

Bebchuk, Lucian; Fried, Jesse

Article

Power, rent extraction, and executive compensation

CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Bebchuk, Lucian; Fried, Jesse (2002) : Power, rent extraction, and executive compensation, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 03, Iss. 3, pp. 23-28

This Version is available at:

<https://hdl.handle.net/10419/166130>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

POWER, RENT EXTRACTION, AND EXECUTIVE COMPENSATION

LUCIAN BEBCHUK* AND
JESSE FRIED**

Executive compensation in companies with substantial separation of ownership and control has long attracted a great deal of attention – from both the public at large and financial economists. During the extended bull market of the 1990s, stock option programs adopted by publicly traded U.S. companies yielded unprecedented compensation for senior executives. These gains were accompanied by a parallel rise in academic work on the subject; in fact, it appears that the growth rate of such work has outpaced even that of executive compensation (Murphy, 1999, at 2487).

In studying executive compensation, financial economists traditionally have followed what might be referred to as “the optimal contracting approach.” Under this approach, executive compensation practices in large, publicly traded companies are viewed as being designed to minimize agency costs arising in the relationship between senior executives (the agents) and shareholders (the principals). The board is seen as seeking to maximize shareholder value, with the compensation scheme designed to serve this objective. Although recognition of potentially large deviations from optimal contracting lies at the heart of public criticism of compensation schemes, such deviations have received insufficient attention from financial economists.

Another approach to the study of executive compensation – the “managerial power approach” – focuses on the role of managerial power in shaping

executive compensation practices. In a recent article written jointly with David Walker (Bebchuk, Fried and Walker (2002)), we have put forward an account of this alternative approach. As will be discussed in this brief note, which draws on the article, the substantial role of managerial power on executive compensation is suggested by both theory and the evidence.

At the level of theory, we argue that an analysis of the compensation-setting process indicates that its outcomes are likely to be greatly influenced by managerial power and by managers’ interest in extracting rents. In addition, we argue that the extensive empirical evidence on executive compensation is consistent with the predictions of the managerial power approach. Indeed, this approach can better explain some significant features of the executive compensation landscape, including ones long regarded as puzzling.

Optimal contracting and its limitations

Financial economists have made great effort to understand, within the optimal contracting model, the executive compensation arrangements that have arisen over the last two decades. Many papers have attempted to show that the various features of executive compensation arrangements, as well as the cross-sectional variation in compensation practices among firms, can be explained from this perspective. But there are good reasons to doubt the ability of this model to explain managerial pay practices adequately. Optimal compensation contracts could result from effective arm’s-length bargaining between the board and the executives, or from market constraints that induce players to adopt such contracts even in the absence of such bargaining. Our analysis, however, indicates that neither of these forces can be expected to constrain executive compensation effectively.

Bargaining with the board is far from arm’s length. In the optimal contracting model, the directors seek to maximize shareholder value in bargaining



Lucian Bebchuk



Jesse Fried

The optimal contracting model cannot adequately explain managerial pay practices

* William J. Friedman Professor of Law, Economics, and Finance, Harvard Law School; Research Associate, NBER and CEPR.

** Acting Professor, Boalt Hall School of Law, University of California at Berkeley.

Constraints on pay are insufficient to produce efficient outcomes

with the managers. However, given that managers do not automatically serve shareholders' interests – which is why incentivizing them adequately is important – there is no reason to expect *a priori* that directors would maximize shareholder value. Even nominally independent directors often have incentives to favor the CEO, who might have played a role in their nomination or will play a role in their re-nomination to the board, and with whom they work closely. Even if directors have no reason to favor the CEO, they commonly have little incentive to exert effort to get shareholders the best executive compensation agreements possible, and often lack independent information and professional advice. Similarly, market forces are not sufficiently strong and fine-tuned to assure optimal contracting outcomes. In our work, we have analyzed constraints posed by the market for control, the market for capital, and the labor market for executives. These markets all impose *some* constraints on what directors will agree to, and what managers will ask them to approve. But these constraints are far from tight and permit substantial deviations from optimal contracting.

Consider, for example, whether the market for corporate control – the takeover threat – could ensure optimal contracting outcomes. Suppose that an executive of a 10 billion dollar company contemplates increasing compensation by 100 million dollars. Clearly, the direct benefit to the executive would be quite substantial. In contrast, the cost to the executive – the increase in the likelihood of a hostile takeover or ouster as a result of the accompanying 1% reduction in company value – would be limited. Undoubtedly, the corporate control market would place some constraint on an increase in pay. At a certain point, shareholders could become outraged enough to support outside challengers or bidders in a control contest. Still, management pay could substantially exceed the amount consistent with optimal contracting, without creating much additional risk of a takeover.

