Executive Compensation: Who'da Figured?

by M. Todd Henderson
The conventional wisdom about executive compensation is that CEOs are paid too much. With the average CEO of a large public firm making over $7 million per year, and with some "superstar" CEOs making many times that amount, often for short periods or in times of weak performance, it is easy to accept the claim as an obvious fact. The claim seems to be supported by the nature of the pay-setting process. The board that decides how much to pay the executive is installed by the CEO in most cases, and is under the CEO's personal influence. It is provided with most of its information by the CEO or consultants chosen by her, and importantly, is paying the CEO with other peoples' money.

Critics of high pay argue that these other people, generally the shareholders, are powerless to constrain CEO's salaries because they are a diffuse and rationally disinterested group, given their small stakes in the firm, not to mention that CEOs camouflage the true nature and amounts of pay. The argument is captured by a recent media account of the pay issue: "Executive compensation is the cancer of corporate America. CEO's have too much power and it has been directed at their own enrichment."

The most common criticism of pay compares the ratio between the earnings of an average worker and CEOs, noting that the ratio increased to 300 to 1 last year compared with a ratio of 92 to 1 in 1982.

Although this account has surface appeal, it fails to withstand close scrutiny. Despite growing to high dollar amounts, the evidence suggests that CEO pay is highly correlated with shareholder returns, is sensitive to firm performance, and is set in an efficient labor market. The evidence also shows that CEO pay is not as a result of a corrupt process whereby the CEO effectively writes herself a check.

We can test the efficiency of CEO pay by looking at cases in which a few sophisticated investors, betting their own money, replace the diffuse shareholders and the potentially corrupted board and write new executive compensation contracts with the CEO. If contracts in these cases, where so-called agency costs between owners and managers are reduced, look similar to those of firms in general, this suggests that compensation contracts are efficient. And at the very least, that increasing the power of shareholders to intervene in compensation decisions is unlikely to be produce much change in compensation forms or amounts. But before we get to this research, we require some background on the debate.

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There are two distinct arguments in the modern criticism of executive pay. The first is a populist argument: CEOs are paid too much compared with the average worker. The second is an efficiency argument: CEOs are paid inefficiently and pay is not linked closely with firm performance. Let us look at each in turn.

Paid too much: The most common criticism of pay compares the ratio between the earnings of an average worker and CEOs, noting that the ratio increased to 300 to 1 last year compared with a ratio of 42 to 1 in 1982. There are many oddities about this argument. For one, how are we as a society to determine what the correct ratio should be at any point in time? Is 300 to 1 a bad or inefficient ratio? Is 42 to 1 a good number? Why not 10 to 1 or even 1 to 1? In other words, the right question to be asking is not what is the ratio, but what are the benefits of various ratios compared with the costs? Moreover, we don't know whether a growing gap is a good or bad thing from a societal welfare point of view, after all, a growing gap may show increasing returns to education and hard work, something that might be expected and a net benefit for society, since it encourages investments in these things.

Since there is no easy answer the question about the socially optimal ratio, and since the answer is, in any event, likely to be different for different firms in different industries at different times, the question for society, and, more specifically for state law governing firms, should not be how much CEOs are paid, but who decides how much they should be paid. After all, if the process for setting pay is free from corruption and represents a market-based
wage, it is hard to argue that the amounts are grossly inefficient or wrong in some way. This is a subject we will return to in a moment.

