-44, 1575-76 (1994).

The noise traders resemble Graham and Dodd's speculators, although this model adds an overlay of psychology to reinforce the description of the speculative mindset. Noise traders chase trends: when they see somebody make a killing on a rising stock, they assume that actor to be smart rather than lucky, and they imitate the strategy.<sup>26</sup> Noise traders also display behavioral biases. They are overconfident in their own investment abilities.<sup>27</sup> When the stock price is trending upwards, they react too favorably to good news. Once a downward trend becomes manifest, they react too unfavorably to bad news. In both cases they suffer from availability bias and place too great a weight on recent events and easily available information.<sup>28</sup> An availability bias also leads noise traders to make poorly considered risk-return projections, in which they underweight the importance of risks of low probability and high magnitude. Finally, at the moment when the trend turns, noise traders can be slow to read the handwriting on the wall. Their irrational inaction<sup>29</sup> results from a hindsight bias, in which traders overweight past events that actually occurred, rather than those that might have occurred.<sup>30</sup> It also follows from confirmation bias, which is the tendency to confirm earlier decisions regardless of their intrinsic soundness.<sup>31</sup> Noise traders get embedded notions about their strategies and shut out information.<sup>32</sup>

Trends dominate the resulting picture of market pricing.<sup>33</sup> When the market trends upward, too much is made of good news, and bad news is filtered out. Indeed, market information may influence the price as much as (or even more than) fundamental value information. Market information most clearly dominates in a bubble, where a feedback loop takes over as one

---

26. See Shleifer & Summers, *supra* note 24, at 28-30.

27. Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L. J. 1397, 1459-1460 (2001).

28. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1127-28 (1974).

29. See Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 659-60 (1996).

30. See Baruch Fischhoff, *Hindsight Is Not Equal To Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 104 J. EXPERIMENTAL PSYCH.: HUM. PERCEPTION & PERFORMANCE 288, 297 (1975).

31. See Charles G. Lord, Lee Ross & Mark R. Lepper, *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCH. 2098, 2099 (1979).

32. The list of behavioral infirmities goes on. See generally Langevoort, *supra* note 29; Stephen J. Choi & Adam Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 7-11 (2003).

33. For models, see Nicholas C. Barberis, Andrei Shleifer & Robert Vishny, *A Model of Investor Sentiment*, 49 J. FIN. ECON. 307 (1998); Kent Daniel, David Hirshleifer & Avanidhar Subrahmanyam, *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839 (1998).

stock price increase feeds the next increase.<sup>34</sup> The trend turns only sometime after information about fundamental value has ceased to justify the price.<sup>35</sup> Eventually the accumulation of bad news causes investors to substitute a new, negative model. Then the trend turns downward, with investors thereafter tending to underweight good news.<sup>36</sup>

Restating the above in less formal terms, speculative investors experience mood swings. Uncertainty is the ultimate cause: no shareholder, whether a speculator or an investor, can ascertain fundamental value with surety, even while staking significant sums in a highly competitive marketplace. Cool rationality can turn out to be the behavioral exception rather than the rule.

### C. Short Term versus Long Term

The speculative interest tends to have a short-term time horizon, with the investment interest more likely to look long. This follows from their differing behavioral characteristics. The market information that drives the speculators bears primarily on the near term. The fundamental value that drives the investment side tends to have meaning only over the intermediate or long term.

The appellations “short term” and “long term” have come to stand in for Graham and Dodd’s terms “speculation” and “investment.” The change in usage has normative implications, as reference to a short-term time horizon avoids the pejorative implication of the “speculation” label,<sup>37</sup> when coupled with strong assumptions about the accuracy of market pricing. Under this approach, widely prevalent in the 1990s,<sup>38</sup> differing time-horizons hold out no

---

34. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 44-68 (2000).

35. See Barberis et al., *supra* note 33, at 307-08 (describing price underreaction to news).

36. ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* 113-14 (2000).

37. Graham and Dodd pointed out that there is no clear line separating the short and long terms and that one can “invest” in the short term and “speculate” in the long term. GRAHAM & DODD, *supra* note 18, at 35.

38. In the 1980s, in contrast, shareholder value maximization practices seemed to hold out more of a threat to management’s freedom to invest. See Michael E. Porter, *Capital Choices, Changing the Way America Invests in Industry*, in *STUDIES IN INTERNATIONAL GOVERNANCE AND CORPORATE FINANCE AND GOVERNANCE SYSTEMS* 6 (Donald H. Chew ed., 1997). The leveraged restructuring movement denuded management of investment discretion, even as it produced large present payments in the form of tribute to shareholders who had long been starved of cash returns. The restructurings’ defenders argued that the transactions had the beneficial effect of constraining management’s tendency to invest equity capital sub-optimally, even as the transactions had the effect of taking the subject firms private, thereby insulating them from left-side shareholder influences. See Michael Jensen, *The Eclipse of the Public Corporation*, *HARV. BUS. REV.*, Sept.-Oct. 1989, at 61, 65-72.

complications for the model of the shareholder, and “shareholder value maximization,” when keyed to today’s stock price, carries a positive normative connotation.<sup>39</sup> Present-value theory brings all time horizons together into today’s market price,<sup>40</sup> and under the efficient market hypothesis (EMH), today’s price reflects fundamental value.<sup>41</sup> It follows that maximizing today’s stock price maximizes fundamental value and that directing management to maximize present value holds out no risk of perverse effects. The converse also obtains under this market-favorable view: maximizing fundamental value maximizes today’s stock price, so that management confidently can invest for the long term without having to worry about being punished by the speculative interest in the stock market.<sup>42</sup>

Problems come up if the EMH drops out of the picture and market underpricing and overpricing become possible. If the market price does not automatically self-correct, then it can be driven in incorrect directions by short-term, noise-trading shareholders. If pursuing a shareholder value strategy causes management to align the business plan with these shareholders’ preferences, the result could be underinvestment in productive projects and overinvestment in suboptimal projects.

#### D. Dumb Money versus Smart Money

The final binary—dumb money versus smart money—complicates the typology’s division of the world into speculators and investors, as indicated by the parentheticals in the chart. The noise traders make up the core of the

---

The transactions’ opponents claimed that high leverage entailed excessive agency costs and choked off new investment. Eventually, history defused the issue by consigning high-leverage restructuring to its scrapheap. Leveraged restructuring came to be seen as shock therapy incurred in the normative transition from post-war managerialism to the superior shareholder value regime of the 1990s, under which managers invested for the long term, even as they adhered to a norm of present shareholder value maximization. See Bengt Holmström & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 127-132 (2001).

39. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278-87 (1999).

40. See Henry Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 288-90 (1990).

41. See WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 154-55 (5th ed. 2003).

42. This assumes, of course, that management credibly can communicate its proprietary information about future prospects to actors in the market. If it cannot, then a market tendency to rely on short-term performance numbers can have perverse effects. See William W. Bratton, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213, 223 (1999).

dumb-money shareholders. But the category can also sweep in an uninformed fundamental value investor—someone, for example, who collects stocks with high price/earnings ratios in an underdiversified portfolio for the long term. The core smart money investor is a well-informed fundamental value investor. But the category includes speculative actors as well. Some smart money will combine fundamental and market value information, watching the noise traders and the market trend. When the noise traders push the market upward, bidding up stocks in a feedback loop where an uptick is good news that triggers another uptick, smart money certainly can ride along. After all, there is money to be made as prices rise; thus did “momentum” funds make an appearance in the institutional investment community during the 1990s. But the smart money knows when fundamentals do not support the market price and, being (relatively) free of behavioral biases, will be ready to be the first to bail out when the trend turns. The same insights invite the smart money to profit by bucking the trend. If fundamental value does not support the market price, then the price inevitably falls. Accordingly, money can be made by shorting the stock (or the whole market), or by buying puts. More generally, given a lot of noise, some smart money will be contrarian.

In its contrarian posture, the smart money plays a key role in the scenario cited in support of the EMH. The EMH asserts that the market price is the best reflection of fundamental value and that new fundamental value information gets into the stock price almost immediately,<sup>43</sup> even as it accepts the existence of dumb money and noise trading. It can do both at once because it asserts that smart money trumps dumb money. Dumb money goes off in every direction, canceling itself out in the random-error term. Smart money goes consistently in the direction of fundamental value, keeping stock prices correctly aligned with fundamentals.<sup>44</sup>

Under the EMH it follows that supply and demand do not determine stock prices. What is on offer in the stock market is money in the future, and demand for money is consistently high. The valuation questions go only to the amount of money, the time of payment, and the quantum of risk—questions answered by fundamental value information. Since demand is a constant, the only thing that can cause a price to change is new fundamental value information. Noise traders, meanwhile, always get wiped out in the long run.

---

43. BREALEY & MYERS, *supra* note 12, at 354-62.

44. BRATTON, *supra* note 41, at 159-67.

Although the EMH continues to have defenders,<sup>45</sup> the contrasting noise-trading description of the market has been ascendant for more than a decade. Erratic stock market behavior encouraged the shift. Under the present consensus view, the stock market is a place where noisy supply and demand intermix with fundamental value because there is not enough smart money to trump the dumb money in the short term.<sup>46</sup> Contrarian investment is just too risky. Overpricing and underpricing are constant possibilities. But in the long run, fundamental value always prevails.