The managerial power approach

The very reasons for questioning the ability of optimal contracting to explain adequately compensation practices also suggest that executives will have substantial influence over their own pay. The managerial power approach focuses on the role of

this influence in shaping pay arrangements. Under this approach, executive compensation is viewed not only as an instrument for addressing agency problems, but also as a *part* of the agency problem itself.

One important building block of the managerial power approach is that of “outrage” costs and constraints. Executives can exert influence on their own pay, but that does not imply an unlimited ability to do so. Although the need for board approval and the presence of market forces cannot be expected to produce compensation arrangements consistent with optimal contracting, they can and commonly do provide some constraints. For example, although the takeover threat is not sufficiently fine-tuned to discourage managers from seeking to extract substantial rent, the concern about losing shareholder support in the event of a control contest places some limits on what managers and directors can do. The tightness of the constraints managers and directors confront depends, in part, on the outrage, if any, expected to be generated by a particular compensation arrangement.

Outrage can be costly to directors and managers in several ways. For instance, outrage may cause embarrassment or reputational harm, and it may reduce the willingness of shareholders to support incumbents in control contests. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve the arrangement, and the more hesitant managers will be to propose it in the first instance. Thus, whether a compensation arrangement that is favorable to executives but sub-optimal for shareholders is adopted will depend on how the arrangement is perceived by outsiders and, in particular, on how much outrage (if any) it can be expected to produce.

The potential significance of outrage costs explains the importance of “camouflage” – a second building block of the managerial power approach. Because outrage arising from outsiders' recognition of significant rent extraction provides a possible check on managers' power to extract rent, managers have an incentive to obscure and legitimize – or, more generally, to camouflage – their extraction of rents. Indeed, even the extensive use of compensation consultants, which could be viewed under the optimal contracting approach as part of an

effort to design the most efficient incentive scheme, can be seen as a means of justifying and legitimizing pay under the managerial power approach. This concept of camouflage turns out to be quite useful in explaining many of the patterns and puzzles provided by the executive compensation landscape.

The desire to camouflage might lead to the adoption of inefficient compensation structures that fail to provide desirable incentives, or even supply perverse incentives. In our view, the reduction in shareholder value caused by these inefficiencies, rather than the rent captured by managers, might well be the biggest cost arising from the influence of managerial power on compensation practices. Thus, better compensation arrangements may provide shareholders with considerable benefits by improving managerial incentives and performance.

Although the managerial power approach is conceptually different from the optimal contracting approach, the former is not proposed as a complete replacement for the latter. Compensation arrangements are likely shaped by both managerial power and what would be considered optimal for shareholders. The managerial power approach merely implies that compensation practices cannot adequately be explained by optimal contracting alone. Rather, practices may deviate significantly from those suggested by optimal contracting, and such deviations can be well understood only with careful attention to the role of managerial power.

A brief look at the evidence

We now discuss three compensation practices to illustrate how the managerial power approach can help explain the executive compensation landscape. (A more detailed analysis of these and other practices can be found in Bebchuk, Fried, and Walker (2002).)

Near-universal use of at-the-money options

Almost all of the stock options used to compensate executives are issued “at-the-money” – their exercise price is set to the grant-date market price. However, it is highly unlikely that this is always the optimal strike price. An optimally designed option scheme would seek to provide risk-averse managers with the strongest cost-effective incentives to

exert effort and make value-maximizing decisions. The optimal exercise price under such a scheme should depend on a multitude of factors that are likely to vary from executive to executive, from company to company, from industry to industry, and from time to time. Such factors might include the degree of managerial risk aversion (which in turn might be affected by the manager’s age and wealth), the project choices available to the company, the volatility of the company’s stock, the expected rate of inflation, and the length of the executive’s contract, among other things. There is no reason to expect that “one size fits all” – that is, that the same exercise price would be optimal for all executives at all firms in all industries at all times.

It is highly unlikely that out-of-the-money options (options whose exercise price is above the grant-date market price) are *never* optimal. As Hall (1999) has argued, out-of-the-money options offer much higher pay-for-performance sensitivity per dollar of expected value than conventional options. And there is empirical evidence suggesting that giving managers out-of-the-money options rather than at-the-money-options would, on average, boost firm value (Habib and Ljungqvist, 2000). The fact that options are almost uniformly issued at-the-money is thus difficult to explain by optimal contracting. Indeed, economists working within this model have called this practice “puzzling” (Hall, 1999, at 43).

