

Empirical evidence indicates executives do not have outsized control over their compensation.

Is ‘Say on Pay’ Justified?

BY STEPHEN M. BAINBRIDGE

UCLA Law School

In the last Congress, House Financial Services Committee chair Barney Frank introduced H.R. 1257, the “Shareholder Vote on Executive Compensation Act.” The Frank bill would amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation. Under it, public companies would be required to hold an annual nonbinding shareholder “Say on Pay” vote on the executive compensation arrangements disclosed in the company’s proxy statement and also would require a separate shareholder vote for any additional compensation that is tied to the sale or purchase of a company. Similar legislation was advanced in the Senate by Barack Obama.

Then, this past February, the U.S. Treasury announced a policy under which banks receiving “exceptional assistance” under the ongoing government bailout must fully disclose their executive compensation structure and obtain a non-binding shareholder vote on that structure. This is the first legally mandated Say on Pay requirement in the United States.

Proponents of broader federal legislation generally entitling shareholders of all public corporations to a vote on executive compensation must prove three distinct claims:

- There is an executive compensation problem justifying legislative intervention.
- Any such legislative intervention should be imposed at the federal level.
- A Say on Pay requirement is an effective solution to the problem.

If any of those claims fails, the case for a federal Say on Pay law collapses. In this article, I argue that none of the three holds up to close examination.

Stephen M. Bainbridge is the William D. Warren Professor of Law at the UCLA School of Law.

IS THERE AN EXECUTIVE COMPENSATION CRISIS?

There is no question that executive compensation has grown significantly over the last two decades. House Report 110-088, which accompanies H.R. 1257, notes that in FY 2005 the median chief executive officer among 1,400 large companies “received \$13.51 million in total compensation, up 16 percent over FY 2004.” The report also notes that “in 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500 to 1.”

But so what? Many occupations today carry vast rewards. Lead actors routinely earn \$20 million per film. The NBA’s average salary is over \$4 million per year. Top investment bankers can earn annual bonuses of \$5 to \$15 million. Indeed, according to an April 24, 2007 *New York Times* article, the “highest paid” investment banker on Wall Street in 2006 was Lloyd Blankfein of Goldman Sachs, who “earned \$54.3 million in salary, cash, restricted stock, and stock options.” Yet, that sum is dwarfed by the pay of private hedge fund managers. The same *Times* story reports that hedge fund manager James Simons earned \$1.7 billion in 2006 and that two other hedge fund managers also cracked the billion dollar level. Accordingly, unless one’s objection to the amounts received by corporate executives is based solely on the size of those amounts, one must be able to distinguish corporate managers from other highly paid occupations.

In their 2004 book *Pay Without Performance*, upon which House Report 110-088 heavily relies, law professors Lucian Bebchuk and Jesse Fried contend that the high compensation for actors and sports stars is acceptable because they must bargain at arm’s length with their employers, while managers essentially set their own compensation. As a result, they claim, even though managers are under a fiduciary duty to maximize shareholder wealth, executive compensation arrangements

often fail to provide executives with proper incentives to do so and may even cause executive and shareholder interests to diverge. In other words, the executive compensation scandal is not the rapid growth of management pay in recent years, but rather the failure of compensation schemes to award high pay only for top performance.

Corporate management is viewed conventionally as a classic principal-agent problem. The literature widely credits Adolf Berle and Gardiner Means' 1932 classic *The Modern Corporation and Private Property* with tracing the problem to the separation of ownership and control in public corporations. They observed that shareholders, who conventionally are assumed to own the firm, exercise virtually no control over either day-to-day operations or long-term policy. Instead, control is exercised by a cadre of professional managers. This

“separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge.”

The literature identifies three particular ways in which the interests of shareholders and managers may diverge:

- Managers may shirk — in the colloquial sense of the word — by substituting leisure for effort.
- Managers make significant non-diversifiable investments in firm-specific human capital and hold undiversified investment portfolios in which equity of their employer is substantially overrepresented. They thus have incentive to minimize firm-specific risks that shareholders can eliminate through diversification. As a result, managers generally are more risk-averse than shareholders would prefer.
- Managers' claims on the corporation are limited to their tenure with the firm, while the shareholders' claims have an indefinite life. As a result, managers and shareholders will value cash flows using different time horizons; in particular, managers will place a low value on cash likely to be received after their tenure ends.