### **E. Summary: Shareholders and Fundamental Value**

The division of shareholders into variegated speculators and investors does not preclude the employment of a unitary model, depending on the question presented. For example, all shareholders want managers to create long-term fundamental value (or at least to be seen as so doing). To see why this is the case, try to imagine a stock market bubble occurring in the absence of a plausible fundamental value story. Absent the story, investors will have no cause to get excited in the first place. Even the dot-com bubble of the late 1990s began within a fundamental value scenario. The Internet was new, and more and more people were becoming acquainted with it, giving rise to the reasonable projection that it would become an important center of commerce. According to the story, that meant there were going to be fantastic profits for a handful of winners who got in early with attractive websites, gained market share, and established a brand. Unfortunately, the story, although rational, also was highly probabilistic. Worse, it became exaggerated in the telling, in the interpretation, and in the wake of actual stock price increases. When the market puts present money on the table, the connection between that market value and the supporting fundamental value story can become attenuated. But the story has to be in place before the market takes off; even at the crest of “tulipmania,” there was an operative fundamental value story.<sup>47</sup>

All of this implies that for a stockholder, whether a noise trader or a fundamental value investor, news about fundamental value always matters. Beyond this base point, however, a unitary shareholder perspective on value

---

45. For a contemporary defense, see Eugene Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283, 284-85 (1998).

46. See, e.g., Andrei Shleifer & Robert Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35, 39-54 (1997).

47. Peter Garber, *Tulipmania*, 97 J. POL. ECON. 535, 555-57 (1989) (arguing that rare bulbs had high fundamental value due to sales of offshoots).

cannot be assumed. As the next part demonstrates, shareholder preferences respecting investment policy, financial reporting, and payout policy vary with behavioral characteristics, time horizons, and the state of the market.

## II. THE VOLATILE SHAREHOLDER INTEREST AND INCENTIVE COMPENSATION

This part draws on the variant shareholder perspectives just described to evaluate prevailing compensation practices. It asks two questions. First, what sort of manager-shareholder is likely to be produced by prevailing incentive compensation practices? Second, does the shareholder interest provide a coherent normative yardstick with which to evaluate prevailing practices? Section A outlines the terms of standard stock option plans, along with the main points made by their critics. Section B asks how the plans affect incentives to invest for the long term. Section C looks into the plans' impact on financial reporting. Section D shows how stock option compensation affects payout policy. Section E looks into the incentive compatibility of two additional components of standard pay packages: cash bonuses and exit payments. Section F summarizes.

### A. Stock Option Plans: Prevailing Practice and Critique

Under prevailing practices, stock option plans have 10-year durations,<sup>48</sup> with options granted under the plans vesting gradually over the period.<sup>49</sup> When an option vests, the manager is free to exercise it and sell the stock. The exercise price is the stock's market price at the time the option is granted. The price remains fixed for the life of the option.<sup>50</sup> Critics question both the pricing and the vesting practices.<sup>51</sup>

As to exercise prices, the critics make a simple behavioral point: higher hurdles require greater effort and therefore hold out a bigger payoff for the shareholders. If exercise prices were set higher than the market price, the manager would have to create some value in order to put the option into the

---

48. Thomas & Martin, *supra* note 10, at 41.

49. YALE D. TAUBER & DONALD R. LEVY, EXECUTIVE COMPENSATION 663 (2002). Vesting usually occurs ratably over time, but could be based on performance incentives. *Id.*

50. Thomas & Martin, *supra* note 10, at 39.

51. Bebchuk and Fried also question the numbers granted. They think that fewer would be better. According to the empirical evidence they cite, the positive incentive effect declines as the number granted increases, so that the benefits of the last option granted may be less than the cost. BEBCHUK & FRIED, *supra* note 5, at 138.

money. Yet, despite the apparent sacrifice of incentive effect, only a small subset of companies price options out of the money, that is, above the market price of the stock at grant.<sup>52</sup> The practice of leaving the price fixed for the life of the option also arguably softens the incentive effect. A fixed price rewards the executive for market-wide and sector-wide upward price movement, in addition to upward movement due to the company's own performance (which is said to account for only thirty percent of stock growth on average).<sup>53</sup> So long as the market rises over time, a payoff is virtually guaranteed. Indexing solves the problem. Under this, the exercise price is reset upward and downward over time to filter out changes attributable to the market or sector. Alternatively, vesting could be conditioned on meeting a fixed performance target.<sup>54</sup> Neither palliative was much seen in practice before 2003. Since then, mounting criticism has caused a minority of boards to attach performance targets.<sup>55</sup>

The critics also question the vesting rules. Once the option vests, the executive is free to exercise it and sell the underlying stock. And executives do sell ninety percent of the stock purchased upon exercise.<sup>56</sup> This, of course, defeats the purpose of aligning their interests with that of the shareholders. No nefarious intentions need be read in, however. The managers sell in order to diversify their portfolios, acting no differently from other rational investors. At the same time, nefarious deeds do occur. Executives use inside information to time their sales.<sup>57</sup>

Other common features of option plans come under fire, most notably reloading and replacement. A reloading feature automatically grants the beneficiary a new option for every option exercised, with the exercise price set at the stock's price at the time of reloading. According to the critics, the new option can serve as a form of protection against subsequent price volatility respecting the shares purchased. So long as the stock price spikes

---

52. *Id.* at 160.

53. *Id.* at 139.

54. *Id.* at 139-42.

55. See Joann S. Lublin, *Boards Tie CEO Pay More Tightly to Performance*, WALL ST. J., Feb. 21, 2006, at A1 (noting that "30 of 100 major U.S. corporations" base a "portion" of equity grants on performance targets, up from seventeen in 2003, but that the targets tend to remain undisclosed).

56. *Id.* at 176-77. Stock sales are not the only problem. Executives also can employ derivative contracts to put themselves in the economic position of diversified stockholders, even as they continue to own the stock purchased under the plan. See Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL. BUS. L.J. 301, 323-24 (1995) (describing risk-shifting in the derivatives market).

57. BEBCHUK & FRIED, *supra* note 5, at 179-83, 191.

above the exercise price of the replacement option during its life, the executive gets a chance to profit on the stock purchased, even if overall price trend is downward. Stock price volatility thereby becomes a potential source of personal profit.<sup>58</sup> Replacement occurs when options expire out of the money. The firm creates new options to replace them, with the exercise price pegged at the lower market price at the time of the replacement grant.<sup>59</sup> The critics assert that this insures against performance failure and works at cross-purposes with the original option, which was granted to discourage the stock price decline that triggers the new option grant.<sup>60</sup>

As a theoretical matter, many of the criticisms are as contestable as is the prevailing practice. As already noted, we have no ironclad theory of optimal incentive contracting. If we did, the theory would tell us how to design the contracts, and there would be nothing to dispute except the level of pay.<sup>61</sup> Absent a theory, there is room for debate about means to induce the productive incentives. As to exercise prices, it can be noted that the stock price at the time of the option grant reflects the market's present expectation about all future value scenarios,<sup>62</sup> expectations shaped in light of the incentive compensation scheme. Strictly speaking, as the option goes into the money, value has been created with the executive's participation. As to the absence of indexing, it has been argued that there may be reason to reward executives for general market increases: the value of good managers may go up during good times,<sup>63</sup> creating a retention incentive. Even reloading could be the means to the end of an optimal long-term incentive arrangement.<sup>64</sup> Perhaps the additional options also have a positive effect; it all depends on the overall mix of incentives, and nobody has a guiding template. Finally, replacement options may not look plausible *ex ante*, but *ex post*, at the time of expiration, new options import continued incentives to succeed.<sup>65</sup>

None of these back-and-forth arguments can be settled here. But a complex model of the shareholder does sharpen one's understanding of the stakes. The following sections take up three matters particularly likely to trigger conflicting interests within the group of shareholders, namely

---

58. *Id.* at 169-70.

59. Formerly, the result also was accomplished by amending the plan to lower the price, a practice that ceased when the Financial Accounting Standards Board changed the accounting treatment in 1998. *Id.* at 165-67.

60. See Thomas & Martin, *supra* note 10, at 43.

61. See Bolton, Scheinkman & Xiong, *supra* note 11, at 33.

62. *Id.* at 34.

63. *Id.* at 37.

64. *Id.* at 35.

65. *Id.* at 36.

investment policy, reporting practice, and payout policy. In all of these cases, the particular shareholder incentive profile fostered by an equity compensation scheme can skew the firm's choices in unproductive directions.

## **B. Investment Policy**

Hypothesize a choice of investments. The firm can invest in a line of business much favored in the stock market—say, a broadband network or internet access business in the late 1990s. Alternatively, it can invest in a less glamorous extension of its core business. The firm does not have the capacity to make both investments. Its managers know three things: (1) that the market will reward the glamorous investment in the near term; (2) that the glamorous investment is highly risky; and (3) that the firm's capital-budgeting analysis yields a slightly higher present value for the less-glamorous investment in the core business.<sup>66</sup>

In theory, the firm should make the less glamorous investment due to its higher net present value. Only an irrationally risk-prone actor would opt for glamour. A properly designed equity compensation scheme should not cause the firm's managers to stray from this rational choice.

Stock option compensation is defended on the theory that it encourages the very risk-neutral investment policy favored in financial economic theory. It does so by counterbalancing the perverse effects of straight salary. Managers on straight salary are thought to tend toward risk aversion. They have an undiversifiable human capital investment in the firm and a consequent interest in institutional stability. This contrasts with the interest of the shareholders, who tend to hold well-diversified portfolios and approach risk neutrality in their evaluation of new investments. The conflict of interest ripens when the managers choose a low-risk, low-return investment instead of the high-risk, high-return investment preferred by the shareholders. Stock options counterbalance the managers' risk-averse tendencies by holding out the possibility of future stock ownership.<sup>67</sup> But they do not thereby automatically make managers risk-neutral. Prior to an option's expiration or exercise, its holder is benefited by an increase in the underlying asset's volatility; high volatility enhances the probability of exercise in the money. This creates a potential problem. High-risk choices made from an option holder's perspective may be too risky, decreasing the firm's long-term

---

66. The analysis applies a higher discount rate to the glamour investment to compensate for its increased risk, with the higher rate resulting in a lower net present value.

67. See Thomas & Martin, *supra* note 10, at 38-40.

fundamental value even as they make the option more valuable. This is just the possibility held out by the glamour investment in the hypothetical. Defenders of standard stock option plans acknowledge the problem, counseling that the solution lies in setting the right mix between options granted and the flow of straight salary tied to the managers' low-risk human capital investment.<sup>68</sup>

Although the theory may well be sound, realizing the theoretically correct mix of incentives presents a serious practical problem. To see why, let us examine the hypothetical from the various shareholders' points of view.