The near-uniform use of at-the-money options is not puzzling, however, when examined under the managerial power approach. Given that executives benefit from lower exercise prices, executives will wish to push exercise prices as far down as possible without generating outrage. Therefore, there is little reason for designers of plans to award out-of-the-money options given that some justification is available for at-the-money options. On the other hand, in-the-money options (options whose exercise price is below the grant-date market price) might be regarded as a windfall and thereby generate outrage costs. Furthermore, a grant of in-the-money options would trigger a charge to accounting earnings, and this might undermine one of the excuses for not using indexed options – that the use of such options would give rise to an accounting charge. Because in-the-money options might thus be difficult or costly for managers to obtain, and at-the-money options are

The managerial power approach can explain deviations from optimal contracting

the ones most favorable to managers within the remaining range of possibilities, a uniform use of at-the-money options is consistent with the managerial power approach.

Freedom to unload options and shares

Another problem for the optimal contracting approach – and one that has received insufficient attention by researchers despite its importance – concerns managers' widespread freedom to undo the financial incentives provided to them by their compensation arrangements. When value is spent on providing managers with incentives, it might well be desirable to place substantial limits on managers' freedom to unwind them. But firms take surprisingly few steps to prevent or regulate the unwinding of the incentives created by grants of options and restricted stock.

Stock options generally vest after a specified period, which ensures that the executive cannot walk away with the underlying shares without first serving the company for the specified period. Although an executive becomes entitled to the awarded options once their vesting period is over, the compensation contract could preclude the executive from "cashing out" the vested options – that is, from exercising the options and then selling the acquired shares. Such a limitation would maintain incentives for an additional period and thus prevent the need to grant new options to replace the ones that have been cashed out. There is no reason to expect that optimal contracts would generally make the vesting date and the cash-out date the same. Yet, the two dates are almost always the same. Not surprisingly, managers exercise many of their options well before expiration, and sell most of the shares acquired through the exercise of these options (Ofek and Yermack, 2000).

An optimal contract also might prohibit managers receiving options from weakening (if not eliminating) the incentive effects of the option grant by selling an equivalent number of shares already owned by them. Standard practice fails to prohibit this, however, and executives receiving new options often respond by heavily selling already-owned shares. Contracts also do not generally prohibit executives from hedging vested or even unvested options, and executives often hedge their equity exposure to the firm when disposal is either not possible or too costly from a tax perspective.

It should be emphasized that permitting executives to unload their positions in the short run can lead to substantial distortions (modeled in Bebchuk and Bar-Gill (2002a, 2002b)) in the way companies are managed. Compared with executives who must maintain their equity positions for the long haul, executives who may sell in the short run would tend to make investment decisions distorted in favor of short-term projects, to misreport corporate performance, and to exert less effort both before and after they unload their stock. The reductions in shareholder value produced by these distortions might far exceed the extra rent executives get from their freedom to unload options and shares.

Furthermore, even if it were optimal in some cases to grant an executive broad freedom to cash out because of the executive's liquidity or diversification needs, there would be little reason to give the executive unrestricted control over the timing of stock sales. When managers can control the exact timing of stock sales, they can profit by selling when they know that the stock is overpriced. Although it is illegal in the U.S. for managers to trade on "material" inside information, the "materiality" standard is sufficiently high that managers can – and do – make significant profits trading on information that is valuable but not considered legally "material" (Fried, 1998). These profits are unlikely to be an efficient mechanism for compensating executives. Indeed, executives' control of the timing of their sales aggravates the perverse incentives created by executives' broad freedom to unload shares and options.

To be sure, executives have liquidity and diversification needs that might require them to sell some of their shares. However, liquidity and diversification needs hardly call for permitting the executive to cash out positions whenever the executive so chooses. Most of these needs can be anticipated and planned for. One could require sales to be carried out gradually over a specified period pursuant to a pre-arranged plan. Or the executive could be required to sell shares directly to the firm for the average share price over a specified and sufficiently long period of time (say, the preceding 6 months). Yet, although some firms have put in place "trading windows" in response to the adoption of tough insider-trading penalties on employers who fail to take steps to prevent illegal insider trading by their employees, many firms

Practices managerial influence can explain include the use of at-the-money options, freedom to unload equity, and "golden goodbyes"

place no limits on the freedom of executives to time the cashing out or hedging of their equity positions.

