

Executive Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution

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INTRODUCTION

The dramatic rise in CEO compensation over the past three decades has resulted in tremendous popular and shareholder discord.³ Two distinct theories have long framed the analysis of this disconcerting trend. The first emphasizes board dynamics, alleging that management-dominated passive boards have allowed powerful executives to extract rent in the form of excessive compensation or perks at the expense of shareholders.⁴ The

³ For long-run trends in executive compensation levels, see Carola Frydman and Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN. ECON. 75, 79 (2010) (showing that during the period prior to the 1970s and after the Second World War, executive pay remained modest and the trend was approximately flat. After 1970 the pay of top executives began a sustained dramatic growth. During the 1990s the annual growth rate in median pay reached about 10%. The median compensation rose from a median level of \$2.3 million in 1992 to \$7.2 million by 2001). A significant portion of corporate earnings are paid out to top executives, see Lucian Bebchuk and Yaniv Grinstein, *The Growth in Executive Pay*, 21 OXFORD REV. ECON. POLY 283, 297 (2005) (showing that the top five executives earned 5.0 percent of aggregate corporate earnings in the 1993-1995 period and to 9.8 percent during 2001-2003). Issues involving executive compensation have captured the public's attention, commonly addressed in newspapers and public hearings, see Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2845 (Orley Ashenfelter and David Card, Eds., 1999) (Observing that "few issues in the history of the modern corporation have attracted the attention garnered by executive compensation in United States companies... executive pay has become an international issue debated in Congress and routinely featured in front-page headlines, cover stories, and television news shows"); U.S. House of Representatives, Committee on Oversight and Government Reform, *Executive Pay: The Role of Compensation Consultants*, Hearing. Washington: Office of the Clerk (December 7, 2007) (Chairman Henry Waxman's opening remarks read, "Reports of astronomical payouts to corporate CEOs have led many to question the fairness and effectiveness of the system for setting executive pay.") Academics have certainly shown interest, the growth in executive pay research vastly out clipped that in executive pay itself during the late-1980s and early 1990s, Kevin F. Hallock and Kevin J. Murphy, *Introduction* in THE ECONOMICS OF EXECUTIVE COMPENSATION (1998).

⁴ For descriptions of management dominated boards following Berle & Means, see generally MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976) (describing passive boards which are dominated by management); MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971) (delineating myth from reality in regards to board conduct, he concludes that at the time the President exercised the real power of control while boards did very little of substance). The management capture theory was naturally applicable to the study of executive compensation, see e.g., GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991) (describing how directors and managers had taken control of executive compensation, decoupling management's pay from their performance); Charles M. Elson, *Executive Overcompensation-A Board-Based Solution*, 34 BOSTON COLLEGE LAW REVIEW 939-942, 937 (1993) (arguing that the compensation problem is "not responsive to a market-based solution" and the best way to encourage more reasonable compensation was through more effective internal corporate oversight. The recommended solution was that independent directors be paid in company stock in order to overcome the "captured board" syndrome). Financial economists have identified empirically several common but incongruous compensation practices which they attribute to management "skimming" or rent capture, see e.g. Marianne Bertrand and Sendhil Mullainathan, *Do CEOs Set Their Own Pay? The Ones Without Principles Do*, 116 Q. J. ECON. 901 (2001) (finding that CEOs in poorly governed firms are more likely to be paid for lucky returns and be charged less for option grants); for a contemporary account of the management-capture arguments see LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). For a formalized model of rent-seeking executives, see Camelia M. Kuhnlen and Jeffrey Zwiebel, *Executive Pay, Hidden Compensation and Managerial Entrenchment* (Rock Center for Corporate Governance, Working Paper No. 16, 2008).

second describes the operation of an efficient market for scarce and valuable executive talent. The level of pay observed among executives is then an unavoidable consequence of exogenous market forces and necessary for the retention of rare and able managers.⁵ In essence, the theories describe the capture of boards by overbearing management in the former, and by omnipotent markets in the latter.⁶ However, the cause of the problem, as we argue in this paper, is not fully susceptible to either explanation.

⁵ This paper abstracts away from the extensive literature on the optimal structure of compensation and incentives. We choose to focus on the overall a priori level of expected compensation. Or, in agency theoretic terms, we restrict our attention to the “participation constraint”, and whether it is binding. For views expressing the perceived binding nature of this constraint as determined within the economic environment, *see e.g.* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292 (1980) (viewing the pricing mechanism of the external labor market as critical to managerial discipline and incentive structures within the firm, “given a competitive managerial labor market, when the firm’s reward system is not responsive to performance the firm loses managers, and the best are the first to leave”); Robert Gibbons and Kevin J. Murphy, *Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence*, 100 J. POL. ECON. 468 (1992) (an explicit treatment of Professor Fama’s conception of the effects of a market’s valuation of current performance on future pay); *and*, Charles P. Himmelberg and R. Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* (Columbia University, Working Paper, 2000) *available at* (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236089) (arguing that a shock to the aggregate demand for an inelastic supply of CEOs increases the marginal value of those CEOs’ services and hence their outside pay opportunities). If a CEO’s skills are not valuable elsewhere they have few external options, the following papers argue for generalist CEOs who can be valued in exchange; Kevin J. Murphy and Ján Zábajník, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 AM. ECON. REV. 192 (2004); Carola Frydman, *Rising Through the Ranks: The evolution of the market for corporate executives* (Harvard University, Working Paper, 2005). The “superstar” CEO market theory is a derivative of early attempts to explain peculiarly skewed income distributions generally. A binding participation constraint may also be determined by sorting in markets where firm size and CEO skill are complementary, *see* Sherwin Rosen, *Contracts and the Market for Executives*, in MAIN CURRENTS IN CONTRACT ECONOMICS (1992); Steven N. Kaplan and Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, 23 REV. FIN. STUDIES 1004 (2010) (analyzing top corporate executive incomes along with the income earned by financial service employees, corporate lawyers, athletes, and entertainment stars); Xavier Gabaix and Augustin Landier, *Why has CEO Pay Increased so Much?*, 123 Q. J. ECON. 49 (2008) (they develop a competitive assignment model in which the growth in firm market capitalization explains the rise in CEO pay since 1970). Legal scholars and other industry practitioners are often persuaded by these arguments from the economics and management sciences professions. They also question the assumption that executives are in fact overcompensated, Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1 (2000); *see also* IRA T. KAY, CEO PAY AND SHAREHOLDER VALUE: HELPING THE U.S. WIN THE GLOBAL ECONOMIC WAR 147 (1998) (“While total CEO compensation is high by “regular people’s” standards, it is at a suitable level given the risks under which CEOs operate and the tremendous value they can create.”).

⁶ Where executive compensation levels are viewed as inevitable market consequences a board has as much discretion as a trader buying a commodity has in influencing its price. In the nineties and today, scholars have debated whether rising compensation was simply a market consequence or a symptom of a board failure to negotiate effectively, Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 BOS. C. L. REV. 937, 949 (1992). For contemporary reviews of these two competing theories, *see* Marianne Bertrand, *CEOs*, 1 ANN. ECON. REV. 121, 133 (2009); Robert J. Gordon and Ian Dew-Becker, *Controversies about the Rise of American Inequality: A Survey* 21, (Nat’l Bureau Econ. Rev., Working Paper No. 13982, 2008). For a description of the contentious debate between the two competing hypotheses, *see* William W. Bratton, *The Academic Tournament over Executive Compensation*, 93 CALIF. L. REV. 1557, 1558 (2005) (“Bebchuk and Fried confront these titans [of contemporary

The theory of management capture, vis-à-vis compensation, argues that the directors of large public companies allow rent-seeking executives to exert an outsized influence over the compensation negotiation process. Directors are inhibited from engaging in effective and autonomous oversight because of significant personal and professional connections with the management and a lack of meaningful incentive to do so. It was argued that executive compensation escalated unchecked, because boards failed to negotiate rigorously with executives. But, calls for reform in the early nineties from scholarly⁷, professional and popular commentators,⁸ a concerted effort by institutional investors⁹, regulatory agencies¹⁰, and the Delaware judiciary¹¹ led to the reformation of modern corporate boards; they called for equity-holding, independent directors, and open elections as the mechanisms for improving board performance and corporate accountability while concomitantly remedying the executive compensation conundrum.

These reforms quickly became accepted standards of practice.¹² Nonetheless, despite the promise that better boards would negotiate more reasonable remuneration,

financial economics]...And the titans have responded”); and the debate in the CHICAGO LAW REVIEW: Lucian Bebchuk, Jesse Fried and David Walker, *Managerial Power and Executive Compensation*, 69 U. CHIC. L. REV. 751 (2002); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHIC. L. REV. 847 (2002).

⁷ Elson, *Executive Overcompensation supra* note 6 at 939 (“[M]ost commentators examining the compensation issue have not focused on reform of the internal corporate governance procedures that created the problem. Rather they have proposed externally-based solutions...The problem of executive overcompensation is best dealt with not at the regulatory or even shareholder level, but by focusing on that body traditionally charged with corporate oversight- the board of directors”)

⁸ See e.g. Breeden, R. C., J. Hinsey, C. Wohlstetter, D. M. Hanson, D. J. Cornwall, J. W. Lorsch, M. Lipton, et al., *The Fight for Good Governance*, 71 HARVARD BUSINESS REVIEW 76 (1993).

⁹ Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). For a present day reflection on these efforts, see INSTITUTIONAL SHAREHOLDER’S SERVICES, OBSERVATIONS ON THE PAST, PRESENT, AND FUTURE OF CORPORATE GOVERNANCE (2011).