The ratio problem is, of course, not unique to CEOs. The data show that top lawyers, football players, recording artists, movie stars, and celebrity journalists have all seen their wages rise dramatically in the past few decades, especially when compared with the paralegals, equipment managers, sound engineers, camera operators, and interns that do work behind the scenes to make these stars look good. Returns to talent have increased dramatically across the board, perhaps because improvements in technology and the globalization of markets allow individuals to exploit their talent over a greater and greater asset base with little additional cost. While this is an interesting phenomenon that deserves greater study, it has little to do with the current executive compensation debate. We don’t see critics lamenting the rising ratio of the wages of Tom Cruise to his make-up artist or Alex Rodriguez to the hitting coach for the Yankees, and this should tell us something about the real issue in the CEO debate—it is about political power in corporate America, not about populist criticism of some people who happened to make it rich. The CEO pay issue has political salience in part because of who the CEOs are and in part because they are earning the money that might arguably belong to others, be they providers of labor or capital. This is why the “Say on Pay” bill designed to give shareholders a voice over compensation has political constituencies—the argument is that CEOs are stealing from shareholders in a way that A-Rod isn’t when he demands hundreds of millions of dollars from George Steinbrenner to play third base for the Yankees. Again, we’ll come back to this shortly.

Finally, the pay-ratio argument ignores the fact that American businesses look very different today than they did in 1982. Most obviously, the average CEO tenure in 1982 was over 10 years, while today it is about 4 years and falling. After accounting for this drop, which, by the way, sure doesn’t sound like CEOs are getting more powerful, the growth in total expected CEO pay is far less dramatic, amounting to less than 5 percent per year. In addition, CEOs have faced increased risks in the form of increased disclosure under securities laws and potential personal liability or even prison time as the result of Sarbanes-Oxley and a growing number of shareholder lawsuits. CEO pay has risen in part because it is much riskier to be a CEO these days.

In addition, American firms are, on average, much bigger than they were in 1982. We might expect CEO pay to bear some relation to the difficult of their job, which may be related to size and complexity, and to their success in creating shareholder value. One test of this is to compare the ratio of total executive compensation to firm market value or total firm sales. Recent research shows that this ratio today is much less than it was from 1940 to 1960, and is about the same as the average over the period from 1960 to the present. This suggests that the ratio is not out of whack, but merely reflects changes inherent in the size of the firms that CEOs happen to run.

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American businesses are also much more profitable and valuable than they were in 1982. The growth in CEO pay is almost entirely explained by the fact that CEOs are paid primarily with equity, and as firm size value has grown, so has pay. (It is worth noting that in many countries CEOs were historically paid with cash instead of equity—stock options were illegal in Germany until very recently—and this helps explain in large part international pay gaps). In 1982, to use that magical year when CEOs and workers were paid at a reasonable ratio, the average CEO was paid like a bureaucrat, receiving a salary and a bonus that was tied to some measure of performance, typically revenue growth. Because pay was modest and was largely de-linked from shareholder returns, the evidence shows that CEOs managed firms in ways that maximized their own utility rather than that of their masters, the shareholder owners of the firm. For example, managers had incentives to be risk averse, lest they be fired, and to build empires, so they could demand a greater salary and to increase their prestige.

Starting in the mid-1980s, firms started paying CEOs like owners, giving them shares of the company stock in the form of options. CEOs now had incentives to maximize profit. Over this period, the growth in CEO compensation has been almost entirely explained by this equity component. (The growth in cash compensation has been less than 5 percent per year over the past 20 years, compared with a constant growth rate of over 50 percent per year for equity compensation). In other words, CEOs are rich today because they have presided over firms that have made
shareholders rich too. In fact, comparing median total return to shareholders (price appreciation plus dividends) and CEO pay over the past 10 years shows that they move in unison. This can also be seen by overlaying the growth in CEO pay since the 1980s over a curve of market capitalization of U.S. equity markets; again, the curves move together in lockstep (both up and down) precisely because CEO pay is so sensitive to firm market performance (Figure 1). (An important footnote here is that paying with options gave some executives incentives to manipulate stock prices for personal benefit. There are, of course, downsides to every form of compensation, and the question should not be whether some executives misbehaved, but whether the net benefits from equity pay exceed the costs.)

The fact that shareholder wealth has increased over this period is not the end of the argument. It merely begs the question of whether CEOs are taking a disproportionate share of gains, either because they are being compensated for things beyond their control (e.g., the market or firm value would have gone up anyway) or because they misuse their power over the pay-setting process to reward themselves—taking what economists call "rents"—at the expense of their shareholder masters. This, like the question begs out-of-whack-ratio problem above, leads us inexorably to a discussion of the efficiency of the compensation setting process and the compensation bargains that result from it. If these are efficient, there is not much more, short of legislating CEO pay amounts, that we as society can do about it.