We begin on the investment side. A long-term shareholder will want management to expand the core competency, despite the short-term opportunity cost to the stock price. On a long-term basis, the core investment causes the stock price to be higher. A fundamental value investor, viewed without regard to the time horizon, will make the same choice, because dispassionate risk appraisal shows the investment to be more valuable. But a caveat must be entered: a smart fundamental value investor with a short time horizon might see things differently, opting for a near-term bump in the stock price.

The noise trader and the short-term holder also will see things differently. The market's near-term reaction matters greatly to both of them, so both favor the glamour investment. Dumb money, impressed by a stock price uptick, also will favor glamour; indeed, additional dumb money might be induced to invest in the wake of the glamour investment's announcement, further driving up the stock price.

If the firm makes the glamour investment, some smart money observers will conclude that the market overvalues it and short the stock. If the smart money thereby corrects the overvaluation, there is little risk that stock option compensation will encourage suboptimal investing by the firm. But how much smart money will be out there to perform the price correction function? The investment decisions of publicly-traded firms tend to be opaque. Their periodic reports do not lay out precise decision parameters such as those assumed in the hypothetical. Accordingly, to perform its job of correcting prices, the smart money needs to be more conversant with the fundamentals of the firm's business than any reference to publicly available information permits. Quite apart from the costs and risks of short positions, smart money will not necessarily be available to correct the stock price.

We now turn to the managers, assuming them to be the beneficiaries of a generous, conventional stock option plan in the middle of its term. They hold

---

68. *Id.* at 40.

vested, exercisable options, unvested options that can be exercised in the near term, and unvested options that can be exercised only in the intermediate term. They also hold firm stock purchased through the past exercise of options. How these holdings affect the investment decision depends on the numbers projected and the managers' personal preferences. From a long-term, fundamental value point of view, the glamour investment is suboptimal. But it also will cause the stock price to be significantly higher in the short term. If the executives are ready to sell the stock they now own or will soon acquire through option exercise during the period in which the firm's stock is overpriced due to the glamour investment, they have an incentive to choose it. If, on the other hand, the glamour investment is so risky that it holds out a possibility of future distress, they may reject it because their job-term projections extend into the intermediate or long terms.

Three points emerge from this exercise. First, the shareholder interest does not necessarily send a clear signal on the choice of investment. Second, conventional stock option compensation does not necessarily direct managers to the creation of long-term fundamental value. Third, managers make stock-price-based calculations from a smart money position. Even if they realize that the glamour investment presents significant negative long-term possibilities, they may opt for it anyway, knowing that they can adjust their stockholdings during the projected period of overvaluation. They can even act before astute market players. There arises a high risk of opportunism.

Two adjustments advocated by the critics of stock option plans address these problems. First, vesting practices could be changed so that the managers are locked into long-term positions in the stock. Plans have typically required executives to retain a minimum amount of stock, but the minimums set have been too low to be meaningful.<sup>69</sup> Stricter retention policies have been mooted,<sup>70</sup> but it is too early to tell whether these will significantly constrain an executive's tendency to dispose of stock in the wake of option exercise. Second, executives could be forced to disclose their stock sales in advance (rather than after the fact) so as to minimize their smart money advantage and increase the stock of information moving market prices in correct directions.<sup>71</sup>

---

69. See JAMES F. REDA ET AL., COMPENSATION COMMITTEE HANDBOOK 259 (2d ed. 2005).

70. *Id.* To be effective, these would have to bar risk-shifting through derivative contracting. See Bank, *supra* note 56, at 323-24.

71. BEBCHUK & FRIED, *supra* note 5, at 179-81, 191; Jensen & Murphy 2004, *supra* note 2, at 68. Late reporting of stock sales was a particularly acute problem where the company had loaned the funds that financed the stock purchases. Such loans now are prohibited by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402(a), 116 Stat. 745, 787-88 (2002).

Some advocate a different approach, suggesting that stock options be abandoned and replaced by restricted stock plans. These award the stock outright and thus ameliorate perverse effects respecting investment policy. As has been noted, options gain value as the firm's stock becomes more volatile, perversely tying executive wealth to stock volatility. To the extent that the executives' risk-averse attachment to their jobs does not counteract this incentive, a problem is presented. Restricted stock addresses the problem by importing more stable incentives. Where options allow for value only in the event that the stock price exceeds the exercise price after vesting and before expiration, long positions in stock have value on both the upside and the downside.<sup>72</sup>

The restricted stock argument is correct so far as it goes, subject to the important caveat that the substitution of long holdings for options does not by itself achieve incentive compatibility. Note that the managers in the hypothetical have long holdings of the stock from past option exercises in addition to options under the present plan. So long as the executives hold significant numbers of shares that may freely be sold in the overpriced market, the sub-optimal glamour investment may make them better off. Absent retention constraints on those long holdings, the incentive problem remains unsolved. The same goes for restricted stock plans.

Restricted stock has an additional shortcoming. As compared to stock options, it holds out an opportunity cost respecting incentives to create value.<sup>73</sup> Restricted stock amounts to an option with an exercise price of zero, and there is no reason to believe zero is an optimal exercise price.<sup>74</sup> To see the point, compare the award of an option to buy 100 shares at \$100 and an outright grant of 100 shares, both awarded with the stock trading at \$100. Assume that the stock price declines to \$80 on the day after the grant and stays at \$80 forever because the firm is badly managed. The holder of the

---

Before the statute's enactment, the loans were often forgiven, along with a gross-up to cover the income tax payable on loan forgiveness. BEBCHUK & FRIED, *supra* note 5, at 116. Alternatively, the executive would borrow money from the firm to exercise stock options and later put the stock back to the firm to repay the loan, taking advantage of a pre-SOX loophole that permitted the executive's report of the stock sale to be delayed until forty-five days after the end of the fiscal year. *Id.* at 117.

72. Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options* 19 (Harvard NOM Working Paper No. 03-33, 2003), available at <http://ssrn.com/abstract=415040> [hereinafter Hall & Murphy 2003]. The corporate world's failure to take advantage of these asserted benefits can be explained in part by reference to accounting and tax regimes, which have pushed preferences in the direction of options. *Id.* at 24.

73. See REDA ET AL., *supra* note 69, at 244.

74. BEBCHUK & FRIED, *supra* note 5, at 170-71; Jensen & Murphy 2004, *supra* note 2, at 58.

option is wiped out; the holder of the stock emerges with 80 cents on the dollar despite poor performance.

These value implications help explain the trend toward restricted stock over the past several years.<sup>75</sup> From one point of view, it looks like a healthy reaction to option-related excesses of the 1990s. But, at a time when stock market averages show little forward motion, it also neatly dovetails with the self-interest of management. In a retrenching market, restricted stock increases net management compensation, not only as compared to the alternative of indexed options but even as compared to conventional, fixed-price options. The restricted stock alternative accordingly makes economic sense only if the grants are conditioned on the firm's meeting strict performance targets, or, in the alternative, the firms take care to make the grant in the form of a trade-off, with the executive taking the stock in lieu of cash salary or bonus payments otherwise to be received.<sup>76</sup>

In sum, given variegated shareholders and the possibility of market mispricing, equity compensation holds out negative possibilities respecting investment policy. The incentive problem is time-sensitive: mispricing occurs in the short and intermediate term, but in the long term, fundamental value controls. It follows that time holds out the cure. Equity incentive schemes, whether in option or long form, should restrict alienation so as to align the incentives of managers with the long-term stock price, and thus the long-term shareholder interest.

The analysis changes for a firm with underpriced stock. Here, two scenarios present themselves. The first is benign. The firm's managers, as smart money, have a strong incentive to hold until the stock price reaches fundamental value, whatever the terms of the plan. The second scenario is more troubling. Here, a lack of upward movement in the stock price induces impatience and ill-advised investment in overpriced assets. Retention constraints are irrelevant in the first case, but beneficial in the second. Across-the-board restrictions on alienation accordingly appear to be in order.

Just how long such retention constraints should endure is another question, with the answer presumably varying from firm to firm, depending on the nature of the business and the state of the market. A one-size-fits-all standard still can be suggested: the executive should be required to retain an amount of stock that is material in light of the executive's overall net worth until a year after the termination of employment at the firm.

---

75. See REDA ET AL., *supra* note 69, at 244.

76. See Jensen & Murphy 2004, *supra* note 2, at 59.

A final caveat should be entered. For most purposes, long-term stock price enhancement and long-term fundamental value creation amount to different terms for the same objective. However, they may send different signals when an unwanted merger bid appears. The long-term fundamental value objective has been used to justify management resistance to a premium bid on the ground that the firm's long-term value under present management exceeds the price offered by the bidder. The justification rings hollow in the eyes of many because long-term fundamental value investors still tend to favor the premium bid. In the hostile offer case, the conflict between long-term and short-term interests occurs not among the outside shareholders, but between inside managers and the outside shareholders as a group. Prevailing stock option practices help to realign managers' interests with those of the outside shareholders. Significant, vested, and alienable equity stakes make managers less likely to oppose the takeover. Thus did stock option compensation apparently counteract the tendency to resist, facilitating unprecedented numbers of friendly mergers during the 1990s.<sup>77</sup> Strict, enduring restraints on alienation would change this. Managers with an equity interest that remains unvested in the wake of a takeover paid for in bidder stock will have every reason to resist, preferring to leave the pursuit of long-term value in their own hands rather than those of a hostile stranger. A united shareholder interest, then, would want revised vesting restrictions made contingent on events in the control market.

### C. Quality of Financial Reports

Now consider the impact of equity-based compensation on management's incentives respecting financial reporting. We take a simple, relatively benign example of 1990s earnings management: the cookie-jar reserve. The firm takes an extraordinary loss in a given quarter respecting an unsuccessful line of business. The stock price effect of the bad news is muted because the loss is a one-time-only affair. Given, say, a \$15 billion company, the market will not be overly concerned as between a write off of \$1.5 billion or \$1.75 billion. So, management, which expects actual write-offs over time to total \$1.5 billion, tops up the present deduction from earnings to \$1.75 billion. The extra \$250 million goes to the cookie jar. In a later quarter when the earnings come in a tad less than expected, management conveniently revisits the loss reserve and reduces it. The released sum supports earnings in

---

77. See William W. Bratton, *The Disappearing Disciplinary Merger* 14-18 (Nov. 17, 2003) (unpublished manuscript) (on file with the Virginia Law & Business Review).

the later quarter.<sup>78</sup> A cookie-jar stash also can derive from any overestimated cost; for example, unrealistically high estimates of any of sales returns, loan losses, or warranty costs.<sup>79</sup>

Managers in the 1990s held out the shareholder interest in justifying the manipulation. First, investors prefer a time-series of smoothly increasing income figures.<sup>80</sup> The drawdowns from the cookie jar let management construct that steadily rising line of earnings, avoiding volatile income results that mean a higher discount rate and a lower stock price. Such income smoothing does not necessarily corrupt the trend, even as it beneficially reduces volatility. And since the trend determines the long run value, any misrepresentation is not material.