¹⁰ Ian L. Dew-Becker, *How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation* (CESifo Working Paper Series No. 2379, 2008); Kevin J. Murphy, *The Politics of Pay: A Legislative History of Executive Compensation*, (Marshall School of Business Working Paper No. FBE 01.11, 2011).

¹¹ For a discussion of judicial standards for compensation see Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1994); A roundtable moderated by Charles M. Elson, *What’s Wrong with Executive Compensation?*, 81 HARV. BUS. REV. 68 (January 2003) (Delaware Supreme Court Justice E. Norman Veasey said that if in exercising bad judgment in awarding executive compensation, “directors claim to be independent [and are] disingenuous or dishonest about it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith.”)

¹² NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, DIRECTOR PROFESSIONALISM—REPORT OF THE NACD BLUE RIBBON COMMISSION (1996, 2001, 2005); BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2002, 2005, 2010, 2012); NEW YORK STOCK EXCHANGE, FINAL NYSE CORPORATE

the rise in executive pay persisted.¹³ We will argue that the successes of such improvements in corporate governance were not alone adequate to rationalize this upward trend in median pay figures. The strengthening of oversight was successful in increasing managerial accountability for poor performance while also reducing the incidence of flagrantly high compensation awards because of an invigorated sensitivity to shareholder concerns. Nonetheless, while effective at reducing the ability of some managers to subsume rents *relative* to other managers, the reforms were unable to address that absolute, though possibly benign, ability of managers as a class to do so through institutional factors and norms. The problem is the standard practice of benchmarking pay to that of peers. While the directors may be well-intentioned, the consistent use of this simple referential process, which we later describe and critique, may better explain the persistent continuation of the systemic rise in pay.

On the other hand, many scholars, particularly financial economists, have derived a powerful *ought* from the empirical observation of what *is* by ascribing the cause of rising pay wholly to the operation of a competitive market—the market for scarce and valuable managerial talent. This is the school of thought broadly classified as the theory of “optimal contracting.”¹⁴ The operation of large and complex business enterprises is a difficult task. Those who can do it well are exceedingly rare and sought after for the value they can create for investors in doing so. Consequently, wages are seen to merely respond to the demand for and value of such skills, while competition precludes the involvement of rents for either party. High wages are the outcome of an efficient bidding for talent and the resultant

GOVERNANCE RULES (November 4, 2003); COLUMBIA BUSINESS SCHOOL AND THE WEINBERG CENTER FOR CORPORATE GOVERNANCE, BRIDGING BOARD GAPS - REPORT OF THE STUDY GROUP ON CORPORATE BOARDS (2011).

¹³ Kevin J. Murphy, *Explaining Compensation* (2002) *supra* note 6 at 852 (“This trend toward more independent boards, coupled with the simultaneous escalation in CEO pay seems directly inconsistent with the hypothesis that CEO pay patterns and practices are driven by managerial power considerations”); Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VANDERBILT L. REV. 1171, 1198 (2004) (“All available evidence seems to show independent directors getting stronger and more numerous, CEO tenure declining and CEO turnover increasing during the same time period.”); Bengt R. Holmström, *Pay Without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 705 (2005) (“Why did the problems with executive pay arise in the 1990s, but not earlier? If anything, executives seem to have been robbed of some of their power since the 1980s... The power theory on its own fails the timing test”).

¹⁴ This methodology is not only used to describe the level of pay, but also the many anomalies in observed pay practices, *see e.g.* Alex Edmans and Xavier Gabaix, *Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories*, 15 EUR. FIN. MGMT. 486 (2009) (arguing that simple models do not capture the complexities of real-life settings along with the rapid increase in pay these include: the low level of incentives, pay-for-luck, the use of options rather than stock, severance payments, and debt compensation. These, among the many other “puzzles”, they and the authors of the studies they surveyed believe can be explained in terms of efficiency contracting). It has otherwise been given cause, effect and sufficient reason that if Columbus had not contracted syphilis during his foray into the New World there would not have been chocolate in the Old. The authors though, fail to give due account for the Lisbon earthquake in support of their Panglossian proposition that ‘Everything is for the best in this best of all possible worlds’.

sorting of managers to firms, which is consistent with maximizing shareholder value. This view has become quite popular, especially subsequent to Xavier Gabaix and Augustin Landier's calibrated general equilibrium model and the explanatory power they claimed it possessed.¹⁵ We question, however, the legitimacy of relying upon such a conception of a competitive market for talent – and as a result the related efficiency claims – in explaining the rising pay of executives. We criticize the competitive markets approach mainly on the basis of market frictions and the characteristics of “thin” labor markets. Specifically, we will address the question of executive transferability and the implications for any notion of a centralized market exchange for talent.

A more recent approach has sought to explain the cause of rising pay from a sociological or an institutional context.¹⁶ The proponents of this view see overwhelming ambiguity as essential to the nature of any appraisal of executive worth and to the corresponding negotiation of compensation amounts. As a result, rather than being founded upon fundamental economic values, the amounts of pay awarded is simply determined through reference to the normative practices within a topography of local networks – in a large part as a response to the need to provide legitimacy to external constituents - and pay is therefore in fact largely unrelated to traditional economic marginal value. Related research has examined the process by which boards then reconcile this inherent ambiguity through the use of a convenient rule of thumb in arriving at a judgment of what they view to be fair, reasonable, and necessary remuneration. In particular, the use of formal targeting of compensation to that of peer companies is addressed.¹⁷

¹⁵ Xavier Gabaix and Augustin Landier, *Why has CEO Pay Increased so Much?*, 123 Q. J. ECON. 49, 84 (2008) (“CEOs are no supermen or women, just slightly more talented people who manage huge stakes a bit better than the rest and, in the logic of the competitive equilibrium, are still paid hugely more.”); see Gregory L. Nagel, *The Effect of Labor Market Demand on U.S. CEO Pay Since 1980*, 45 FIN. REV. 931, 932 (2010) (“The model has had a profound impact, perhaps because [of] its rigorous derivation results [and] intuitively compelling predictions.” He cites instances where it has caught the attention of the public; the paper was referenced by Towers Perrin principal John England as well as the Federal Reserve Chairman Ben Bernanke); David Wessel, *With CEO Pay, Size Does Matter*, THE WALL ST. J. (November 2, 2006) (discussing the paper and the associated popular reaction to its findings).

¹⁶ Thomas A. DiPrete, Gregory M. Eirich and Matthew Pittinsky, *Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay*, 115 AM. J. SOC. 1671 (2010) (they argue that rent extraction resulting from governance failures at individual firms causes pay escalations throughout the market by spreading through the network of compensation peer group comparisons); see also James B. Wade, Joseph F. Porac and Timothy G. Pollock, *Worth, words, and the justification of executive pay*, 18 J. ORGANIZATIONAL BEHAV. 641 (1997) (examining the means by which compensation committees provide justification for their compensation practices to shareholders in regards to pay decisions and company returns).

¹⁷ Financial economists typically ask whether (a) the peer groups are manipulated so as to create an upward or aspirational bias, and (b) whether the practice of targeting to median or higher levels creates an asymmetric upward-ratcheting effect in the levels of compensation. The null result is that peer groups simply reflect and enable companies to be responsive to an efficient and competitive market for CEO talent. John M. Bizjak, Michael L. Lemmon and Lalitha Naveen, *Does the use of peer groups contribute to higher pay and less efficient compensation?*, 90 J. FIN. ECON. 152 (2008); see Gregory L. Nagel, *Persistently Underpaid CEOs and their Influence on Pay Benchmarks* (Unpublished manuscript, 2007); Ana M. Albuquerque, Gus De Franco and Rodrigo S. Verdi, *Peer Choice in CEO*

In setting the pay of their CEO, boards invariably reference the pay of the executives at other enterprises in similar industries and of similar size and complexity. For this, compensation consultants are retained to construct a “peer group” of such companies and survey the pay practices which are prevalent. Then, in what is described as “competitive benchmarking”, compensation levels are generally targeted to either the 50th, 75th, or 90th percentile. This process is alleged to provide an effective gauge of the “market wage” which is necessary for executive retention.¹⁸ In essence, this process creates a market for executives where it otherwise does not exist. As we will describe, this conception of such a market was created purely by happenstance, and by its uniform application across companies the effects of structural flaws in its design can have potentially compounding macro-effects on the level of executive compensation.

It has been observed in both the academic and professional communities that the practice of targeting the pay of executives to median or higher levels will naturally create an upward bias and movement in total compensation amounts. Whether this escalation has been dramatic or merely incremental, the compounded effect has been to create a significant disparity between the pay of executives and what is appropriate to the companies they run. This is not surprising. By basing pay primarily on external comparisons, a separate regime which was untethered from the actual wage structures of the rest of the organization was established. Over time, these disconnected systems were bound to diverge. Unfortunately, the pay of the executive has a profound effect on the incentive structure throughout the corporate hierarchy. Rising pay thus has costs far greater than the amount actually transferred to the CEOs themselves. To mitigate this, pay must be more consistent with internal corporate wage structures. An important step in that direction is to diminish the focus on external benchmarking.