Whether or not the board restricts the timing of sales, it could require enhanced disclosure of those trades. Until recently, the securities laws required that executives disclose their trades to the SEC by the tenth day of the month following the trade. In the wake of the Enron and other corporate scandals, Congress has required executives to disclose their trades shortly after they are made. Congress might not have gone far enough. It might be desirable to require executives to publicly disclose shortly in advance of their planned trades, as one of us has proposed (Fried, 1998). In any event, when the law did not compel disclosure of trades until the month after the trade, one might have expected firms adopting optimal contracts to require executives to make earlier disclosures. Yet firms, including those that use trading windows, made no attempt to provide timely disclosure of managers' sales until forced by the government to do so. In fact, many firms have moved in the opposite direction and taken steps to reduce the transparency of insider sales.

The lack of restrictions on the amount and timing of stock selling, while difficult to explicate from an optimal contracting perspective, can easily be explained under the managerial power approach. Under this approach, the design of compensation plans is partly influenced by managerial power. Avoiding such restrictions benefits managers and does so in a way that in the past has been largely under the radar screen.

"Golden Goodbyes"

Another significant practice worth noting is that of the board giving the CEO "gratuitous" goodbye-payments. The payments are "gratuitous" in that they are not required under the terms of the CEO's compensation contract. These payments can arise in a number of contexts – an important one being the acquisition of the CEO's firm. CEOs of acquired firms, in many cases, receive payments from their firm or the acquiring firm. These payments take a number of different forms, including increases in the contractual golden parachute payout and separate cash payments. Another context is that in which CEOs are "pushed" out by the board of directors. Even when these CEOs have performed poorly, they commonly receive gratu-

itous payments and benefits not called for by their contract.

Some believe that such "golden goodbyes" can benefit shareholders. Given that executives' influence over their boards enables them to resist beneficial acquisitions or their own firing, such payments might be needed to make a beneficial acquisition or CEO departure possible. Even on this account, which views the payments as overall (second-best) beneficial for shareholders *given* managers' power, the payments indicate the existence of substantial managerial power.

Conclusion

In sum, there are reasons to suspect that managerial power has had a substantial impact on the design of executive compensation in companies in which ownership and control are separated. Executive compensation can be analyzed fruitfully not only as an instrument for addressing the agency problem, but as a part of the agency problem itself. The main cost to shareholders might well arise from inefficient pay arrangements that are designed to camouflage the extraction of rent and which provide sub-optimal or even adverse incentives.

The conclusion that managerial power and rent extraction play a significant role in executive compensation has important implications. To the extent that the way in which compensation arrangements are perceived is important, it is desirable to ensure not only that information about executive compensation be in the public domain but also that the compensation be disclosed in a highly visible and transparent manner. Because boards cannot be relied on to negotiate optimal contracts with executives, institutional investors would do well to pressure firms to stop using some of the conventional practices that appear to be sub-optimal. We are planning to explore these and other implications in future work on the subject of managerial power and executive compensation. We hope that the significance of managerial power will receive, from financial economists studying executive compensation, some of the attention that the optimal contracting model has long enjoyed.

To limit rent extraction, compensation disclosure should be transparent

References

Bebchuk, Lucian, Jesse Fried, and David Walker (2002), "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review*, 69, 751–846.

Bebchuk, Lucian and Oren Bar-Gill (2002a), "Executive Compensation with Short-term Incentives," Working Paper, Harvard Law School.

Bebchuk, Lucian and Oren Bar-Gill (2002b), "Misreporting Corporate Performance," Working Paper, Harvard Law School.

Fried, Jesse (1998), "Reducing the Profitability of Corporate Insider Trading through Pre-trading Disclosure," *Southern California Law Review*, 71, 303–392.

Habib, Michel and Alexander P. Ljungqvist (2000), "Firm Value and Managerial Incentives," Working Paper, London Business School.

Hall, Brian (1999), "A Better Way to Pay CEOs?," in Jennifer Carpenter and David Yermack, eds, *Executive Compensation and Shareholder Value: Theory and Evidence* 35–46 (Kluwer Academic).

Murphy, Kevin J., "Executive Compensation," in *Handbook of Labor Economics* (Orley Ashenfelter and David Card eds.) (North Holland: Amsterdam) (1999).

Ofek, Eli and David Yermack (2000), "Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership," *Journal of Finance*, 55, 1367–1384.