Managers cited the noise traders in the alternative. In the overheated 1990s market, the noise interest hyped every piece of news about fundamental value to such a degree as to make it plausible to argue that earnings management serves a higher shareholder interest.<sup>81</sup> If, to take a much used example, the firm misses its expected quarterly earnings number by one cent and the overheated market as a result punishes the stock by bidding it down 10 percent, then a reserve that holds out the missing penny benefits the shareholders.<sup>82</sup> It allows management to anticipate and counteract the shareholders' behavioral shortcomings, protecting the stock price from short-term market mood swings.

---

78. The use of the "big bath" write-off to increase cookie-jar reserves is constrained for business exits commenced after December 31, 2002; liabilities incurred in respect of closures must now be recognized upon incurrence and not in advance. ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES, Statement of Fin. Accounting Standards No. 146 (Fin. Accounting Standards Bd. 2002).

79. See Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at NYU Center for Law and Business: The "Numbers Game" (Sep. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

80. Mary E. Barth, John A. Elliott & Mark W. Finn, *Market Rewards Associated with Patterns of Increasing Earnings*, 37 J. ACCT. RES. 387, 398, 412 (1999) (showing that firms with patterns of higher earnings have higher price-per-earnings ratios, after controlling for other factors).

81. For a detailed description of quarter-to-quarter earnings pressures in the late 1990s, see Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street* (Feb. 2002) (unpublished manuscript), available at <http://ssrn.com/abstract=297156>.

82. A ten percent decline based on a one-cent shortfall can be explained as rational. If stock traders are skeptical about earnings figures and assume that management accounts aggressively, then the one-cent shortfall signals that management's cookie jars have run out and all other aggressive gimmicks have been used to the maximum. Given this read, the one cent shortfall signals very bad news. Management, moreover, has no choice but to account aggressively.

Shareholder responses to these justifications depend on the state of the market and the makeup of the particular shareholder.

We begin on the investment side. The fundamental value investor will not favor the manipulation of earnings figures through loss reserves. Since this investor only cares about cash flows in the future, it wants an unvarnished present report. Management advocacy that results in smoother numbers makes it harder to work through to the most accurate valuation. Since greater volatility means a higher discount factor, the appraiser needs accurate information about volatility so as to make the adjustment.

The profiles of long-term and smart-money investors will differ. The long-term investor, once situated in a stock, presumably will not be destabilized when management turns up a couple of cents short of expectations in the current quarter. At the same time, earnings management, pursued in moderation, will not inflict any significant injury on this investor. In the long run, the empirical cash flow absolutely controls, and the long-run question is whether the company produces competitively. Therefore, the long-term investor could profess indifference to earnings management keyed to the short-term interest. The profile alters as accounting manipulation becomes more aggressive and holds out a risk of *ex post* enforcement. An accounting scandal means deadweight costs of defense and accompanying institutional instability. All of these impair long-term value. Better to submit accurate reports in the first place.

The smart money is supposed to be able to see through the ruse to the periodic cash flows, at least so long as the published reports give it an adequate basis for so doing. It incurs the cost of the analysis, but, since it is smart, it will be doing the analysis in any event. For example, from a smart money point of view, there arguably would have been nothing wrong with the Enron Corporation's practice of pumping up its earnings numbers with results from sham transactions with special purpose entities, so long as Enron fully disclosed the transactions in the footnotes to its financials.<sup>83</sup> Enforcement costs remain a negative, but the smart money, by definition, gets out first.

Now let us consider the speculators. Assume a shareholder buys a stock on a trend-chasing basis. The trend is that earnings are rising. The holding period is short or intermediate, without a definite termination date. Given this profile, an earnings shortfall hyped as bad news could be destabilizing, causing this shareholder to sell and incur tax and transaction costs. It follows

---

83. For a description of the Enron fraud, see William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1314-22 (2002).

that a little finagling to avoid the firm being short on its earnings projections will not be objectionable. Just by arranging the numbers, management protects a shareholder from herself and from the manic nature of the market.

Unfortunately, earnings management also holds out problems for speculators, even as they are its nominal beneficiaries. It works well only so long as management massages the numbers to protect an upward trend that responds by staying on trajectory for at least the intermediate term. Let us suppose that the upward trend stalls, causing management to draw down from the cookie jar to protect the slope of the line. There will be some shareholders who are influenced to hold who might otherwise have sold because of the stall. As to these, the income-smoothing may or may not be beneficial. It will certainly turn out to be detrimental if events make clear that the upward trend was history as of the time of the income-smoothing. Once the trend turns down, the manipulation undertaken protectively turns out to be injurious. Indeed, all speculative investors' interests then presumptively lie in getting out in the first wave. Where the unvarnished truth prompts that sale, income-smoothing injures the holder. The injury is even worse for the holder buying in reliance on the manipulated numbers at or after the turning point in the trend.

With earnings management, then, the speculative investor to which management caters could turn out to be an injured party.

Standard stock option plans do nothing to skew management's incentives to a long-term, fundamental value view of financial reporting. Managers who massage numbers protect a trend into which they can sell stock purchased through option exercise, pocketing a premium over fundamental value. They do so as the smartest of smart money, for they control the reports. Bolton, Scheinkman, and Xiong show this in a formal model in which, given large differences of opinion about the value of the stock, even a contract that optimally trades off risk-sharing and management incentives will induce a short-term orientation and encourage actions that feed speculation.<sup>84</sup>

Presumably, smart-money shareholders of managers thus incentivized, whether noise traders or value investors, will be closely watching the managers' selling activity so as to benefit along with them. These holders can protect themselves. A sharper conflict of interest opens up between managers employing aggressive accounting and noise-trading, dumb-money shareholders who rely on the trend and hold on to the stock.<sup>85</sup>

---

84. Bolton, Scheinkman & Xiong, *supra* note 11, at 6.

85. Note also an additional conflict between management and the dumb-money interest.

Speculative shareholders acted out this volatile behavior pattern in the real world over the last decade. In the standard account of the recent corporate reporting crisis, managers in the late 1990s, incentivized by stock options, used consulting rents to induce auditors to accord a free hand to manage bottom-line numbers. Auditors defended the practice by reference to the shareholder interest: if the threat to independence did not upset the shareholders, then regulators should not intervene to impose their more conservative views about accounting choices.<sup>86</sup> At the time, the supply-and-demand dynamic respecting audit services operated to make auditors sensitive to the speculative shareholder interest. Unfortunately for the auditors, stock market reverses later caused the speculators to take a fundamental value view of financial reporting, condemning accounting formerly viewed with favor or indifference. The experience of Enron, WorldCom, and other scandals ameliorated the incentive problem respecting financial reports by prompting a shift in the way investors view the numbers.

The recent shift in shareholder demand respecting reporting does not solve the incentive problem, however. The same shift in demand occurred after 1929, with conservatism prevailing long thereafter. But speculative demands for aggression eventually returned during the bull markets of the 1960s and early 1970s. A similar, cyclical return to the speculative perspective on financial reporting thus can be predicted to occur at some point in the future. When the time comes, unrestricted management stockholdings will hasten the transition.

There again arises a powerful case for retention constraints. A long-term restraint on alienation ties management's interest to long-term cash flows rather than constructed numbers in present reports. Here again the need for constraint is reduced in undervalued firms, whose managers only want to get the markets to see the truth. But a clear distinction cannot be made in practice between overvalued and undervalued firms—no one ever knows for certain

---

Prior to the change of the accounting rules in 2005, stock option compensation did not entail a charge to periodic earnings. See ACCOUNTING FOR STOCK-BASED COMP., Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995). Thus could management compensate itself without reporting the arrangement's economic cost to existing shareholders. Of course, smart-money shareholders, whether speculators or investors, were not fooled. Dumb money presumably would have taken the earnings reports at face value.

86. RICK ANTLE, P.A. GRIFFEN, DAVID J. TEECE & OLIVER E. WILLIAMSON, *An Economic Analysis of Auditor Independence for a Multi-Client, Multi-Service Public Accounting Firm* (Report for AICPA, 1997), available at <http://ftp.aicpa.org/public/download/members/div/secps/isb/0117194.doc>. The industry's advocates also pointed to informational advantages and the adequacy of legal liability constraints.

which firm is which. Indeed, if the manager of an overvalued firm believes the firm to be undervalued, an incentive to overstate results could follow. Strict retention rules again are signaled across the board.

#### **D. Payout Policy**

Hypothesize a firm with free cash flow. Management has a choice as to how to disgorge the money. It can raise the regular dividend (or declare a special dividend), or it can cause the firm to repurchase its shares in the open market. If the EMH were true and the choice had no tax consequences, the shareholders would be indifferent regarding the choice.<sup>87</sup> In the real world, however, the choice has tax implications. In addition, the real world holds out the complicating possibility that stock may be overpriced or underpriced at the time of the repurchase.

Different shareholders will have a different view of the choice. Long-term taxpaying holders who view the stock as correctly priced or underpriced will favor repurchase. Even under the regime of rate parity between ordinary income and capital gains introduced by the Jobs and Growth Tax Relief Reconciliation Act of 2003,<sup>88</sup> repurchase holds out the benefit of a tax deferral for long-term holders.<sup>89</sup> Short-term and noise-trading holders need not disagree. Repurchase announcements are taken as good news and tend to trigger a three percent announcement period gain.<sup>90</sup> They thus can figure into the stock's momentum. Disagreement breaks out only if the stock is overpriced at the time of repurchase. Here, repurchase programs disadvantage long-term, fundamental value investors, particularly if they are not smart enough to see the temporary overvaluation. A noise trader who overcredits the signal might be similarly disadvantaged.