We will argue that: (I) theories of optimal market-based contracting are misguided in that they are predicated upon the chimerical notion of vigorous and competitive markets for transferable executive talent; (II) that even boards comprised of only the most faithful fiduciaries of shareholder interests will fail to reach an agreeable resolution to the compensation conundrum because of the unfounded reliance on the structurally malignant and unnecessary process of peer benchmarking; and (III) that the solution lies in avoiding the mechanistic and arbitrary application of peer group data in arriving at executive compensation levels. Instead, the independent and shareholder-conscious compensation committee must develop internally created standards of pay based on the individual nature

Compensation (Forthcoming in J. FIN. ECON.); Michael Faulkender and Jun Yang, *Inside the black box: The role and composition of compensation peer groups*, 96 J. FIN. ECON. 257 (2010); IRRRC INSTITUTE, *Compensation Peer Groups at Companies with High Pay* (June 2010); John Bizjak, Michael Lemmon and Thanh Nguyen, *Are all CEOs above average? An empirical analysis of compensation peer groups and pay design*, J. FIN. ECON. 538 (2011); ISS CORPORATE SERVICES, *EXECUTIVE PAY THROUGH A PEER BENCHMARKING LENS* (July, 2011); Brian Cadman and Mary Ellen Carter, *Compensation Peer Groups and their Relation with CEO Pay* (Boston College, Working Paper, 2011); Michael Faulkender and Jun Yang, *Is Disclosure an Effective Cleansing Mechanism? The Dynamics of Compensation Peer Benchmarking*, Under Review at REV. FIN. STUD.(2012). These studies are referenced later in more detail.

¹⁸ See Bruce R. Eilig, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* (2002).

of the organization concerned, its particular competitive environment and its internal dynamics. Relevant considerations include the executive's current and historic performance based on a variety of factors and the specific nature of the company or industry, but they must also inculcate the notion of internal pay equity in their formulations. Some casual reference to peer groups may be warranted, though the process must maintain the flexibility necessary to arrive at a reasonable approximation to what is absolutely necessary to retain and encourage talent. Admittedly, our prescription is not concrete or easily implemented, but as the shareholder value movement has empowered directors as never before to act in their investors' interest, any solution to the compensation conundrum must be founded upon their expert judgment and discretion.¹⁹

I. PEER BENCHMARKING: THE PROCESS

The boards of most U.S. public companies set executive compensation through the use of a mechanistic process referred to as "peer grouping." Typically, boards engage compensation consultants who aid in the structuring of the pay package to be negotiated with the executive concerned.²⁰ These consultants, advising the board's compensation committee, are asked to put the proposed pay package into some perspective vis-a-vis the overall competitive job market. To do so, they construct a framework of comparative metrics based on the level and structure of pay at companies deemed similar²¹ — as selected by the compensation committee and consultants, often with varying degrees of input by management.²² The executive's proposed compensation is based on this comparison. Generally, after the peer group market analysis is completed, the board will

¹⁹ For a related approach to board authority and an argument for "Director Primacy" in board/shareholder engagement, see Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (in public companies shareholders should and do prefer to delegate decision-making authority to a small centralized group of directors so as to avoid collective action problems. In the U.S. system of corporate law the agency problems which necessarily result because discretion can be used irresponsibly are balanced against the virtues of giving directors this discretion); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 Tex. L. Rev. 1615, 1643 (2004) (book review).

²⁰ E.g., Ellig, GUIDE TO COMPENSATION *supra* note 18..

²¹ The main criteria for a company's inclusion in a peer-group typically involves whether the firm is in a similar industry and of a similar size. Peers tend to also be comparable in accounting performance, market-to-book ratios, credit ratings, geographic or product diversity, and visibility (as proxied by S&P 500 membership), see Bizjak, *Are All Above Average* (2011) *supra* note 17 (analyzing explicit disclosure of company peer group composition following a 2006 Securities and Exchange proxy disclosure requirement); Faulkender, *Black Box* (2010) *supra* note 17.

²² Murphy, *Executive Compensation* (1999) *supra* note 3 (a thorough and authoritative discussion of the compensation-setting process and the elements of compensation).

choose to create a package that is usually targeted at the 50th, 75th,²³ or 90th²⁴ percentile of their target peer comparison group. Targeting levels below the 50th percentile is rarely, if ever, done.²⁵

But, why these levels? It is because any other action would seemingly place the board in an uncomfortable and disadvantageous position. In the current construct, pay below the 50th percentile does not simply send a message of the relative performance and merit of an executive, as embodied in one's compensation relative to one's peers. Instead, such board action may raise concerns over the executive's position within the company, possibly undermining that individual's ability to lead effectively. Additionally, boards seemingly use the 75th and 90th percentiles as a common method to signal institutional aspiration and standards,²⁶ in the same way that the terms "better" and "best" are designed to enhance product differentiation.²⁷ In a similar sense, pay below the median would consequently signal "worse."

After the compensation committee selects the appropriate percentile level, a package is then designed by the consultant to meet the specified numerical goal. This is typically accomplished by using a mix of salary, bonus and long-term incentives— usually restricted stock or stock options. The package so created and recommended by the compensation committee is then approved or ratified by the full board.

²³ E.g., Peter Whoriskey, *Cozy relationships and 'peer benchmarking' send CEOs' pay soaring*, WASH. POST (October 3, 2011) (Kevin W. Sharer of Amgen's stock compensation was targeted at the 75th percentile in 2011, he receiving a 37% raise to \$21 million in compensation in 2011 despite poor recent performance).

²⁴ *Id.*, Angelo Mozilo of Countrywide Financial earned more than \$180 million during the five-year period before the housing bust of 2007-2008, his pay was at times targeted at the 90th percentile of peers.

²⁵ Bizjak *Peer Groups* (2008) *supra* note 17 at 153 (the "vast majority of firms that use peer groups target pay at or above the 50th percentile of the peer group").

²⁶ A roundtable moderated by Charles M. Elson, *What's Wrong with Executive Compensation?*, 81 HARV. BUS. REV. 68, 72 (January 2003) (Edgar S. Woolard, Jr., a former DuPont CEO, said, "Most boards want their CEO to be in the top half of the CEO peer group, because they think it makes the company look strong."); *Executive Pay: Fat Cats Feeding*, ECONOMIST (October 9, 2003) ("No selection committee wants to award their new choice less than the industry average. That will, they feel, not attract the best man to the job, and it will also suggest that their company has settled for someone less than average"); Rachel M. Hayes and Scott Schaefer, *CEO pay and the Lake Wobegon Effect*, J. FIN. ECON. 280 (developing a model where CEO compensation serves as an external signal of match-surplus and hence firm value).

²⁷ This is, however, often unrelated to the executives themselves. It is an interesting phenomenon when a company will revise its compensation from the 50th to a higher percentile under the guise of attracting talented executives and positioning themselves to be industry leaders while the executive remains the same as before. To our knowledge, additional cash or stock does not augment ability or talent.

A. Historical Origins

The origins of this benchmarking process have been, unfortunately, obscured from the academic and popular commentary for some time. Few either inside or outside the compensation industry when asked can identify the precise origins of this approach. However, an understanding of its history is particularly important for evaluating its validity and acceptance by the industry. After noting this absence of a scholarly historical account of the process' origins, we reviewed a variety of related publications and consulted with a number of long-time industry participants.²⁸ All paths eventually led to Milton L. Rock, the former managing partner of the Hay Group consulting firm – one of the original compensation consultancies.

In 1949, when Rock joined Edward N. Hay at his consultancy,²⁹ the traditional business environment had been disrupted by the Second World War and was in a process of transformation. In earlier times, businesses had operated in a more localized manner. Labor markets, especially so, were locally oriented. In this environment, an employee would base comparisons of the relative standing and perceived equity of his or her compensation to what other local professionals were earning. The compensation of company presidents was likewise determined in a similar localized context. But, the global war effort had convinced Rock that corporate demands and managerial skills were no different from locale to locale or even country to country. With this in mind, Rock and Hay developed a uniform, systematic method for evaluating and classifying the nature and demands of specific jobs in order to facilitate broad comparisons.³⁰ This approach, called the Hay Point system, was said at one point to have been used in setting the compensation of eighty percent of the global managerial market. The Hay system ascribed points to jobs based on such categories as revenue, reporting employees, and industry groups. These indicated the relative complexity of the position, and suggested the appropriate compensation level, thereby making jobs comparable both within and outside a company or industry.³¹

²⁸ For this section we rely on interviews {find date of interviews} with Frederic W. Cook (date), Bud Crystal (date), Michael Davis (date), Bruce R. Ellig (date), Ira T. Kay (date), Pearl Meyer (date), Milton L. Rock (date), Robert Rock (date), and David Swinford (date). We are grateful for their knowledge and assistance.

²⁹ Hay Group, *Hay Group through the years: 1943-2008*, accessible at <http://www.haygroup.com> (May 16, 2012).

³⁰ *Id.* (“Hay started the Hay Compensation Survey Comparisons (HCC) with eight companies [in 1954]”).

³¹ Interestingly, the Hay Group never focused on the value of *individuals* in the labor marks, choosing rather to base comparisons on a job classification system which measured the relative worth and nature of similar jobs *roles* or positions, Arienne Minch, *Executive Compensation: Woolard Fellow presents research, ignites debate at Weinberg Center event*, UDAILY (May 14, 2012) (“At first peer groups were formed to weigh the value of a job not the individual,” said [Robert] Rock. “The goal was to create a universal measurement that could be a benchmark throughout the world.”).

And, so evolved the framework of analysis to support the developing conception that workers and managers were participating in a global exchange of talent. This idea was naturally applicable to the top of the corporate hierarchy as well. It was, therefore, an easy leap for the Hay Group to attempt to apply such a metric for determining the appropriate compensation of top executives as well.