In theory, those divergences in interest can be ameliorated by executive compensation schemes that realign the interests of corporate managers with those of the shareholders.

According to Bebchuk and Fried, boards of directors — even those nominally independent of management — have strong incentives to acquiesce in executive compensation that pays managers rents (i.e., amounts in excess of the compensation management would receive if the board had bargained with them at arm's-length). As a result, as their title implies, executives are getting high pay that is largely decoupled from performance incentives.

It is certainly true that directors all too often are chosen de facto by the CEO. Once a director is on the board, pay and other incentives give the director a strong interest in being reelected; in turn, because of the



CEO's considerable influence over selection of the board slate, this gives directors an incentive to stay on the CEO's good side. Finally, Bebchuk and Fried argue that directors who work closely with top management develop feelings of loyalty and affection for those managers, as well as becoming inculcated with norms of collegiality and team spirit, which induce directors to "go along" with bloated pay packages.

Since Bebchuk and Fried provide much of the intellectual framework for H.R.1257, it is worth noting that their claims have faced strong criticism. One review by John Core, Wayne Guay, and Randall Thomas argues "that in many settings where 'managerial power' exists, observed contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally." Another review by Franklin Snyder argues that "most of the results that [Bebchuk and Fried] see as requiring us to postulate managerial dominance turn out to be consistent with a less sinister explanation." Finally, and perhaps most importantly, Xavier Gabaix and Augustin Landier find that "the six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large U.S. companies." In other words, CEOs got richer because their shareholders got richer.

An important piece of evidence in support of this claim is that there are relatively modest differences in pay practices between firms that have a controlling shareholder and those with dispersed share ownership. Why would a controlling shareholder permit managers to extract rents at its expense? Does it not seem more plausible that large blockholders tolerate the challenged compensation practices because they are consistent with shareholder interests rather than representing management's ability to extract rents inconsistent with shareholder wealth maximization? Support for this explanation is provided by a recent study by Robert Daines, Vinay Nair, and Lewis Kornhauser finding that "highly paid CEOs are more skilled when firms are small or when there are fewer environmental constraints on managerial discretion. This link between pay and skill is especially strong if there is a blockholder to monitor management." As such, the observation that the allegedly questionable compensation practices occur both in companies with dispersed ownership and those with concentrated ownership may suggest that those practices are attributable to phenomena other than managerial control.

As another example, consider the much maligned practice of management perquisites. If managerial power has widespread traction as an explanation of compensation practices, one would assume that the evidence would show no correlation between the provision of perks and shareholder interests. In fact, however, an interesting study of executive perks found just the opposite. As described in a December 2, 2004 article in the *Economist*:

Raghuram Rajan, the IMF's chief economist, and Julie Wulf, of the Wharton School, looked at how more than 300 big companies dished out perks to their executives in 1986-99. It turns out that neither cash-rich, low-growth firms nor firms with weak governance shower their executives with unusually generous

perks. The authors did, however, find evidence to support two competing explanations.

First, firms in the sample with more hierarchical organizations lavished more perks on their executives than firms with flatter structures. Why? Perks are a cheap way to demonstrate status. Just as the armed forces ration medals, firms ration the distribution of conspicuous symbols of corporate status.

Second, perks are a cheap way to boost executive productivity. Firms based in places where it takes a long time to commute are more likely to give the boss a chauffeured limousine. Firms located far from large airports are likelier to lay on a corporate jet.

In other words, executive perks seem to be set with shareholder interests in mind.

In sum, the evidence simply does not support the managerial power model on which H.R. 1257 rests. To the contrary, executive pay turns out to be closely linked to performance. The legislation attacks a problem that doesn't seem to exist.