Meanwhile, standard stock options skew management's choice away from dividends and toward repurchases in all states of the world. Consider the choice between a dividend and a repurchase from an option holder's point of view. Dividends are paid to shareholders but not to option holders. One dollar paid out as a dividend does an option holder no good unless the option is dividend-protected, i.e., unless the option contract provides for a

---

87. This follows from the irrelevance hypothesis of Modigliani and Miller. See Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

88. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C., 42 U.S.C., and 46 U.S.C.).

89. William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L. J. 845, 852-55 (2005).

90. *Id.* at 863.

diminution of the exercise price to make up for the dividend. But only 1 percent of executives have dividend-protected stock options.<sup>91</sup> It follows that stock option value is negatively related to the firm's expected dividend payout. Assume a manager with a ten-year option. Further assume that the firm's stock price has a volatility of thirty percent, and that the risk-free rate of return is five percent. Under the Black-Scholes option pricing model, a cut in the dividend yield from two percent to one percent increases the option's value by 18 percent. Cutting the dividend entirely raises option value by thirty-nine percent.<sup>92</sup>

Stock options, then, raise the financial stakes of the choice between dividends and repurchases, giving managers a strong incentive to prefer repurchases. Unsurprisingly, empirical studies show a strong correlation between stock options and payout choices. The probability of stock repurchase is positively related to the presence of stock options.<sup>93</sup> Firms with large stock option plans are more likely to announce share repurchase plans.<sup>94</sup> Dividends are strongly negatively correlated with options.<sup>95</sup> A study of the largest S&P 500 firms from 1994 to 1997 shows that even as the repurchase payout rose from seventeen percent to forty-one percent as a percentage of income, the dividend yield dropped steadily from 2.76 percent to 1.41 percent.<sup>96</sup>

In addition, the number of shares repurchased in open-market repurchase programs relate positively to the total numbers of options exercisable.<sup>97</sup> Some studies report that firms repurchase gradually over the lives of options

- 
91. Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECON. 2485, 2509-10 (Orley Ashenfelter & David Card eds., Elsevier B.V. 1st ed. 1999).
  92. Scott J. Weisbenner, *Corporate Share Repurchases in the 1990s: What Role Do Stock Options Play?* 9 (Fed. Reserve Bd. Working Paper No. 2000-29, 2000), available at <http://www.federalreserve.gov/pubs/feds/2000/200029/200029pap.pdf>.
  93. Christine Jolls, *Stock Repurchases and Incentive Compensation* 15-17 (Nat'l Bureau of Econ. Research, Working Paper No. 6467, 1998), available at <http://www.nber.org/papers/w6467>.
  94. Mary E. Barth & Ron Kasznik, *Share Repurchases and Intangible Assets*, 28 J. ACCT. & ECON. 211, 238 (1999).
  95. See George W. Fenn & Nellie Liang, *Corporate Payout Policy and Managerial Stock Incentives*, 60 J. FIN. ECON. 45, 47-48 (2001) (using the Lambert model to show that a one percent standard deviation change in the stock option variable reduces dividends by thirty-eight basis points).
  96. Nellie Liang & Steven A. Sharpe, *Share Repurchases and Employee Stock Options and Their Implications for S&P 500 Share Retirements and Expected Returns* 17 (Fed. Reserve Bd. Working Paper No. 1999-59, 1999), available at <http://www.federalreserve.gov/pubs/feds/1999/199959/199959pap.pdf>.
  97. Kathleen M. Kahle, *When a Buyback Isn't a Buyback: Open Market Repurchases and Employee Options*, 63 J. FIN. ECON. 235, 238 (2002).

to reduce the options' dilutive effect.<sup>98</sup> But there also is evidence that firms time repurchase announcements around the times stock options are being exercised.<sup>99</sup> Whatever the timing, the numbers are large. One survey finds that firms repurchase roughly thirty-eight percent of the shares underlying their option grants prior to exercise.<sup>100</sup> The more stock options outstanding, the more stock the firms repurchase. Managers admit this. Three-fifths of the executives reporting in one survey acknowledged that they instituted an open market repurchase program to prepare for stock option exercise.<sup>101</sup>

The situation can be corrected in part. Interpolating dividend protection in option plans removes the incentive-skew toward repurchases. Of course, given a dividend-paying firm, dividend protection increases the value of the options; the giveback would be a decrease in the number granted or an increase in the exercise price. But, even given dividend protection, management may retain the urge to warehouse in advance of exercise, particularly in light of the new rules requiring that the option's cost must be deducted from periodic earnings. Now that options cause earnings to be lower, there appears to be more reason than ever to reduce the number of shares outstanding so that the earnings-per-share figure, so critical in the eye of the noise traders, stays as high as possible.

## **E. Bonuses and Exit Payments**

Stock option plans, whatever the shortcomings in their design, have one great merit. They condition rewards on the stock price, which in turn is determined by free-market actors. Firms also dispense large cash bonuses. These could be tied to the stock price, but tend not to be. This section looks first into periodic performance bonuses and then into bonuses paid on exit.

### **1. Performance Bonuses**

Many cash bonus plans employ periodic earnings targets. This practice returns us to incentives respecting financial reports. Accounting standards give management room to manipulate numbers to magnify current results.

---

98. Weisbenner, *supra* note 92, at 3.

99. Konan Chan, David Ikenberry & Inmoo Lee, *Do Firms Knowingly Repurchase Stock for Good Reason?* 2 n.4 (Aug. 2001) (unpublished manuscript), available at [http://www.ruf.rice.edu/~jgspaper/W\\_Ikenberry\\_insiderv6.pdf](http://www.ruf.rice.edu/~jgspaper/W_Ikenberry_insiderv6.pdf).

100. Weisbenner, *supra* note 92, at 23.

101. *Id.* at 8 (citing a 1999 survey of 1600 CFOs).

Conditioning bonuses on earnings encourages this, with possible benefits for short-term holders and noise traders, at least where the earnings reports cause the stock to be overvalued. On the other hand, to the extent that smart money investors determine the market price and the stock is valued correctly, earnings ruses do not hold out stock price benefits. But the perverse incentive remains: the cash bonus scheme still rewards management for putting numbers on a page, without spillover benefits to shareholders of any type.

Other periodic cash bonus awards are tied to particular performance targets. To the extent the targets are tied to the improvement of bottom-line performance, these bonuses may be unobjectionable. Indeed, in the case of a firm with undervalued stock, they may be an effective means to provide periodic rewards to effective managers pending the stock's recovery. In addition, these bonuses can be tailored to the performance of particular tasks. Unfortunately, however, the practice often falls short. Some performance targets lack a strong connection to the improvement of bottom-line performance. Consider one common target—spending all the funds in an annual budget.<sup>102</sup> This has the benefit of being cash-flow based and thus less subject to manipulation than an earnings target. On the other hand, it holds out a bonus for the act of investment rather than for the longer process of investing successfully and realizing projected returns.<sup>103</sup> Compare a bonus paid for closing an acquisition.<sup>104</sup> As with the budget bonus, the target's accomplishment lies within the discretion of the executive payee, and the bonus is paid for the act of investing, rather than the result of investing successfully.<sup>105</sup> Recent results have been particularly dismaying. Despite stock option compensation, the period 1998–2001 was the worst in history with respect to acquirer losses due to bad mergers.<sup>106</sup> In these cases, a unified model of the shareholder suffices to condemn the practice; no shareholder interest is advanced.

The criticisms trigger a question. If accounting numbers fall short as a performance metric, and the stock price suffices only on a long-term basis, is

---

102. See JAMES F. REDA, COMPENSATION COMMITTEE HANDBOOK 115-16 (2002).

103. Unfortunately, these budget-based bonus plans tend to open doors for manipulation. By setting thresholds and caps, they encourage smoothing and manipulation of the capital budgeting process. See Jensen & Murphy 2004, *supra* note 2, at 69-75, which recommends a linear approach that is not keyed to any particular year's capital budget.

104. In addition, when performance targets are not met, they often are lowered *ex post*. BEBCHUK & FRIED, *supra* note 5, at 124-27.

105. *Id.*

106. See Sara B. Moeller, Frederik P. Schlingemann & René M. Stulz, *Wealth Destruction on A Massive Scale? A Study of Acquiring Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 758, 770 (2005).

there any reliable bonus metric available from quarter to quarter? Critics of the prevailing practice point to cash flow as an alternative metric. Private equity firms use cash flows to reward the managers of leveraged-buyout firms, triggering bonuses on the generation of cash flows sufficient to service debt.<sup>107</sup> Other firms reward managers when cash flows exceed the cost of capital.<sup>108</sup>

Consider, as a possible variation on this theme, the dividend. Oliver Hart shows that in an ideal (and taxless) world, first-best results easily can be achieved with an all-common-stock capital structure and a simple incentive compensation system. Hart describes a simple two-period situation where the firm is founded at  $t = 0$  and liquidated at  $t = 2$ , with an intermediate decision respecting liquidation or continuance to be made at  $t = 1$ , along with a dividend payment. Hart would make the compensation of the manager depend entirely on the dividend  $d$ . That is, incentive compensation  $I$  should equal  $\beta(d_1 + d_2)$ , where  $\beta$  is a proportion of the firm's total returns. If the payment also covers liquidation proceeds, where  $I = \beta[d_1 + (d_2, L)]$ , the manager can be expected to make an optimal decision respecting liquidation at  $t = 1$ . If the expected value of  $L$  at  $t = 1$  is greater than the total returns expected at  $t = 2$ , the firm is liquidated at  $t = 1$  and no costly contracting designed to align the manager's incentives with those of outside investors is necessary.<sup>109</sup> The problem, in Hart's conception, is that the bribe  $\beta$  required to align management incentives with those of outside security holders is unfeasibly large.<sup>110</sup> Accordingly, a complex capital structure must be devised in order to align incentives in the direction of optimal investment and insure that the actor with the appropriate incentives controls the assets.