Consequently, Rock then asked the top executives at his client companies to share their confidential compensation information with him in order to facilitate an exchange of information amongst the business executive community. They provided the data, and his firm would supply the industry- and market-level analytics. His firm formalized these peer comparisons, which then worked their way into the standard practices for formulating the pay of top executives throughout the country. Along with internal human resources departments, other consultants emerged who also used this comparison-based analysis. By the late 1990s, peer group comparisons were ubiquitous to the formulation of executive compensation. Hence “peer group” metrics were born; they were not established through academic study, theory or concentrated industry deliberation on the matter but had simply evolved from what was merely a valuable commercial tool. This approach was eventually formally institutionalized in 2006 when the Securities and Exchange Commission required proxy disclosure of the precise composition of company peer groups used in public company executive compensation formulations.³² Further, the two major institutional investor voting advisory services, Institutional Shareholder Services (ISS) and Glass-Lewis, have recently begun to create their own concurrent peer groups to aid in their evaluation of executive pay at those companies they rate for voting on compensation-based issues.³³

B. The Problem with Peer Group Analysis

While we have witnessed a dramatic rise in the levels of executive compensation over the past several decades, the peer grouping process itself, by which pay is actually set, has remained largely unexamined. Rather, pay critics instead focused their attention on what they termed the “management captured board” which they believed was responsible for this phenomenon. Boards which were appointed and dominated by corporate management and advised by management-selected compensation consultants had little incentive or ability to negotiate effectively over pay. This one-sided bargaining process was one explanation for the rise in executive pay. For this and other reasons, reformers called

³² SEC Final rules 33-8732a Item 402(b)(2)(xiv) (August 29, 2006) (recommended disclosure in the Compensation Discussion and Analysis includes “whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies)” 32)

³³ Emily Chasan, *Watchdog Challenged Over Pay Benchmarks*, WALL ST. J. CFO REPORT (May 8, 2012)

for changes in board composition³⁴ and the alignment of the compensation consultants with the boards which retained them.³⁵ The demands for equity-holding, independent board members advised by pay consultants who were solely retained by and responsible to the board have largely reshaped standard practice.³⁶ In terms of legal standards, regulatory guidelines and investor expectations, the board-room has changed dramatically in the past decade. Independence and equity-ownership are the watchword of the contemporary directorship. The independent, shareholder-focused board is central to the Sarbanes-Oxley and Dodd-Frank federal reforms as well. Yet, the increase in executive pay and the coincident controversy continue nonetheless.

The real problem with the compensation process that is unaffected by board compositional-based reform is the use of comparable data to set pay. These metrics were originally used by the Hay Group and others as a way to simulate the operation of a competitive labor market where, in fact, the effective operation of that market was impaired by the nature of executive ability. Executives have many firm-specific skills and attributes which constrain the free flow of human capital. As such, without the possibility of centralized exchange based valuation, boards have long struggled to define an executive's worth. Because boards may have very different views of the intrinsic value of an individual they are forced to rely on extrinsic comparisons between companies as, they believe, a necessary step for retention. This is the reasoning behind and the origin of the peer grouping process which today is central to pay design.

There are problems with this use of peer groups that have led to the ratcheting up of pay in a fashion which is seemingly unrelated to the performance rendered. Traditionally, critics have argued that the manipulation of the selected peer comparison companies distorts the pay process. Where boards are dominated by management, there is a natural incentive to pick as peers companies with significant compensation, despite differences in size, scope, pay and performance from the company in question.³⁷ The higher the

³⁴ *E.g.*, JAY W. LORSCH AND ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICAN CORPORATE BOARDS (1989) (advocating various board compositional reforms); Elson, *Duty of Care* (1994) *supra* note 11

³⁵ THE CONFERENCE BOARD, EXECUTIVE COMPENSATION CONSULTING: A RESEARCH WORKING GROUP REPORT ON BEST PRACTICES (2005); *Executive Pay: The Role of Compensation Consultants; Hearing Before the H. Comm. On Oversight and Government Reform*, 110th Cong. (2007) (statement of Charles M. Elson) (advocating independent compensation consultants).

³⁶ *E.g.* NYSE, Listing Standards; NACD, DIRECTOR PROFESSIONALISM; CBS & WCCG BRIDGING BOARD GAPS, *supra* note 12.

³⁷ For evidence of bias in the selection of larger and higher paying peer firms, see IRRC, *High Pay* (2010) *supra* note 17 (finding that though all companies in their study tended to select larger and better performing peers, This bias was particularly pronounced in high paying companies); ISS, *Lens* (2011) *supra* note 17; Faulkender, *Black Box* (2010) *supra* note 17; Bizjak, *Are All Above Average* (2011) *supra* note 17; Matthew Pittinsky and Thomas A. DiPrete, *Peer Group Ties and Executive Compensation Networks*, (Working Paper, June 3, 2011) available at (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2025384). Several studies have found either mixed or no evidence

compensation of one's peers, the higher the consequent compensation of the target company executives. The process, at its core, is vulnerable to such manipulation by the consultant, the board and the executive because there is no real objective standard in existence to precisely identify an appropriate peer given the significant and multiple variables involved in selection.³⁸ Reform efforts have attempted to remedy this problem by focusing on disclosure, more independently comprised boards and greater independence from management on the part of the compensation consultants. The idea is to provide the proper incentive and structure to create more realistic and unbiased peer groups. The 2006 SEC peer group disclosure requirements and the recent Dodd-Frank independence mandates attempted to mitigate this opportunistic peer selection.³⁹

Manipulation of the peer group sampling is a real problem. But simply fixing the alignment of those involved in the peer group selection process will not ultimately solve the pay issue. First, as discussed, boards typically gravitate in setting compensation to a set of arbitrary targets — i.e. the 50th, 75th and 90th percentiles of peer group pay. A blind reliance on these pay targets has resulted in a mathematically based upward pay spiral.⁴⁰ This dynamic is popularly referred to as the “Lake Wobegon” effect⁴¹. If all aspire to pay at or above the median, it is clear that pay will continue to rise significantly and indefinitely; there is an obvious upward bias. This median adjustment is justified in two ways. From a theory of pay equity, it is seen as a necessary means of redressing perceived pay inequity and the consequent effect on motivation. Market-based theories of executive pay assert that such adjustments are necessary for retention. For example, Mahmoud Ezzamel and

of biased selection, *See Albuquerque Peer Choice* (2009) *supra* note 17; Cadman, *Relation* (2011) *supra* note 17. For earlier evidence of manipulation in the selection of performance peer groups, Joseph F. Porac, James B. Wade and Timothy G. Pollock, *Industry Categories and the Politics of the Comparable Firm in CEO Compensation*, 44 ADMIN. SCI. Q. 112 (1999).

³⁸ Consider the dialogue between voting services and corporate boards, there is enough flexibility to allow the voting services to present widely different peer groups than the companies. While the company's consultant presents the peer group suggesting the highest pay, the advisory services seek the lowest. This insight was drawn from a conversation with Michael Faulkender at the University of Delaware.

³⁹ Faulkender, *Disclosure* (2012) *supra* note 17 (finding evidence that manipulation became *more* severe following the SEC mandate).

⁴⁰ The theoretical literature on this effect is sparse, but, *see* Hayes, *Wobegon Effect* (2009) *supra* note 26 (modeling the assumption that a CEO's wage provides external signals about match-surplus and firm value they derive conditions where equilibrium wages are distorted upwards). Intuitively though, it is clear that where median and above targets are strictly applied pay cannot, in the very least, be revised downward. Where median wages are exclusively targeted and peer groups are properly centered, hence targeted and current compensation are closely aligned without bias, a mechanical escalation may then be located in the ramps used by consultants to adjust prior year pay data for trends and inflation.

⁴¹ Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N. Y. TIMES (November 26, 2006).

Robert Watson found that asymmetric responses⁴² to pay anomalies resulting from these external pay surveys resulted in a “bidding-up” of executive cash compensation in U.K. companies which explained changes in executive pay during the sample period. They argue, however, that “irrespective of firm performance, for motivational, recruitment, and retention reasons, a firm's compensation committee has to ensure that its senior executives are paid at least the going rate.” They conclude that the potential costs involved with paying an executive significantly below the levels suggested by market surveys preclude even independent and effective boards from avoiding this “ratchet effect.”⁴³

Though the pay of other executives may provide a beneficial indication of the outside compensation opportunities available and the necessary retention wages, the external references can have perverse systemic effects on the aggregate level of compensation where even only a few executives are overpaid. Thomas DiPrete and Gregory Eirich argue that excessive pay increases for even a relatively small proportion of CEOs can have a significant effect on the pay of the remaining executives. This “leapfrog effect” propagates through the networks constructed by the peer grouping process. As a result, one firm’s overpayment affects all the connected firms for which they are a peer.⁴⁴ Whether the excess compensation is awarded for merit or otherwise, a talented individual who is paid on a scale deserving of their abilities should not, through the peer group mechanism, be allowed to bolster the pay of less able executives; particularly when those executives would be paid less if serving in a similar fashion. An individual executive may deliver phenomenal performance and be likewise compensated, but why should that individual’s contribution to their company be relevant to another individual’s actions at

⁴² That is, the sensitivity to year-to-year changes in cash compensation to underpayment is greater than the sensitivity to overpayment.