*Inefficiently paid.* Arguments about how much CEOs should be paid lead inevitably to how CEOs are paid and who decides how much. The pay-setting process for most firms is the same: the board, on advice from compensation consultants, decides how much to pay the CEO, who, although technically employed by the board, has tremendous power over them. This circularity of power leads compensation critics like Lucian Bebchuk of the Harvard Law School to argue that CEO pay is not based on performance, but instead is based on managerial power. He and co-author Jesse Fried wrote an entire book on this subject, premised on the assumption that "[f]lawed compensation arrangements have been widespread, persistent, and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exercise considerable influence over their boards." This inefficiency view is shared by former SEC Chair Arthur Levitt, who wrote recently that "excessive compensation . . . packages are a consequence of boards falling victim to a seduction by the CEO and the solution is, in part, to create greater board independence."

The managerial power view asserts that executive compensation contracts made through the typical board process are decidedly not negotiated at arm's length. The specific factors limiting the ability of boards to do so are: (1) the power of the CEO over the appointment of directors; (2) the ability of the CEO to reward cooperative directors; (3) the social and psychological influences the CEO has over directors, such as the power of friendship, loyalty, collegiality, and authority; (4) the cognitive biases of directors that come from being CEOs or former CEOs themselves; and (5) the time and informational barriers most directors face to making an informed and reasoned decision about pay.

Bebchuk and Fried also argue

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**Figure 1**

![Graph showing CEO Total Pay and CEO Cash Pay over time](image-url)
that certain methods of compensation, such as traditional (non-indexed, at-the-money) stock options are suboptimal from an efficiency perspective. The argument is that traditional options do not provide as much incentive bang for the buck as indexed options with a strike price above the current market price. For example, if an oil firm grants the CEO 100,000 non-indexed, at-the-money options on January 1, and on July 1 the price of oil increases (because of, say, a crisis in the Middle East), causing the firm’s stock price to rise $10 per share, the CEO will earn $1 million largely thanks to events outside of his control. In addition, because the shares of all oil firms will rise, shareholders in this firm get nothing from this payment that they could not have received from holding a diversified basket of oil firm securities. It would be more efficient, the argument goes, to set the strike price above the market price (to give the executive an incentive to increase share value above a certain threshold level) and to link compensation to firm-specific performance by comparing the firm’s performance with an index of other firms in that industry. Because this compensation design is rather straightforward and yet not used by firms, it is believed that the “design of option programs is consistent with the presence of managerial power.”

A first response to the claim that pay is de-linked from performance is to look at the data. Recent work by Steve Kaplan and Joshua Rauh, my colleagues across the Midway at the Graduate School of Business, shows that pay and performance are actually tightly linked: top decile firms (in pay) outperform their industries by over 60 percent, while the bottom decile firms (in pay) underperform their industries by about 20 percent. This comports with the evidence discussed above, showing that CEO pay has risen and fallen consistently with the stock market. For example, average real CEO pay reached its peak at the height of the stock market in 2000, and has fallen along with the stock market almost 30 percent over the past three years. Also, as noted above, CEO tenure has fallen by half over the past decade, which casts some serious doubt on the Full Monty version of the managerial power theory.

A second bit of research looks instead at the pay-setting process in a special case where managerial power is reduced to see what impact the reduction has on how and how much CEOs are paid. I looked at about 80 firms in financial distress that were reorganized under Chapter 11 of the Bankruptcy Code or worked out debt privately to see whether pay practices, say the use of nonindexed options, changed once sophisticated investors were in charge of writing compensation contracts.