In theory, then, the dividend cannot feasibly serve as the exclusive basis for measuring executive pay. But might it serve a limited purpose as a metric for periodic cash bonuses? Unlike accounting numbers such as periodic

107. See Jensen & Murphy, *supra* note 2, at 76.

108. *Id.* at 76-77.

109. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 146-48 (Clarendon Press 1995); see also Anat R. Admati and Paul Pfleiderer, *Robust Financial Contracting and the Role of Venture Capitalists*, 49 J. FIN. 371 (1994) (articulating a fixed-fraction model of venture capitalist participation in the decision of whether to continue). In the model, there is no *ex ante* prospect of firm continuance in the event of poor results; in the real world, managers do derive private benefits from asset management and might opt to continue.

110. The large  $\beta$  is conceded in venture-capital financings and private-equity restructurings. But the context is different from that of the pay debate. Venture capital and private equity both involve arm's-length negotiations with outside equity capital that exercises control, and transaction structures share a limited duration. The pay debate concerns mature publicly traded firms, with their separation of ownership and control, and an implicit, unlimited time horizon.

earnings, the dividend follows from actual operations and cash flows. Unlike the stock price, it is not the product of valuation under uncertainty. A dividend-based bonus scheme would encourage firms to pay dividends, alleviating problems of overinvestment and excess reliance on open market stock repurchases. The question is whether a dividend-contingent bonus would cause the opposite problem, underinvestment. Dividends, like bonuses contingent on acquisition closings, follow from actions within the zone of management discretion. Managers seeking larger bonuses could divert cash flows needed to finance good projects into dividend flows. But there could be countervailing incentives. Managers holding stock options subject to retention constraints would retain an incentive to make good long-term investments. Given such a long-term incentive alignment, a dividend-based bonus might have the limited effect of causing the managers to raise one notch the hurdle rate applied in evaluating investments, which need not be a bad thing. The matter would come down to the amount of the dividend-based bonus: it should import an incentive toward objective evaluation of new investments, without skewing hurdle rates to destructive, uneconomically high levels.

That said, a dividend-based bonus suits only mature firms with steady cash flows. For a contrast, hypothesize a firm at an early growth stage of its life cycle with an investment set that holds out excellent returns for the indefinite future. Further hypothesize that the firm seriously pursues an incentive-compatible, long-term equity compensation scheme. Stock purchases through option exercises are locked down so that executives at all times have a material portion of their wealth tied to the long-term performance of the firm's stock. Regular salaries are capped at \$1 million per year in light of Internal Revenue Code section 162(m).<sup>112</sup> Finally, cash bonuses are paid only in tandem with dividend announcements, with the payment mechanism designed so that no perverse incentives arise respecting investment policy. The scenario implies a problem: as of  $t = 0$ , the top team has to wait for the long term to come about before receiving big payoffs. The long wait fails to synchronize with tournament economics. As of  $t = 0$ , any potential manager with bargaining power will reject the terms of the compensation plan. At  $t = 1$ , an impatient manager might look for a job

---

112. Internal Revenue Code § 162(m) (2005), enacted in 1994, limits the deductibility of straight salaries to \$1 million; compensation beyond \$1 million is not deductible unless conditioned on a link to performance.

elsewhere. This firm, then, will be thrown back to more problematic bonus calculations.

## 2. Exit Payments

Firms also pay bonuses on entry and exit. Bonuses for signing are unsurprising, assuming a competitive market for the best managers. Bonuses for leaving, whether by firing, retirement, or acquisition, are more disturbing,<sup>113</sup> competitive market or not. The average severance package equals three or more years of compensation, with only two percent of firms reducing it in the event the CEO finds new work. The critics argue that firing should not be a cash bonanza.<sup>114</sup>

Exit payments still can be defended in theory. Long-term value creation follows from long-term investment under uncertainty. A payment that cushions failure arguably encourages risk-taking, for whatever the reputational consequences of forced exit, the executive does not have to worry about personal cash flow. This argument resonates especially well with respect to undervalued firms whose executives might be unjustly blamed for a languishing stock price. It also comes to bear in defense of golden parachutes triggered by acquisitions, as the bonus encourages a neutral posture with respect to sale of the company.<sup>115</sup>

Questions still arise, however. The golden parachute makes sense because exit coincides with a premium payment to the other shareholders more easily secured with the executive's cooperation. Other terminations, whether for retirement or incompetence, do not coincide with such upside events. If these exiting executives already are the beneficiaries of supersize pay packages, cash flow should not be a near-term problem. In addition, the exit payment, by insuring against failure even as the executive is richly compensated at present, could diminish incentives to succeed. The tournament incentive obtains only for those trying to reach the top team. For the winners, continued high-powered incentives depend on the post-tournament compensation package. Of course, reputational incentives motivate executives whatever their pay arrangements. But recent decades' experience counsels against reliance on reputation. If reputation mattered greatly, firms presumably would revert to the practice of three decades ago and remit the lion's share of compensation in the form of straight salary, saving the shareholders the dilution costs of

---

113. BEBCHUK & FRIED, *supra* note 5, at 88-89.

114. *Id.* at 132-35.

115. See REDA, *supra* note 69, at 231-32.

supersize equity compensation. The system abandoned reliance on reputation a decade and a half ago when it shifted its focus to high-powered incentives. Whatever the system's present shortcomings, turning back is not a plausible option.

#### **F. Summary**

This part began with two questions. First, what kind of manager-shareholders are prevailing incentive compensation practices likely to produce? Second, does the shareholder interest provide a coherent normative yardstick with which to evaluate prevailing practices?

The answer to the first question depends on the case. With an undervalued firm, the managers are likely to resemble long-term, fundamental value shareholders. With an overvalued firm, present practice aligns their interest with short-term noise traders, making it rational for managers to make suboptimal investments, distort financial reports, and follow suboptimal payout practices. The informational advantage that comes with the managers' inside positions exacerbates the problem.

The answer to the second question is yes and no. Sometimes, as with some bonus payments, the shareholder interest answers normative questions with a unitary voice. But responses often depend on the shareholders' type, the state of the market, and the undervaluation or overvaluation of the particular firm's stock. The noisier the stock market and the more overvalued the firm's stock, the less coherent the signal from the shareholder interest. The shareholder interest will more likely be united, and management's incentives will more likely be well aligned with it when the firm's stock is undervalued. Undervalued firms attract the fundamental value interest; noise traders stay away.

But suppose that managers of all firms are prone to believe that the market undervalues their stock? One often enough hears managers complaining that the market underappreciates their firms' stock. If widespread belief in undervaluation is the case, it helps explain the laxity in prevailing practice, for conventional plans make more economic sense assuming undervalued stock. But the incentive problem is simultaneously aggravated. Some managers may believe their stock to be underappreciated when the stock in fact is overvalued. Managers of other overvalued firms may accurately appraise the situation. Either way, incentive pay schemes invite suboptimal investment, inaccurate financial reports, and skewed payout policy.

### III. THE VOLATILE SHAREHOLDER INTEREST AND THE DEBATE OVER SUPERSIZE PAY

The debate over executive compensation focuses on the quality of the bargaining space in which corporate boards and top team members effect trade-offs between incentives and compensation.

The leading critics, Lucian Bebchuk and Jesse Fried, charge that compensation practices fail to satisfy the validation standard of an arm's-length contract. Managers, they say, possess and effectively wield power, assuring that compensation prevails over incentives and that performance rewards come on easy terms.<sup>116</sup> Bebchuk and Fried make a short, direct prescription, reasoning as follows: given that (a) the victims of the imbalanced arrangement are the shareholders and (b) the injury is due to management empowerment, it follows that (c) the only plausible cure lies in empowering the shareholders.<sup>117</sup>

Those who view the governance system more favorably offer three defenses of pay practices. First, the same phenomena that the critics ascribe to executive empowerment can be better explained in terms of the economic relationship between risk and return, as higher risks attending equity-based pay must be compensated with higher upside payouts. Second, to the extent the practice falls short of the arm's-length ideal, informational shortcomings are responsible. Boards incorrectly believe that stock options are a bargain mode of compensation and tend to overvalue them in comparison to cash payments. Third, whatever the shortcomings of the practice, the system is fundamentally sound. Managers have on the whole done well for the shareholders since shifting to performance pay in the early 1990s. Loud attacks only enhance the political credibility of the outsider social critics, whose calls for social justice will only crimp the incentive system.

This part reviews this debate against the background of volatile shareholder behavior. It shows that less ground separates the various positions than first appears. Both sides agree that incentive compatibility must be traded off against present compensation. They thus together hold open a door for the perverse effects of speculative shareholding.

---

116. BEBCHUK & FRIED, *supra* note 5, at 4-5, 61-117.

117. *Id.* at 10-12, 189-216.

## A. Power and Rents

Bebchuk and Fried's normative base point is a model of arm's-length bargaining. Under the model, executive pay packages should reward an executive with a sum in excess of his or her reservation price; should contain terms that encourage the executive to increase the value of the firm; and should avoid terms that reduce the value of the firm.<sup>118</sup> More particularly, "arm's length" means modifying existing arrangements to add more upside pull. Stock options should be priced out-of-the-money at grant and the price should be indexed so as to filter out market-wide advances.<sup>119</sup> Reloading and backdoor repricing should be prohibited.<sup>120</sup> Retention constraints should be imposed.<sup>121</sup> Bonus triggers should be performance-sensitive, and exit payments should be curtailed.<sup>122</sup>

### 1. The Arm's-Length Bargain

Compensation packages, say Bebchuk and Fried, do not conform to the arm's-length model because managers influence independent directors. Restating the point, managers use power to extract rents, defined as benefits better than those available under an arm's-length bargain.<sup>123</sup> A prediction follows: the more power a manager possesses, the greater the rents in the pay package.<sup>124</sup> Power, of course, cannot be observed and quantified directly, forcing Bebchuk and Fried to back their positive assertion with inferences drawn from institutional arrangements. They point out that corporate institutions are ill-suited to foster arm's-length bargaining between top managers and their corporate employers, drawing on a list of shortcomings well known to students of corporate governance.<sup>125</sup>

---

118. *Id.* at 18-19. Jensen and Murphy describe a similar base point, noting that the firm faces a trade-off with respect to the amount of pay conceded and the hiring of better-motivated employees. Jensen & Murphy 2004, *supra* note 2, at 20-21.