⁴³ Mahmoud Ezzamel and Robert Watson, *Market Comparison Earnings and the Bidding-Up of Executive Cash Compensation: Evidence from the United Kingdom*, 41 ACAD. MGMT. J. 221, 221 (1998). Other empirical studies have found a similar significance of pay surveys and the pursuit-of-the-median inflationary effect, Bizjak, *Use of Peer Groups* (2008) *supra* note 17 (finding that CEOs paid below the median receive pay raises which are \$1.3 million more than those with above median pay. They conclude that the asymmetric adjustments are consistent with retention objectives rather than rent-seeking executive behavior); Nagel, *Underpaid CEOs* (2007) *supra* note 17 (presents evidence that board reactions to CEO underpayment had a significant effect on the upward trend in compensation which is also consistent with the increased availability of external pay data from compensation consultants starting in the 1980s).

⁴⁴ DiPrete, *Leapfrogs* (2010) *supra* note 16. See also Jerry Kim, Bruce Kogut and Jae-Suk Yang, *Executive Compensation, Fat Cats, and Best Athletes* (Columbia Business School Research Paper April 24, 2012) (finding empirical support for network contagions through peer groups. This effect has been theorized to occur even within perfectly competitive executive markets, see Gabaix and Landier, (2008) *supra* note 15, see also Frederick L. Bereskin and David C. Cicero, *CEO Compensation Contagion: Evidence from an Exogenous Shock*, forthcoming the J. FIN. ECON., (January 31, 2012) (providing empirical evidence of this compensation contagion effect).

another company. Pay and opportunity wages should reflect and adjust to this evaluation of an individual merit.⁴⁵

Regardless of whether the mechanical aspects of peer benchmarking are labeled “efficient” or not, it is clear that the comparative peer metrics and median targeting at the very least sustain the current pay levels. If we concede that high-pay is a problem, obviously the only corrective response is to award less in compensation than we currently do. This cannot and will not be accomplished under the current regime. Simply put, peer group comparisons and median targeting are a central part of today’s “mega-pay machine.”⁴⁶ Any executive compensation reform must start there.

II. EVALUATING MARKET BASED PAY RATIONALIZATIONS

Many scholars, particularly financial economists, have attempted to explain the trends in executive compensation by referencing the free operation of efficient, competitive markets. In this section, we critique that line of argument and suggest that the mechanical operation of the peer grouping process better explains the rise in executive pay. Traditionally peer groups are seen as a tool used either for enabling the extraction of rent by managers through the manipulation of their composition or, alternatively, for simply allowing boards to match and respond to competitive market demand. We attempt to drive a wedge between these opposing theoretic descriptions of improper versus proper use. We argue that the process itself has in fact the means to drive rising pay without reference to either alternative theory of rising pay. Regardless of board intentions, as long as peer group analysis continues to be relied upon, pay will continue to rise. We assert that the use of peer groups is problematic in and of itself—determining whether they are used in a manner consistent with the competitive markets or the management capture theory is not necessary or essential. Even perfectly comprised boards will fail to solve the problem of rising pay unless the structural bias created by peer-group mechanics is addressed.

A. *Athletes, musicians, and... corporate superstars*

In 1981, Sherwin Rosen addressed what was at the time a recent trend towards the concentration of output and income amongst a small selection of individuals in certain occupational. He described and gave economic justification for this “phenomenon of

⁴⁵ Taekjin Shin, *Peer Comparisons of CEO Compensation: Fair Pay of Power Play?* Under review at ACAD. MGMT. J. 6,7 (2010).

⁴⁶ Geoffrey Colvin, *The Great CEO Pay Heist*, FORTUNE, (June 25, 2001) (he outlines the operation of the “machine” which he argues is rigged so as to award higher and higher pay.)

superstars".⁴⁷ It was becoming increasingly apparent at the time that a relatively small proportion of the population, comprised of the most talented market participants, was dominating the markets for their respective professions and receiving a substantial and growing amount of the total rewards for talent. Other individuals were seemingly left out of what was later described as the winner-take-all society.⁴⁸ Rosen's key insight was that a joint consumption technology combined with imperfect substitution in demand had together enabled this development, and indeed the outcome was, economically speaking, efficient. In other words, the ability of a musician to sell their product, a musical performance or recording, to a large audience with little additional effort on their part combined with the consumers' preference for hearing the best musicians among them, to the exclusion of lesser abled performers, meant they could capture most of the market. While star performers had always been able to fill large venues with paying customers, improvements in this joint consumption technology, especially in the area related to mass media, had added fuel to this market-dynamic. This allowed the best products and performances to occupy the record players, bookshelves, and television programming of millions of consumers to the exclusion of lesser substitutes.⁴⁹ And, the few who produced them were able to receive tremendous rewards.

It was argued that this phenomenon of superstars was similar to the economic dynamics which characterized the market for executives. Indeed the rapid growth in their compensation levels as well as the increasing skew was suggestive of such a dynamic.⁵⁰ It was argued that a chief executive's talent for implementing corporate operations,

⁴⁷ Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845, 845 (1981)

⁴⁸ Robert H. Frank and Philip J. Cook, *THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US* (1996). However, Thomas Sowell has pointed out a common misconception about the distribution of income. Commentators too often focus on "statistical categories" rather than "flesh-and-blood people." While there exists a disparity between the incomes contained in upper and lower quintiles where actual people are concerned mobility between groups is high. If one tracks actual individuals rather than categories, the results are less surprising. Across time, the lower income bracket has been overwhelmingly comprised of 18-24 years olds, but actual people do not stay 18-24 years old for long, Thomas Sowell, *Income Distribution* in THE THOMAS SOWELL READER 98 (2011). The intuitive explanation for income statistics is that people work their way up the income ladder as they get older. "There is a reason only old people go on cruises," Thomas Sowell, *Who's in the Top 1 Percent*, NAT'L. REV. (November 8, 2011).

⁴⁹ Recent evidence suggests, however, that in the movie industry the ability of movie stars to exclude lesser substitutes has waned. Low budget films with lesser known, and significantly cheaper actors, are able to achieve Oscar and box office success. Perhaps scale effects were in part drawn not from the ability to satisfy many consumers simultaneously, but also the economic infeasibility of differentiating between the many consumers. As a result, large upfront salaries to stars, like the \$20 million earned by Julia Roberts in "Erin Brockovich", are becoming rare. See Michael Cieply, *For Movie Stars, the Big Money is Now Deferred*, N. Y. TIMES (March 3, 2010); Dorothy Pomerantz, *Death of the Movie Star? Sandler and Cruise Flop at the Box Office*, FORBES (June 17, 2012). We suggest later that the excludability of CEO talent may also be recently diminishing.

⁵⁰ E.g. Kaplan, *Wall Street and Main Street* (2012) *supra* note 15. It has also been suggested by some scholars that the rise in pay for executives was in part directly attributable to the comparisons with newly-minted millionaire athletes.

providing inspiring leadership, or for pursuing effective investment strategies is made more valuable by the fact that their actions can be “rolled out” to effect the entire firm.⁵¹ Marginal returns to an executive’s talent could effectively be leveraged through the corporate structure and hierarchy. Analogous to the musician’s ability to sell millions of CDs, an executive could impact the return received on billions of dollars of corporate assets through their choice of strategy or through the quality of its implementation. The firm became their Madison Square Garden. Further, improvements in communication technology, data storage, and data retrieval substantially broadened the executive's potential sphere of influence and enhanced this "scale of operations" effect.⁵² Executives were then seen to be a class of superstars. Though perhaps only marginally better than the rest, they were highly valuable and sought after for the incremental returns they could produce. With so much value at stake and under their control, they were purportedly worth every dollar they were paid to deliver such large potential gains in corporate wealth.⁵³ Recently, Xavier Gabaix and Augustin Landier made explicit use of this effect in a competitive assignment model, claiming that because of a multiplicative production function the increase in compensation since the 1970s can be explained by the coincident growth in firm size.⁵⁴

But, as Robert Gordon and Ian Dew-Becker argue, this analysis is not obviously applicable to CEO and managerial compensation.⁵⁵ The original paper by Rosen specifically addressed top billing comedians, classical musicians, textbook authors and the like, to which Gordon and Dew-Becker are comfortable adding investment bankers, consultants and lawyers. They distinguish between these occupations, where compensation is clearly market-driven, and the compensation of executives, where pay levels are determined by non-market based considerations.⁵⁶ For the former group, their rewards are ultimately determined by the indubitable operations of a market. No independent judgment of value and therefore appropriate compensation, as necessarily done by boards of directors in deciding executive rewards, is necessary. Rather, profits and pay for these marketable

⁵¹ Alex Edmans, Xavier Gabaix, and Augustin Landier, *A Multiplicative Model of Optimal CEO Incentives in Market Equilibrium*, 22 REV. FIN. STUD. 4881, 4882 (2009)

⁵² Luis Garciano and Esteban Rossi-Hansberg, *Organization and Inequality in a Knowledge Economy*, 121 Q.J. ECON. 1383 (2006). (presenting an equilibrium model of wages and organization where knowledge is levered through hierarchical management structures.)

⁵³ *Supra* note 5.

⁵⁴ Gabaix, *Why has Pay Increased?* (2008) *supra* note 5.