Or, perhaps more accurately, a problem that has gone away. According to the July 20, 2006 *Economist*, the University of Chicago's Steven Kaplan "calculates that ... for firms in the S&P 500 index, average chief-executive compensation peaked in 2000, and has since fallen by about a third." *Fortune* editor Dominic Basulto goes so far as to say that CEOs are now underpaid:

There's strong evidence that, far from being paid too much, many CEOs are paid too little. Not only do the top managers of multibillion-dollar corporations earn less than basketball players..., they are also outpaced in compensation by financial impresarios at hedge funds, private equity firms, and investment banks. Should we care? Yes. If other positions pay far more, then the best and the brightest minds will be drawn away from running major businesses to pursuits that may not be as socially useful — if not to the basketball court, then to money management.

A FEDERAL SOLUTION?

We live in an era of creeping federalization of corporate law. Indeed, some among Delaware's elite finally seem to be waking up to the threat. A March 2, 2008 (Delaware) *NewsJournal* article reports:

The most significant intrusion into Delaware territory came in 2002, following Enron and other corporate scandals. Congress passed the Sarbanes-Oxley Act, which created accounting and governance standards for public companies. It was seen by some as a turning point because it marked the first time Congress explicitly intruded into corporate governance.

[Mark] Roe, of Harvard, said: "If I was a Delaware lawyer, Sarbanes-Oxley would make me wary that there's a renewed chance the things I do for a living could move to Washington."

I believe that federalizing corporate governance is a task

that should be approached with extreme caution. The state-based system of regulating corporate governance is one of the main strengths of the U.S. capital markets. Indeed, as Yale Law's Roberta Romano famously claimed, state regulation and the resulting regulatory competition between jurisdictions is the "genius of American corporate law."

The basic case for federalizing corporate law rests on the so-called "race to the bottom" hypothesis. States compete in granting corporate charters. After all, the more charters a state grants, the more franchise and other taxes it collects. According to the theory, because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes allowing corporate managers to exploit shareholders. As the clear winner in this state competition, Delaware is usually held up as the poster-child for bad corporate governance. Interestingly, the two main poster-children for reform, Enron and WorldCom, were not Delaware

Romano's findings are buttressed by Robert Daines's well-known 2001 study in which he compared the Tobin's Q of Delaware and non-Delaware corporations. (Tobin's Q is the ratio of a firm's market value to its book value and is a widely accepted measure of firm value.) Daines found that Delaware corporations in the period 1981–1996 had a higher Tobin's Q than those of non-Delaware corporations, suggesting that Delaware law increases shareholder wealth. Although subsequent research suggests that this effect may not hold for all periods, Daines' study remains an important confirmation of the event study data.

Additional support for the event study findings is provided by takeover regulation. Compared to most states, which have adopted multiple anti-takeover statutes of ever-increasing ferocity, Delaware's single takeover statute is relatively friendly to hostile bidders. A 1999 empirical study of state corporation codes by John Coates confirms that the Delaware

Federalizing corporate governance is a task that should be approached with extreme caution.

corporations — they were incorporated in Oregon and Georgia, respectively.

Basic economic common sense tells us that investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not lend to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers thus have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters should deter states from adopting excessively pro-management statutes.

The empirical research bears out this view of state competition, suggesting that efficient solutions to corporate law problems win out over time. Romano's 1985 event study of corporations changing their domicile by reincorporating in Delaware, for example, found that such firms experienced statistically significant positive cumulative abnormal returns. In other words, reincorporating in Delaware increased shareholder wealth. This finding strongly supports a "race to the top" hypothesis. If shareholders thought that Delaware was winning a race to the bottom, shareholders should dump the stock of firms that reincorporate in Delaware, driving down the stock price of such firms. As Romano found, and all of the other major event studies confirm, there is a positive stock price effect upon reincorporation in Delaware.

statute is the least restrictive and imposes the least delay on a hostile bidder. Given the clear evidence that hostile takeovers increase shareholder wealth, this finding is especially striking. The supposed poster child of bad corporate governance, Delaware turns out to be quite takeover-friendly and, by implication, equally shareholder-friendly.