119. BEBCHUK & FRIED, *supra* note 5, at 137-46, 159-62.

120. *Id.* at 164-70.

121. *Id.* at 174-85.

122. *Id.* at 121-36.

123. *Id.* at 5.

124. *Id.* at 63.

125. More particularly, outside directors tend to be loyal to or dominated by the CEO due to process infirmities such as large numbers, CEO chairmanship, interlocks, and financial dependence. *Id.* at 80-82. In addition, most firms lack a substantial outside shareholder, the financial interest of whom would influence bargaining over pay. *Id.* at 82-83. Oversight by large institutional shareholders ameliorates the problem, but tends to be sporadic across firms. *Id.* at 83.

Bebchuk and Fried's assertions about power, rents, and the boardroom bargaining context all follow from a basic assumption concerning the appropriate trade-off between incentives and compensation: an arm's-length deal, they assert, would tightly tie pay to performance. At first this seems surprising; one somehow expects a firmer foundation than an intuitive association of hurdle height and value creation. But, on reflection, Bebchuk and Fried have no basis for proceeding other than by raw assertion. After all, we have no robust positive theory of optimal incentive compensation. The absence of a theory also explains why process infirmities figure so prominently in Bebchuk and Fried's substantive case, for if managers possess a bargaining advantage and intrinsically prefer more compensation and less incentive compatibility, then the resulting contract will reflect their preference. Given Bebchuk and Fried's assumption respecting the appropriate trade-off, the contract is *ipso facto* substantively infirm.

Bebchuk and Fried bump up against the problem of trading off incentives and compensation at two critical points in their analysis. The issue arises when they propose stricter terms for option plans, like out-of-the-money pricing and indexing. Both of these increase the option price and thus decrease the value of each option granted. They propose a reciprocal adjustment: the number of options granted can be increased to adjust for the price increase so that the present value of the grant (and thus the compensation) remains unchanged.<sup>126</sup> Here, in effect, incentives and compensation synchronize perfectly so that the firm's value can be increased due to intensified management effort without management having to give up even a single dollar of compensation value. Although the managers may end up working harder in exchange for the same overall compensation value, the harder work is rewarded with a bigger upside payoff.

The trade-off problem also arises with respect to retention constraints. All other things being equal, a tighter restraint on alienation decreases the pay plan's compensation value by blocking the executive's access to liquidity and portfolio diversification. But here, Bebchuk and Fried propose no Pareto-optimal swap. Instead, they see a pie to be sliced. An "efficient" contract, they say, slices carefully, striking a balance between the competing interests with staged holding periods that would vary from case to case.<sup>127</sup> A question arises: Why not gross up again in this case, compensating the executive with a larger number of inalienable shares so as to make up for the loss in value to

---

126. *Id.* at 140-43.

127. *Id.* at 174-76.

the alienation restraint? Bebchuk and Fried appear to intuit a limit to usefulness of tit-for-tat trades of compensation for incentives.

The differential treatment is puzzling, given the strong commonalities in the two cases. In both, present value would be increased in exchange for incentive compatibility. The difference is that in the first case, the gross-up pays for forward motion in the stock price, while in the second case, it guards against perverse effects. Perhaps the benefits of forward motion justify increased compensation because the firm is projected to be more valuable net of the trade, where downside-avoided costs of misalignment with the speculative shareholder interest are more difficult to confront and gauge. Note that such a judgment is more likely to follow if the shareholder is modeled in a unitary and benign mold.

Other factors also may be at work. Perhaps the problem identified by Hart creeps into the option compensation scenario at some point: full incentive compatibility may just cost too much in terms of the percentage interest in the firm conceded. But trade-offs made in practice probably follow from a very different intuition. Corporate actors may perceive a small-scale trade-off or no trade-off at all because they perceive the management interest at stake in the case of retention constraints to be more legitimate than that implicated in a negotiation over price. In this view, diversification and liquidity are to shareholding what freedom of movement is to citizenship, and only a limited concession can reasonably be expected at the bargaining table. So limited is the concession demanded that the question of countervailing compensation never arises. Significantly, this approach also tends to imply a unitary and benign model of the shareholder.

A contrasting approach to the trade-off should be put on the table for consideration. Under this, the firm “just says no” to short-term liquidity and diversification because proper incentive alignment should not be negotiable. To remit the matter of a long-term time horizon to the black box of arm’s-length contracting leaves open the possibility of perverse effects. Even assuming an arm’s-length bargaining context, the more bargaining power brought to the table by the executive, the more the incentives are skewed toward the speculative shareholder model. Executive pay plans have two purposes: to compensate and to incentivize. If, in the context of a package that mixes straight salary, cash bonuses, and equity awards, it is the incentive purpose that justifies the equity-based component, then it is unclear why retention constraints automatically must be countered by significant concessions to the compensation objective.

## 2. Shareholder Empowerment

The skew toward the speculative interest persists when Bebchuk and Fried set out a menu of governance improvements. Some of the items on the list would tweak the present system so as to make it more likely that the shareholder voice registers inside boardrooms. For example, transparency could be enhanced. All compensation could be reported with a dollar value attached, and executive stock sales could be directly reported by the company.<sup>128</sup> In addition, the shareholder vote could be made more meaningful, with separate votes on different segments of compensation plans giving shareholders the opportunity to pinpoint objectionable provisions.<sup>129</sup> Other proposals on the menu are more radical and would empower the shareholders, fundamentally changing the system. For example, binding shareholder initiatives on compensation could be permitted.<sup>130</sup> More than that, the board could lose its legally vested control of the agenda over important corporate legislation so that shareholders could remove entrenching provisions.<sup>131</sup> Finally, shareholders could have access to the ballot on terms broader than those recently proposed by the Securities and Exchange Commission.<sup>132</sup>

As the proposals become more radical, volatile shareholder behavior becomes more of a problem, or at least holds out no circumstantial guarantee of a solution. To see why, consider the counterfactual possibility of a decade in all respects like the 1990s, except that Bebchuk and Fried's shareholder access reforms are in place. The question is whether the shareholder voice rises up to insist on reforms assuring that compensation packages hold out no perverse effects respecting investments, financial reports, and payout policy. The scenario is highly unlikely. Shareholders at the time, including the institutional investors on which access schemes rely, were happy to ride market momentum. It took a bear market and scandals to trigger shareholder demands about bad mergers and the quality of financial reports. At the same time, on some compensation issues, shareholders probably have unified and

---

128. *Id.* at 192-94. The Securities and Exchange Commission, apparently influenced by all the criticism, has proposed new rules requiring more extensive disclosures of executive compensation arrangements. See Securities and Exchange Commission, Executive Compensation and Related Party Disclosure, Release Nos. 33-8655, 34-53185, 71 F.R. 6541 (Feb. 8, 2006).

129. *Id.* at 197.

130. *Id.* at 198.

131. *Id.* at 211-12.

132. *Id.* at 210. For an extended discussion, see Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

unproblematic interests. Out-of-the-money pricing and indexing stand out as possibilities. As to these matters, which go purely to the issue of “bang for the buck,” shareholder access might have a consistently beneficial effect. Meanwhile, the access cure holds out minuses as well as plusses.

## B. Defensive Tactics

Defenders of the practice respond to the critics at three levels. The first level presents a full-dress defense of the prevailing practice. The second level steps back to admit process infirmities, but to reject the unequal bargaining power description. The third level steps farther back still to admit management empowerment but to argue that the system is robust nonetheless.

### 1. The Fair Deal

The full-dress defense, put forward by Professor Murphy and others, draws on the economic relationship between risk and return to describe prevailing compensation practice as a fair trade.<sup>133</sup> This analysis turns on comparison of outside and insider option valuation. From the firm’s point of view, the cost of an executive stock option is the cash consideration the firm would receive from a third party investor for the same contingent interest in the stock. But third-party investors and firm employees differ in a critical respect as option buyers. Third-party investors are fully diversified and positioned to hedge the risk attending the option position.<sup>134</sup> They accordingly are risk-neutral, where employees are underdiversified and risk-averse. It follows that the option’s value to the employee is less than its value to the third party.<sup>135</sup> It further follows that an option makes no sense when considered as pure compensation in comparison to cash: in order to constitute \$1 of pay in the eyes of the employee, option compensation must be increased to make up for the employee’s valuation discount. The option thereby costs the firm more than the \$1 in value the employee receives. An option nevertheless might make sense as incentive compensation.<sup>136</sup> But the

---

133. See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives* (Harvard NOM Research Paper No. 00-05, Nov. 2001), available at <http://ssrn.com/abstract=252805> [hereinafter Hall & Murphy 2002].

134. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 859-60 (2002) [hereinafter Murphy 2002].

135. Jensen & Murphy 2004, *supra* note 2, at 38.

136. To expand upon the claim of inefficient use of stock options, Murphy looks to grants to

overall terms of an arm's-length option package should be expected to reflect the employee's risk aversion. This explains terms that otherwise could be seen as giveaways, such as exercise prices set at-the-money rather than at a discount, the failure to index the exercise price,<sup>137</sup> and the allowance of both early exercise<sup>138</sup> and stock sales after exercise.<sup>139</sup>

This fair deal emerges only on a critical assumption—that the employee's compensation objective and the firm's incentive objective may be traded off without any further scrutiny of the resulting contract's incentive properties. This contrasts sharply with Bebchuk and Fried's assumption that an arm's-length deal tightly ties pay to performance and avoids harm to the firm. It also leads to a strange result when viewed through the lens of this Article's typology of shareholding. In the fair deal story, the executive bargains to attain the status of a fully diversified outside shareholder with full exit rights. The bargained-for status invites the executive to take the speculative mindset, much like an aggressive mutual fund. The question asked above comes up again: Why should a bargaining zone holding out that result be deemed normatively acceptable?