⁵⁵ Robert J. Gordon and Ian Dew-Becker, *Selected Issues in the Rise of Income Inequality*, BROOKINGS PAPERS ON ECON. ACTIVITY 169, 176 (2007)

⁵⁶ See also Robert S. Gordon, *Has the Rise in American Inequality Been Exaggerated?*, 52 CHALLENGE 92, 105 (2009) (“While superstars and top professionals have their incomes chosen by the market, CEO compensation is chosen by their peers, a system that gives CEOs and their hand-picked boards of directors, rather than the market, control over top incomes.”)

professions are dependent on the preferences of consumers, derived from their resultant demand and subject to a related market-driven discipline. Although one may disagree as to who is most talented in a particular field, their *ex post* economic value is laid bare and clearly discernible. The net of these consumer preferences is expressed in the revenue generated from ticket billings, book sales, or services demanded. On the other hand, an executive's marginal productivity is not so unambiguously separable from the organization they run. While the athlete, musician or author is *the* product, which is central to a multibillion dollar industry, the executive's role is less direct, being charged with such tasks as organization, motivation, or the responsibility for strategic decisions. Rather than being a factor of production an executive directs and organizes other factors. It is precisely this ambiguity that suggests the involvement of non-economic considerations related to board-management dynamics, as the management capture literature suggests. The amount and structure of an executive's remuneration is ultimately subject to the discretion of the board of directors, and all their attendant biases, limitations of faculty, and common misunderstandings.

Nonetheless, the market is still seen by many to be critical to understanding the level of and the trends in executive compensation. Demand for scarce human capital dictates a competitive outcome and, as many believe, is capable of explaining most observed compensation practices⁵⁷. Through the operation of a market, it is argued, wages are bid up to an executive's outside opportunities. Actual wages are simply the product of the board of director's need to retain and motivate an executive.⁵⁸

Casual inference should inform us otherwise. When buying goods and services both price and quality are considered concurrently. A lesser quality product may be preferred to one of better quality if the equalizing difference in price is sufficient. In a similar manner, a company seeking to acquire a new CEO from an open market would consider the trade-off between expected future performance and the required wage amongst various alternative candidates. This is simply not how this market works. In most regressions, performance explains less than five percent of pay⁵⁹—hardly the expected effect of equalizing differences. There is a consensus that the single variable which possesses the most substantial explanatory value is the size of the firm.⁶⁰ The reason for this puzzling discrepancy is the process of chief executive selection, and then the peer process used subsequently in setting pay. In a CEO succession, the next executive is picked by the board

⁵⁷ Edmans, *A Survey of Optimal Contracting Theories* (2009) *supra* note 14.

⁵⁸ See Paul Oyer, *Why Do Firms Use Incentives That Have No Incentive Effects?*, 59 J. FIN. 1619 (2004) (presenting a model of equity compensation which focusses on participation constraints rather than incentive compatibility by introducing the assumption that outside opportunity wages are correlated with firm performance.)

⁵⁹ Henry L. Tosi, Steve Werner, Jeffrey P. Katz, and Luis R. Gomez-Mejia, *How much does performance matter? A Meta-Analysis of CEO Pay Studies*, 26 J. MGMT. 301 (2000).

⁶⁰ David R. Roberts, *A General Theory of Executive Compensation Based on Statistically Tested Propositions*, 20 Q.J. Econ. 270 (1956)

largely without consideration of price beyond what is generally affordable.⁶¹ Price enters into the decision only when the compensation package is negotiated, after the successor CEO has been selected⁶² and largely without regard for the additional cost of inducing a move. In contrast to other typically understood markets, equalizing differences are not allowed to promote price competition. Finally, the pay level determination is accomplished through the use of the peer analysis. The well documented pay-size correlation is likely a “self-perpetuating” artifact of these size-based regressions⁶³ and is rooted as well in the general mechanics of hierarchical wage structures⁶⁴. The reason why executive compensation does not conform to market-based expectations and that alternative institutions are utilized is simple: the necessary skills to successfully run a company cannot be acquired besides through actual experience at the company; therefore, executives are not typically transferable between firms. Hence simple market pricing mechanisms are ineffective.

B. “The Firm & Industry Leaping Superstars”

The notion of market driven executive compensation is derived from a false conception of executives possessing transferable management abilities. In a market where management talent is largely homogenous, firms and managers could meet in the market just as they can for other conventionally understood products. Naturally, and coincident with the insights about returns to scale from the superstar theory, a sorting of the best managers to the largest firms in this marketplace would produce the most substantial gains in wealth. Therefore, through this operation, it is believed that prices are driven to efficient levels where executive wages then equate with marginal productivity.⁶⁵ Yes, they argue, pay is high and rising, but efficiently so.

If a manager’s skills are valuable to other companies, boards must meet this exogenously determined outside opportunity or reservation wage as a necessary means of

⁶¹ This point was raised by Jon Lukomnik, Managing Partner, Sinclair Capital, LLC, at the University of Delaware Conference “Punting Peer Groups” (May 14, 2012) (transcript on file with the Weinberg Center for Corporate Governance, University of Delaware).

⁶² See Stewart J. Schwab and Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 Wash. & Lee L. Rev. 231, 236 (2006)

⁶³ George P. Baker, Michael C. Jensen and Kevin J. Murphy, *Compensation and Incentives: Practice vs. Theory*, 43 J. Fin. 593, 610 (1980) (“Results from widely accepted surveys are ultimately self-perpetuating.”)

⁶⁴ The pay-size correlation is a long established relationship, predating the widespread use of compensation surveys, this was originally attributed to a structural necessity, Herbert A. Simon, *The Compensation of Executives*, 20 SOCIOLOGY 32, 34 (“salaries are determined by requirements of internal “consistency” of the salary scale with the formal organization and by norms of proportionality between salaries of executives and their subordinates”). Accord. *id.*, Pay surveys have likely only reinforced this relationship.

⁶⁵ Gary S. Becker, *A Theory of Marriage: Part I*, 81 J. POL. ECON. 813 (1973).

retention. Failure to respond to the external market environment would result in raids of talent by other firms or in the inability to obtain such able individuals in the first place.⁶⁶ This conception of a competitive market where managers are freely interchangeable has therefore given rise to a new form of board capture. Rather than being beholden to management and thus ineffective in negotiating pay because of a lack of arms-length bargaining, boards are now often seen as captive to the market. They are forced to participate as “price takers” in a market where the cost of talent is invariably bid up to an executive’s marginal productivity. Effectively, they are removed from the equation. Pay increases then, cannot be a product of a CEO’s usurpation of the power to extract rents, because boards have no countervailing power to begin with.

In such a competitive market, it is then imperative that boards respond to demand by matching a CEO’s compensation to the economic environment in which they are situated. The use of peer (competitive) benchmarking has been defended along these lines. The process is viewed as a practical means of ensuring that pay is consistent with an executive’s outside opportunities in the market for the purposes of retention and motivation.⁶⁷ The view is best expressed by Bengt Holmstrom and Steven Kaplan: “prices, including wages, are ultimately set by supply and demand, and benchmarking is nothing other than looking at market prices.”⁶⁸ Benchmarking is, of course, a process which is firmly rooted in market-based theories of executive compensation. Take, for example, the language used by compensation consultants themselves to describe targeted pay packages in relation to market surveys; pay below the median is deemed “below market” as opposed to “competitive”.⁶⁹

The potential mobility of a CEO is of course influenced by the transferability of that individual’s human capital or skills. If an executive’s productivity is mainly derived from firm-specific knowledge and skills, which have little value elsewhere, the executives themselves will have little value to outside firms. In such a case the executive is essentially stuck with their current employer, unable to be similarly productive elsewhere. If, on the other hand, CEO human capital is largely general and therefore transferable between different companies, the outside opportunities should more closely match wages and executives should freely move to their most efficient allocation. The latter case would

⁶⁶ We have seen much made of this concern with the recent pushes for compensation regulation at banks which received TARP funding, automobile companies who received bailouts, and at Fannie-Mae and Freddie-Mac. The concern, which is perhaps justified in this extreme example of government intervention, was that the companies would not be able to retain their top managers.

⁶⁷ Bizjak, *Peer Groups* (2008) *supra* note 17 (“[Our empirical results generally support the view that] benchmarking is a practical and efficient mechanism used to gauge the market wage necessary to retain valuable human capital”).

⁶⁸ Bengt Holmstrom and Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?*, 15 J. APPLIED CORP. FIN. 8 (2003).

⁶⁹ Michael C. Jensen, Kevin J. Murphy, and Eric G. Wruck, *CEO Pay...and how to fix it* (Harvard Business School NOM Research Paper No. 04-28, ECGI Working Paper No. 44/204, 60, 2005).

suggest that the cause of rising executive compensation is, in fact, a market-driven process which is ultimately responsive to changes in CEO marginal productivity. In the former, a certain ambiguity lies at the core of the determination of compensation. When wages and within-match productivity manager-firm pairing can depart from, and far exceed, the alternatives offered by other combinations, the ex post negotiation over the sharing of such rents takes place in an indeterminate setting and is thus susceptible to non-economic considerations.⁷⁰ This setting offers great potential for the manipulations alleged in management power theories of executive compensation, but also for our purposes, the influence of peer group metrics. Conventional economic analysis is a blunt tool for understanding such phenomenon, where the foundational law of one price is violated. The concepts of supply and demand aid in an analytical determination of price in traditionally understood markets, but they are unable to provide precise conclusions where bargained outcomes may bear little relation to such competitive constraints and considerations. The market sets a floor and a ceiling on executive compensation, but, as we will argue, between which there is wide range for board discretion. There is no mechanism to guide prices to fundamental values which do not exist in the first place.