Arguments in favor of federal preemption, moreover, betray a complete lack of sympathy for — and perhaps even awareness of — the vital relationship between federalism and liberty. In other words, even if state competition is a race to the bottom, basic federalism principles would still counsel against federal preemption of corporate law. The corporation is a creature of the state, "whose very existence and attributes are a product of state law," according to the U.S. Supreme Court in its 1987 ruling in *CTS Corp. v. Dynamics Corp.* States have an interest in overseeing the firms they create. States also have an interest in protecting the shareholders of their corporations. Finally, a state has a legitimate "interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs," according to the Court. In other words, state regulation not only protects shareholders, but also protects investor and entrepreneurial confidence in the fairness and effectiveness of the state corporation law.

According to the *CTS* decision, the country as a whole benefits from state regulation in this area. As Justice Powell explained in that case, the markets that facilitate national and international participation in ownership of corporations

are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that corporations generally are organized under, and governed by, the law of the state of their incorporation. This is so in large part because ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis pointed out in his 1932 dissent in *New State Ice Co. v. Liebmann*, “It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic exper-

1257 proposes only an advisory vote. Yet, the logic of an advisory vote on pay seems to be the same as that underlying precatory shareholder proposals made pursuant to Rule 14a-8. Even though neither is binding, they are nevertheless expected to affect director decisions.

Moreover, Say on Pay is just one of an array of proposals for empowering shareholders. In that context, it is part of an ongoing effort by a handful of activists to shift substantially the locus of decisionmaking authority. The trouble is that shareholder involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the vesting of “authoritative control” in the board of directors.

The director primacy model is grounded in Kenneth Arrow’s

Shareholder involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable.

iments without risk to the rest of country.” So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion, but instead may lead to more efficient corporate law rules.

In contrast, the uniformity imposed by federal law will preclude experimentation with differing modes of regulation. As such, there will be no opportunity for new and better regulatory ideas to be developed — no “laboratory” of federalism. Instead, we will be stuck with rules that may well be wrong from the outset and, in any case, may quickly become obsolete.

The point is not merely to restate the race to the top argument. Competitive federalism promotes liberty as well as shareholder wealth. When firms may freely select among multiple competing regulators, oppressive regulation becomes impractical. If one regulator overreaches, firms will exit its jurisdiction and move to one that is more *laissez-faire*. In contrast, when there is but a single regulator and exit is no longer an option, an essential check on excessive regulation is lost.

SAY ON PAY AND DIRECTOR PRIMACY

There is no more basic question in corporate governance than “Who decides?” Is a particular decision or oversight task to be assigned to the board of directors, management, or shareholders?

Corporate law generally adopts what I have called “director primacy.” It assigns decisionmaking to the board of directors or the managers to whom the board has properly delegated authority. Executive compensation is no exception.

The proponents of Say on Pay often emphasize that H.R.

work on organizational decisionmaking, which identified two basic decisionmaking mechanisms: “consensus” and “authority.” Organizations use some form of consensus-based decisionmaking when each voting stakeholder in the organization has identical information and interests. In the absence of information asymmetries and conflicting interests, collective decisionmaking can take place at relatively low cost. In contrast, organizations resort to authority-based decisionmaking structures where stakeholders have conflicting interests and asymmetrical access to information. In such organizations, information is funneled to a central agency empowered to make decisions binding on the whole organization.

Small business firms typically use some form of consensus decisionmaking. As firms grow in size, however, consensus-based decisionmaking systems become less practical. By the time we reach the publicly held corporation, their use becomes essentially impractical. Hence, it is hardly surprising that the modern public corporation has the key characteristics of an authority-based decisionmaking structure. Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions. Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly. Rather, shareholders should prefer to irrevocably delegate decisionmaking authority to some smaller group. As Arrow explains, under condition of disparate access to information and conflicting interests, it is “cheaper and more efficient to transmit all the pieces of information to a central place” and to have the central office “make the collective choice and transmit it rather than retransmit all the information on which the decision is based.”

The board of directors as an institution of corporate gov-

ernance, of course, does not follow inexorably from the necessity for authoritative control. After all, an individual chief executive could serve as the requisite central decisionmaker. Yet, corporate law vests ultimate control in a board acting collectively rather than in an individual executive. I have elsewhere suggested two reasons for doing so:

- Under certain conditions, groups make better decisions than individuals.
- Group decisionmaking is an important constraint on agency costs.