Substantive scrutiny of incentive effects cannot be avoided under the fair-deal story's own basic assumptions. The trade-offs that make the deal fair follow from the assumption that stock options, viewed solely as compensation, amount to an intrinsically inefficient form of compensation. It follows that option compensation can only be justified based on the incentives it creates.

A justificatory standard can be set loosely or strictly. The relaxed standard takes a Kaldor-Hicks approach, i.e., the value of the incentives created must

---

employees outside of the top team, noting that in 2002, ninety percent of options granted went to employees below the management level. Hall & Murphy 2003, *supra* note 72, at 16. The efficiency objection implicates the tournament justification. Since options are worth less to employees than their opportunity cost to the firm, option compensation makes sense only when it provides the best available means to import high-powered incentives. This is not the case with subordinate employees; for them, the firm's internal advancement tournament and the prospect of equity compensation in the event of a tournament victory already provide incentives. In addition, within the general employee population, it is impossible to tell whose effort improves the stock price, inviting free-riding among the beneficiaries of an equity-based reward system. *Id.* at 16-17.

137. Hall & Murphy 2002, *supra* note 133, at 3.

138. *Id.* at 13.

139. John E. Core, Wayne Guay, and David F. Larcker point out that if the executive already holds the firm's stock at the time of the option grant and is allowed to sell on a one-to-one basis as options are exercised, the executive will place the same value on the option as a third-party investor. See John Core et al., *Executive Equity Compensation and Incentives: A Survey* 30 (Jan. 2002) (unpublished manuscript), available at <http://ssrn.com/abstract=276425>.

exceed the options' opportunity cost as compensation and the costs of perverse effects. This allows incentive incompatibility to be traded for compensation so long as the overall result makes the firm more valuable. Real world trade-offs could only be evaluated by intuition, of course; here, as with any other exercise in valuation, present verification is not a possibility. The strict standard takes the "just say no" approach mooted above and aspires to a Pareto-optimal result, in which the value of the incentives created must exceed the options' opportunity cost, and the scheme may allow no foreseeable perverse effects. This standard's benefit lies in the imposition of retention constraints on a *per se* basis. Bargaining and unverifiable cost-benefit trade-offs proceed in respect of the other elements of the deal. Assuming an arm's-length context, the executive with bargaining power gets a gross-up in the number of shares granted; the executive with fewer chips at the table comes away with reduced compensation value.

## 2. The Free Lunch Fallacy

Now we turn to a process defense mooted to counter the charge of executive empowerment. This begins with the same assertion as the fair deal defense: stock options, viewed as compensation, fail to pass the cost-benefit test. The follow-up assertion is that board members fail to appreciate the costs. They incorrectly believe stock options to be a bargain mode of compensation and overvalue options in comparison to cash payments by underestimating the options' economic cost to the shareholders whose stakes they dilute.<sup>140</sup>

Jensen and Murphy use this point to account for a number of practices. For example, during the 1990s, firms continued to grant the same number of stock options year after year even as their stock prices doubled, causing the value of incentive grants to balloon. Had pay plans been tightly focused on performance sensitivity, the number of options would have been cut back as the market rose. In contrast, when the market fell after 2000, option value decreased in lockstep with it. Had the value of the grants been the center of attention, rather than the absolute number of shares granted, further adjustments would have been required.<sup>141</sup> (Indeed, if management were all-powerful, the market decline by itself should have caused a gross-up in the numbers.) For Jensen and Murphy, this "free lunch" fallacy does a better job of accounting for practices during the past decade and a half than executive

---

140. Jensen & Murphy 2004, *supra* note 2, at 37-39.

141. *See id.* at 37.

empowerment. They also look to lack of sophistication to explain the absence of indexing: prior to 2005,<sup>142</sup> firms were required under GAAP to expense the value of indexed options from their earnings, while no deduction was required for fixed-price, unindexed options. It follows that boards gave up performance sensitivity not because they were dominated but because they were naively fixated on earnings per share (EPS), and the applicable GAAP was badly articulated.<sup>143</sup>

Murphy takes this a step farther, folding the free lunch fallacy into the fair deal story. The firm grants options not to incentivize, but because it mistakenly believes them to be cheap compensation.<sup>144</sup> It follows that concessions keyed to the managers' risk aversion—the fixed price set at market and the absence of restraints on alienation—bother the firm little because it does not view them as costly. The manager would prefer an exercise price set below market; the firm would prefer an exercise price above market; and they split the difference when they set the price at the market.<sup>145</sup>

This analysis suffers from the same infirmity as the substantive defense in chief. The mistaken perception of low cost starts out as a positive observation that counters the power description, casting board decisionmaking in the positive light of good faith. But the observation ends up as a statement of purpose, and the purpose is compensation taken alone. The transformation creates a normative problem. Given that stock options are intrinsically inefficient when viewed only as compensation, a board that proceeds on this basis and trades away incentive properties may be making a bad deal.

The lack of sophistication resonates better as pure description. Of course, one can only go so far in depicting board members as dumb money. But the characterization still carries due to the agency context: board members are not trading for their own accounts when approving compensation packages, and they operate in a cooperative environment. Given these qualifications, it is plausible to model businesspeople reacting differently to cash and scrip. At the same time, EPS matters in the boardroom because it matters to noise traders in the markets. A boardroom seminar on basic financial economics accordingly would fall short as a cure. For whatever reason—and the fact that someone else's money is being spent provides a good reason—the economic costs of equity kickers are not perceived as equivalent to those of cash payments.

---

142. See SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 2004).

143. Murphy 1998, *supra* note 4, at 21.

144. Murphy 2002, *supra* note 134, at 865-66.

145. *Id.* at 863-64.

Admitting lack of sophistication into the picture detracts from the power explanation only if we define power narrowly as the authority to direct the actions of others, the power possessed by a sovereign or a military superior. If we relax the definition and describe power in terms of a position to exploit others economically, lack of sophistication fits neatly into the power description. The unequal bargaining power described in contract law is power in this lesser mode. It is also the mode of empowerment referenced by the critics.

### 3. Substantial Performance

The third defense makes still more concessions. Just as management power is hard to prove, so is its presence hard to deny. Many defenders accordingly concede it a place in the institutional description.<sup>146</sup> Some even concede that some managers take excessive rewards, that equity compensation is more liquid than shareholders would want, and that perverse incentives have cropped up in the form of accounting manipulation.<sup>147</sup> The dispute goes to the normative implications of the diagnosis of systemic imperfection. Here is the question: To what extent does the system succeed or fail in cost-effectively channeling the energy of empowered managers to productive ends that serve the shareholder interest? To answer the question is to make a judgment call. Defenders of the practice make a three-part case for relative success.

The first part of the defensive case takes a broad view and looks at the bright side. Shareholders, it is said, should be pleased with the way things have gone in the last decade and a half. Returns, measured net of the cost of executive compensation, have been generally higher since the switch to option-based compensation. And the shift did succeed in aligning management interests with those of the shareholders to a greater extent than in the past. Meanwhile, from 1992 to 2000, growth of gross domestic product

---

146. See Hall & Murphy 2003, *supra* note 72, at 27-28 (reporting sympathy with the view that pay decisions are not made by truly independent boards, but contending that rent extraction is not a compelling explanation); Holmström & Kaplan, *supra* note 1, at 13 (agreeing that the biggest payees use positions of power to command excessive awards); Jensen & Murphy 2004, *supra* note 2, at 54 (recommending changes in structural and psychological environment and noting that “changes in these practices will require a major change in the power relationship between the board and the CEO”); see also John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay without Performance?* 103 MICH. L. REV. 1142, 1160-61 (2005) (agreeing that pay structures reflect power and a positive correlation between power and pay).

147. Holmström & Kaplan, *supra* note 1, at 3-4, 12-14.

in the U.S. was higher than in any of Italy, France, Britain, Germany, or Japan.<sup>148</sup>

Defenders also point to governance improvements initiated in the 1990s. Boards became smaller and more independent, shareholders became more vigilant, compensation committees became the norm, and federal disclosure regulations required greater transparency than ever before.<sup>149</sup> Shareholders apparently welcomed the shift to option compensation as they enjoyed the bull market of the 1990s. In contrast, a much smaller net-pay increase to management during the 1980s triggered a populist backlash, due to the association of high salaries with layoffs, plant closings, and downsizing.<sup>150</sup>

Finally, the defenders argue that problems with executive compensation after the year 2000 mainly concern a few cases of abuse, and that any breakdowns due to the strain of the 1990s boom market have been addressed quickly.<sup>151</sup> Cases where high pay and poor performance coincide can be identified statistically and dealt with accordingly. The existence of bad apples does not compel the conclusion that the whole economy suffers from governance problems.<sup>152</sup>

No one on either side of the debate questions any of these points. The matter comes down to a dispute over the characterization accorded to a system that is admittedly dysfunctional. There is no objective resolution. Meanwhile, the whole discussion deflects attention from the important question: Assuming that equity incentive compensation can be better designed, should it be better designed? The answer clearly is yes.

## CONCLUSION

To the extent equity incentive compensation turns managers into speculative shareholders, supersize pay will yield perverse effects. Redirecting incentives to the investment mode of shareholding cures those problems but creates new ones. A compensation plan designed to create manager-investors delays supersize cash payoffs in order to keep the focus on long-term fundamental value. The delay reduces the value of the compensation package.

---

148. *Id.* at 3-4.

149. Hall & Murphy 2003, *supra* note 72, at 27-28.

150. Murphy 1998, *supra* note 4, at 1. Moreover, in Jensen & Murphy 2004, *supra* note 2, at 1, the authors point out the resurgence of outrage directed at the amount of pay in connection with recent scandals. They are impressed by the negative publicity attracted by the Jack Welch and Richard Grasso retirement packages, noting that nobody questioned the quality of the performance of either.

151. *See id.* at 3-4.

152. Core et al., *supra* note 146, at 1166.

One must then ask whether the purpose of “incentive compensation” is actually to incentivize, or merely to compensate. To the extent that the answer is “both,” perverse effects remain a constant possibility. It is time to raise the bar and emphasize incentives. Incentive compatibility should be the first priority, with the level of compensation being fixed in a framework that lacks foreseeable perverse effects.