C. CEO Skills: The Generalist

What should facilitate an active market for executives is the importance of general CEO talent or abilities as opposed to specific skills.⁷¹ General abilities are universally valuable across companies and thus can be exchanged and valued in central markets. They are the same as the general one-dimensional “talent” or “ability” which is utilized in competitive assignment models and theoretical managerial production functions. Tasks such as fostering good investor and constituent relations, financial management, or marketing initiatives are consistently identifiable with the general component of a chief executive’s ability.

But, what of the depth of specific knowledge regarding the company’s competitive positioning within the market environment which is undoubtedly required for effectively setting a company’s strategic direction and strategy? The development and implementation of such planning requires the intimate knowledge, coordination, and direction of complex interrelated corporate assets and personnel. To be effective a manager must draw on an accumulated specific knowledge of a company’s culture, strengths, weaknesses, and interpersonal dynamics. The CEO must simultaneously envision how these factors relate to the broader economic environment. Kevin Murphy and Ján Zábajník argue that society has

⁷⁰ Dale T. Mortenson and Christopher A. Pissarides, *New developments in Models of Search in Labor Markets*, IN: 3 HANDBOOK OF LABOR ECONOMICS 3 (1999).

⁷¹ David Harris and Constance Helfat, *Specificity of CEO Human Capital and Compensation*, 18 STRATEGIC MGMT. J. 895, 896 (1997).

steadily accumulated a body of knowledge in economics, management science, accounting and finance among other disciplines, which, if mastered by a CEO, can substantially improve their ability to manage *any* modern corporation successfully. These skills are applicable across organizations and are not specific to a given organization.⁷² They contend that, by drawing on this incontrovertible collection of business strategies, methods, frameworks of analysis, and decision methods an executive can approach, analyze and respond to any modern business problem or situation in an effective and decisive manner. They argue further that advances in information technology and data storage allow unfettered access to a vast accumulation of firm-specific knowledge which previously was deeply embedded in the organization and inaccessible to an outside CEO. This trend, they argue, coincides with the increases in pay starting in the 1970s. While before the advent of computers a CEO's access to this trove of analytics depended on years of discovery and on-the-job learning, they are now a mere keystroke away from anyone. A CEO can then simply subject this information to the treatments available in the aforementioned body of knowledge of the management sciences. This ability, they contend, makes CEOs ever more interchangeable.

As evidence for this conjecture, they find that CEOs are increasingly hired externally. While in the 1970s and 1980s about 15% of CEO successions involved the appointment of an outside executive, the proportion rose to about 25% in the 1990s and almost a third in the early-2000s.⁷³ Murphy and Zábajník interpret this evidence to suggest a greater importance of and an increased reliance upon general managerial skills. This generalizing trend should naturally cause both the increasing probability of external versus internal successions and the rising trend in executive pay. In their model, returns to general skills are fully captured by an executive's compensation, while the surplus attributable to specific skills must be shared with the firm. They claim that where general skills comprise a larger proportion of an executive's productivity the importance of hiring internally is diminished; outside opportunities should then rise in value with pay increasing concomitantly.

Carola Frydman also finds support for the increasing necessity and importance of general transferable CEO skills by examining change in the actual career path and educational characteristics of a sample of top executives during the period from 1936-2003. In favor of the "increasing general skills" hypothesis, she cites as evidence the rapid increase in business education credentials (M.B.A. degrees as opposed to degrees in other disciplines such as engineering), a decrease in the fraction of executives employed exclusively by one firm throughout their entire career (the fraction having decreased from

⁷² Kevin J. Murphy and Ján Zábajník, *Managerial Capital and the Market for CEOs* (Working Paper, 3, 2007).

⁷³ *Id.* at 3 (Using data from the *Forbes* annual surveys, they find that during the period from 1970-1979 14.2% of newly appointed CEOs were external hires; during 1980-1989 17.2% were external hires; and during 1990-2000 26.5% were external hires). See also Martijn Cremers and Yaniv Grinstein, *The Market for CEO Talent: Implications for CEO Compensation* (3rd Annual Conference on Empirical Legal Studies Papers; Yale ICF Working Paper No. 09-11, 2008) (their results from an Execucomp sample from between 1993-2005 are consistent with those cited above); Mark R. Huson, Robert Parrino, and Laura T. Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001).

about 70% in the 1960s to less than half in the 1990s), a decrease in the average tenure at a firm before becoming one of its highest paid executives (from a peak of 29 years in the 1960s to about 24 years in the 1990s), and an increase in the average age of late-career mobility.⁷⁴ It is important to note that even the downward revision leaves a substantial tenure; twenty-four years is a long time to acquire firm-specific skills and human capital.

These characteristics of the modern executive may not necessarily be a symptom of a generalizing of the nature of executive functions and abilities. The 1980s, the period in which the phenomenon of externally oriented executive succession appeared to begin accelerating, was a significant time in American economic history more broadly. Following a serious recession, a wave of corporate restructurings dramatically altered the economic landscape. Where the notion of the “Organization Man” had long been the norm, pressure from institutional investors and an active takeover market were redefining a long held implicit contract between corporations and society. Earlier in the century, corporations promised employees stability and long-term employment with ample opportunities for career advancement through internal promotion in exchange for their loyalty. The shareholder value movement of the 1980s swept such arrangements aside by demanding from corporations higher standards of efficiency and performance amidst a climate of deregulation and heightened competition.⁷⁵ With this monumental shift of the economy in mind, the change in the nature of executive turnover and careers may be better seen as a symptom of this erosion of traditional patterns of internal advancement. Early career job stability was likely disrupted, leading to more cumulative employers in an executive’s job history.

Also, the demands for restructuring in response to exogenous market shocks and increasingly globalized competitive pressures often necessitated outside hiring of top management as a means of restructuring ailing firms. An outside executive (here referring to an industry-outsider) is brought in as CEO to respond to “dramatic changes in a firm’s environment or a decision to make a dramatic change in the firm’s internal structure.”⁷⁶ For this type of “organizational disruption” an outsider is thought to be needed to either bring with them abilities and skills which are not inherent to a company’s current human capital structure, or to override existing organizational or institutional inertia.⁷⁷ In related

⁷⁴ Carola Frydman, *Rising Through the Ranks: The Evolution of the Market for Corporate Executives, 1936-2003* (Sloan School of Management, Working Paper, 2005) (the data set includes the compensation and biographical data of what were the top 50 firms in 1960 for the period from 1936-2003, containing 1545 individuals of which 63% are matched to biographical data from sources such as *Who’s Who in Finance and Business*).

⁷⁵ Peter Cappelli and Monika Hamori, *The Path to the Top: Changes in the Attributes and Careers of Corporate Executives, 1980-2001* (Nat’l Bureau Econ. Research Working Paper No. 10507, 6, 2004)

⁷⁶ Anup Agrawal, Charles R. Knoeber and Theofanis Tsoulouhas, *Are outsiders handicapped in CEO successions?*, 12 J. CORP. FIN. 619 635(2006).

⁷⁷ Rakesh Khurana and Nitin Nohria, *The Performance Consequences of CEO Turnover* (Massachusetts Institute of Technology, Working Paper Series, 6, 2000)

research, a Booz-Allen report identified mergers and buyouts as an important driver of turnover trends and levels. They also find that outsider successions are associated with a higher likelihood of an acquisition but substandard long-term performance, indicative of a restructuring oriented skill set rather than the organizational development type abilities which enable a manager to produce long-term growth. This ability is found amongst a distinct set of turnaround specialists not necessarily the CEO markets in general.⁷⁸ A company under duress may seek an outside executive as a means of restructuring an organization in order for it to remain competitive or as preparation for a sale or merger, but what the company seeks is not the “general” portion of an executive’s ability, but the accumulated specific-abilities which were acquired at a company which was previously successful in achieving such narrow goals and objectives. The skills sought by a company are not necessarily general just because the executive is hired externally; rather they may remain specific, only in respect to specific circumstances and demands which differ from the normal operations of a company.⁷⁹

Even large diversified companies do not require this general managerial ability; rather they require a combination of specific-skills which are pertinent to each respective business. This fact serves only to make the required skill sets necessary to running these large diversified enterprises more distinct from company to company. This unique skill set is solely attainable through experience at the company itself.

If general skills are an important aspect of the qualifications for top executive positions, a strategy of gaining broad experience by frequent career moves would be actively pursued and in practice lead to greater career success. Monika Hamori and Maria Kakarika study the effectiveness of such an “external labor market strategy” and conclude that CEOs who have spent a smaller fraction of their career in their current organization had taken longer to be promoted to the top of the corporate hierarchy. They then sample executives at the 500 largest corporations in 22 European countries and the 500 largest United States corporations. They track their career histories from entry level to the CEO post, as had Frydman. On average, a CEO who had been a lifetime employee at their firm took 23.1 years to get to the top of their organization; those with six or more prior employers took 26.75 years.⁸⁰ It would seem that the years spent acquiring “general” experience rather than a firm-specific expertise were unproductive.

⁷⁸ Chuck Lucier, Steven Wheeler, Rolf Habbel, *The Era of the Inclusive Leader*, 47 STRATEGY+BUSINESS (Summer 2007) (in 2003 11% of departing CEOs left because of a change in control, 18% in 2005, 22% in 2006. In their data set, all executives who had once sold a company, had also sold every other company they had run).