In any event, the key point is that effective corporate governance requires that decisionmaking authority be vested in a small, discrete central agency rather than in a large, diffuse electorate.

Whatever flaws board governance may have, they pale in comparison to the information asymmetries and collective action problems that lead most shareholders to be rationally apathetic. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh the costs. Given the length and complexity of corporate disclosure documents, especially in a proxy contest where the shareholder is receiving multiple communications from the contending parties, the opportunity cost entailed in becoming informed before voting is quite high and very apparent. In addition, most shareholders' holdings are too small to have any significant effect on the vote's outcome. Accordingly, shareholders can be expected to assign a relatively low value to the expected benefits of careful consideration. Shareholders are thus rationally apathetic. For the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile.

Most shareholders recognize that they are better off pursuing a policy of rational apathy rather than an activist agenda. They know that directors have better information and better incentives than do the shareholders. Instead, activist shareholders — the type likely to make use of the powers Say on Pay and its ilk would empower — have tended to come from

a distinct subset of institutional investors; namely, union and public employee pension funds. As I observed in a 2004 *Tech Central Station* op-ed:

The interests of unions as investors differ radically from those of ordinary investors. The pension fund of the union representing Safeway workers, for example, is trying to oust directors who stood up to the union in collective bargaining negotiations. Union pension funds have used shareholder proposals to obtain employee benefits they couldn't get through bargaining (although the SEC usually doesn't allow these proposals onto the proxy statement). AFSCME's involvement especially worries me; the public sector employee union is highly politicized and seems especially likely to use its pension funds as a vehicle for advancing political/social goals unrelated to shareholder interests generally.

Public pension funds are even more likely to do so. Indeed, the *LA Times* recently reported that CalPERS' renewed activism is being "fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a CalPERS board member, who is considering running for governor of California in 2006." In other words, Angelides is using the retirement savings of California's public employees to further his own political ends.

The deficiencies of shareholders as decisionmakers thus compound the inherent undesirability of reposing ultimate control of an authority-based organization in the hands of a diffuse electorate rather than a central agency.

CONCLUSION

Legislation that "fixes" a nonexistent problem by upsetting basic principles of federalism ought to be a nonstarter. Unfortunately, the executive compensation debate has become so thoroughly bollixed up with issues of class warfare and financial populism that rational arguments seem to fall on deaf ears. R

Readings

- *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms*, by Michael C. Jensen. Harvard University Press, 2000.
- "An Index of the Contestability of Corporate Control: Studying Variation in Takeover Vulnerability," by John C. Coates IV. SSRN working paper 173628, September 1999.
- "Does Delaware Law Improve Firm Value," by Robert Daines. *Journal of Financial Economics*, Vol. 62 (2001).
- "Is U.S. CEO Compensation Inefficient Pay without Performance?" by John E. Core, Wayne R. Guay, and Randall S. Thomas. SSRN working paper 648648, January 13, 2004.
- "Law as a Product: Some Pieces of the Incorporation Puzzle," by Roberta Romano. *Journal of Law, Economics, and Organization*, Vol. 1 (1985).
- "More Pieces of the CEO Compensation Puzzle," by Franklin G. Snyder. *Delaware Journal of Corporate Law*, Vol. 28 (2003).
- *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, by Lucian Bebchuk and Jesse Fried. Harvard University Press, 2004.
- "Privately Ordered Participatory Management: An Organization Failures Analysis," by Stephen M. Bainbridge. *Delaware Journal of Corporate Law*, Vol. 23 (1998).
- "The Good, the Bad, and the Lucky: CEO Pay and Skill," by Robert Daines, Vinay B. Nair, and Lewis Kornhauser. SSRN working paper 622223, August 2005.
- *The Limits of Organization*, by Kenneth J. Arrow. W. W. Norton, 1974.
- "Why a Board? Group Decisionmaking in Corporate Governance," by Stephen M. Bainbridge. *Vanderbilt Law Review*, Vol. 55 (2002).
- "Why Has CEO Pay Increased So Much?" by Xavier Gabaix and Augustin Landier. SSRN working paper 901836, May 8, 2006.