The primary effect of bankruptcy is to wipe out the claims of the distant, diffuse, and disinterested shareholders, the ones that managerial power theorists claim allow managers to get away with rent extraction, and to leave only sophisticated investors, such as banks, insurance companies, hedge funds, and specialty bondholders known as “vulture investors”. These investors are specialist, repeat players in workouts or distressed investing. They achieve control either by buying significant blocks of a firm’s outstanding debt or by agreeing to loan the debtor additional funds, subject to restrictive debt covenants that grant the lender contractual control of many of the firm’s activities. In most cases, the holders of bank debt consolidate their interests in and around financial distress by creating a single credit facility that reorders the existing debt of many providers and pumps new cash into the debtor. A similar consolidation happens with the bond debt, which vulture investors buy up in order to secure a blocking position in the reorganization process. The end result is that these 80 cases, like most other bankruptcies, the thousands of shareholders are replaced with a few, highly sophisticated investors betting huge amounts of money on turning the firm from distress to profitability.

CEO power over pay is greatly reduced in these cases. For one, existing CEO compensation contracts were ripped
up and written anew, since they were voidable in bankruptcy. This suggests that any stickiness in compensation amounts or forms is reduced, since the parties are bargaining on a clean slate. Actual bargaining was also observed in these companies. Instead of the CEO bargaining over pay with a board she appointed, the firms in the study showed actual, arm’s-length bargaining between the CEO and the vulture investors and banks that made large investments to turn the firm around. In addition, unlike in healthy firms, CEO pay contracts in each of these cases was approved by a court overseeing the reorganization. In short, pay was set for these firms in a manner that was about as good as we could possibly expect.

The study looked at pay amounts and the form in which pay is delivered before, during, and after bankruptcy to see what change the reduction in managerial power had. Although there were variations in the amounts of pay in these three periods, as we would expect given the trauma bankruptcy has on firms and given the impact this is likely to have on attracting and retaining talent, the key finding here was that compensation in periods outside of bankruptcy (say four years before and four years after) were very similar. In other words, the contracts written in bankruptcy by sophisticated investors trying to maximize the value of the firm, delivered the same compensation amounts as those written in periods where managerial power was high.

This conclusion may be seen even more clearly in the case of the form of compensation used in these cases. No firm in the dataset changed compensation formats—say, moving from nonindexed stock options to indexed stock options—in the way that Bebchuk and Fried argue is obviously beneficial. If firms with very low agency costs and weak managerial power (compared with healthy firms) do not move to one form of compensation over a type prevailing in the market, this casts doubt on claims that it is only managerial power standing between shareholders and more efficient compensation contracts.

It might be, one could argue, that the entire market for CEO pay is distorted, and that bankrupt firms, like all other firms, have no choice but to pay the (distorted) market wage—they are “price takers.” Pay might also be sticky in some sense, in that the amount that the CEO made in prior, pre-distress periods is the amount that the new CEO would expect in the post-distress period. Accepting these criticisms as true, this still cannot explain why firms in distress would deliberately choose inefficient forms of compensation. Consider an example: a firm in distress needs to attract a new CEO, and the leading candidate demands $10 million per year. The firm may not be able to move the CEO from her reservation price, but it certainly has discretion over the form in which the $10 million can be delivered. Failure to innovate here demonstrates that the prevailing forms are likely as efficient as we can expect, even assuming an increase in shareholder monitoring or power over the pay-setting process. This is not to say that firms and the market might learn over time about new ways of providing incentives for managers, since capitalism is still surely a work in progress. It does show, in my view, that the silver bullet of giving shareholders more say is unlikely to have much impact.

Executive compensation is a classic political football, and we should expect the debate to rage, die away, and then rekindle depending on the prevailing political winds. The real challenge for law is to ensure that the process for setting pay is not corrupted by cronyism while policing obvious frauds, such as the manipulation of stock prices for personal benefit. The work being done by boards and compensation consultants is even more important, since they are developing new tools. If boards do their job, by being fully informed and making decisions in the best interest of shareholders, as required under clear state law precedents, the issue of who decides is moot, and we can rest assured that CEO pay is set in a relatively efficient labor market. What more could we ask?

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2 Lucian Bebchuk & Jesse Fried, *Pay Without Performance at ix (2004).*