⁷⁹ Robert Parrino, *CEO turnover and outside succession: A cross-sectional analysis*, 46 J. FIN. ECON. 165, 179 (1997) (“Overall, the evidence suggests that industry-specific human capital is highly valued in most industries and that when a firm does hire an individual with no industry experience, it is often to obtain specific skills rather than general management expertise”)

⁸⁰ Monika Hamori and Maria Kakarika, *External Labor Market Strategy and Career Success: CEO Careers in Europe and the United States*, 48 HUM. RESOURCES MGMT. 355 (2009)

General Electric has long been an example of superb internal management development. They trained their managers in-house by rotating them across corporate divisions. Their executive development program was meant to give their future managers a strong foundation of general management experience in order to groom them for higher positions of more responsibility through frequent job changes.⁸¹ However, according to a recent Wall Street Journal article, this policy has changed.⁸² Their corporate development strategy is now to promote individuals through specific divisions, particularly their engineering and energy divisions. They hope to develop managers with a deep knowledge and mastery of their respective fields rather than broad and shallow understanding of many areas in order to allow them to compete effectively in difficult markets. “The world is so complex, we need people who are pretty deep,” explained Susan Peters, the head of GE’s executive development. The CEO, Jeffrey Immelt, explained that “customers won’t tell [GE’s managers] exactly what they want, if you are very generic, if you don’t have that domain understanding, you will develop products that are average and not very successful. GE cannot take the generic approach here. We have to be viewed as the specialist.”⁸³ They seem to have discovered the inherent futility in a reliance upon general skills in highly competitive environments.

The idea that corporate management is progressing towards general skills is obviously counterintuitive. The basis for such claims is suspect; while we may grant an increasing scope of influence for a chief executive’s actions because of improvements in communication and information technology that fact alone does not comport with an increasing sphere of competence, let alone excellence, in their managerial activities. Returns to scale do not equate generally to returns to scope. It is stated that general managerial abilities have crowded out that studied and carefully acquired specialized expertise and that this is to account for rising managerial productivity and compensation.⁸⁴ It is argued that we, society, have heretofore discovered the sound principles of enterprise management. What is tasked to the corporate executive is then to simply summon the proper data, and, reaching into that depth of amassed societal knowledge for guidance, apply the proper treatment. But, reason should inform us otherwise. It has never been keystrokes or computational power which inhibits human undertaking, but it is rather cognitive constraints. Liberalization of capital and information did not create the corporate titan, master of all areas of economic production, but marked the egress of such general managers. The corporate executive today must navigate a shifting topography of technology, consumer preferences, costs - all the while striving to stay abreast of those at

⁸¹ Carola Frydman, *Learning from the Past: Trends in Executive Compensation over the 20th Century*, 55 CESINFO ECON. STUD. 458 (2009).

⁸² Kate Linebaugh, *The New GE Way: Go Deep Not Wide*, WALL ST. J. B1 (March 7, 2012).

⁸³ Id at B4

⁸⁴ More precisely, it is meant that some form of general or innate “talent” may exclude or always be better than acquired skill in the market for corporate managers.

every corner of the market who possess the increased means to compete through their likewise improved access to capital and information which has driven down the barrier to entry in many industries.⁸⁵ Regardless of what this development suggests as to the returns to skilled labor, the CEO of a large company must know their specific business well. A focused expertise is absolutely necessary to sustained competitive advantage in this difficult environment. Reliance upon general managerial skills, principles, and techniques will not suffice.⁸⁶ In this environment, the jack of all trades would soon be the master of none—as smaller niche businesses will inevitably develop superior products in the areas where the CEO's depth of expertise is shallow. The corporate superstar, excelling in every sphere of economic activity, is a myth. Intense specialization is necessary for their success, a singular focus on the development of those particular skills which will enable their success, if only within their limited area of expertise. Otherwise, their efforts at generalized management through simply drawing on amassed techniques of management, corporate data and information would amount to feeble attempts to “drink the ocean”, as Toynbee described his attempt at historical synthesis in his famous massive survey of civilizations.⁸⁷ As General Electric has determined, without the intimate specific knowledge gained through years of experience, such efforts would be futile.

The argument amounts to proclaiming that because academic studies, books, and treatises are readily accessed through the internet, the talented university professor may be the master of all academic domains. It is to say that a specialist in finance may just as well excel in economics or management sciences. But, it is well known that specialization is the rule; such a mass of information and analysis means only that the work in derivative valuation may be incomprehensible to those specialists in, say, incentive contracting. Talent for corporate management, as for academic study, does not give license for its broad and indiscriminate application across industries or even companies. It does not allow for a general specialist.

D. Evidence on CEO Skill Transferability: Performance

⁸⁵ Thomas, *International Pay Gap* (2004) supra note 13 at 1223 (“increased access to financial markets has driven down the barriers to entry in many industries which accompanied by increased international competition, has forced large vertically integrated firms to break up and allowed the development of many smaller niche firms.”)

⁸⁶ Barry M. Straw and Lisa D. Epstein, *What Bandwagons Bring: Effects of popular Management Techniques on Corporate Performance, Reputation, and CEO Pay*, 45 ADMIN. SCI. Q. 523, 523 (2000) (“There is not a steady progression of ideas based on systemic knowledge of people and organizations, nor are they clear-cut discoveries of principles for motivating or coordinating the work of others. Instead, the chronology of management techniques reads more like a list of claims not quite substantiated and promises not quite fulfilled.”) They find no positive economic performance related to the use of such popular methods of management.

⁸⁷ Ronald N. Stromberg, *The Deconstructive 1980s* in EUROPEAN INTELLECTUAL HISTORY SINCE 1789, 326 (1994).

Geoff Colvin, Fortune's senior editor at large, surveyed top performers who have achieved tremendous success in their fields. He sought out the common denominator amongst a wide array of individuals, from Tiger Woods to Mozart.⁸⁸ He concluded that their success was not based upon innate talent or ability, but on a process of lengthy, deliberate practice. The best performers began early, and persisted in rigorous training, mastering every possible element and skill useful to their professions. They were trained deliberately, often encouraged by parents, and started at a very early age. Likewise, an executive's effectiveness depends upon the mastery of every conceivable situation pertaining to the business they run. This vast accumulation of knowledge and experience which pertains to a particular enterprise is best acquired by starting early at a company and maximizing tenure.

Jim Collins, in his now iconic book *Good to Great*, asked what distinguishes companies which were able to make the transformation from good performers to great industry leaders.⁸⁹ He carefully drew a sample of eleven companies which had excelled, vastly outpacing the market and creating lasting innovation. He found that "larger-than-life, celebrity leaders who ride in from the outside are *negatively* correlated with taking a company from good to great".⁹⁰ Ten out of the eleven companies he identified had CEOs groomed from within; Darwin Smith, the CEO of Kimberly Clark was previously the "mild-mannered in-house lawyer"⁹¹; Colman Mockler, started at the Gillette Company in 1957 as a staff assistant and only by 1976 had worked his way up to become CEO of the company; George Cain, who revitalized the stodgy family-controlled Abbott Laboratories, was an 18-year insider.

Rakesh Khurana believes that struggling companies, facing pressure from stakeholders and other corporate constituents in succession situations, irrationally seek outside executives from high-performing companies rather than carefully evaluating their potential successors' specific capabilities and organizational fit.⁹² He finds the widespread belief in charismatic, high-profile corporate saviors problematic. There is no conclusive empirical evidence that outside succession leads to more favorable corporate performance, or even that good performance at one company can accurately predict success at another. In short, executive skills cannot pass the most basic test of generality; transferability. Richard Cazier and John McInnis found that while externally-hired CEOs averaged \$5.5

⁸⁸ Geoff Colvin, *TALENT IS OVERRATED: WHAT REALLY SEPARATES WORLD-CLASS PERFORMERS FROM EVERYBODY ELSE*, (2008).

⁸⁹ Jim Collins, *GOOD TO GREAT: WHY SOME COMPANIES MAKE THE LEAP...AND OTHERS DON'T* (2001).

⁹⁰ *Id.* at 10.

⁹¹ *Id.* at 17.

⁹² Rakesh Khurana, *The curse of the superstar CEO*, 80 HARV. BUS. REV. 125 (2002).

million in excess compensation there was no significant relation between performance at their prior company and at their new employers.⁹³ Other studies have similarly concluded that external hires do not generally produce better performance than internal hires, even among high-performing outside executives. Gregory Nagel and William Hardin III, by studying executives who concurrently managed multiple companies, directly tested the notion of transferability. While they found evidence that some CEO skill is transferable between firms, the ability to do so was marginal. Among large complex firms, the multi-CEOs they studied exhibited superior performance at their initial firms while only delivering competitive results at their subsequent firms. In their sample, the externally hired CEOs underperformed both multi-CEOs and internal hires.⁹⁴ Mark Huson, Paul Malatesta and Robert Parrino initially found statistically significant differences between the performance of internal and external hires, but the outsider advantage was subsequently eliminated when controls were introduced.⁹⁵ Additionally, Chuck Lucier, Steven Wheeler, and Rolf Habel found that “experienced” CEOs, those who were formerly chief executives, underperformed.⁹⁶ James Ang and Gregory Nagel likewise found significant underperformance by outside hires in a large sample of all public company CEOs in the period from 1986-2005. They analyzed the choice between hiring inside candidates versus external successors and found an economically significant gain realized from an internal succession. Consistent with Khurana, they concluded that because of incomplete information about expected net benefits, boards mistakenly hired externally. Computed ex ante expected net benefits show that given complete information they should have expected a net loss from hiring externally 86.2% of the time.⁹⁷ In an earlier paper, they also tested the temporal consistency of Murphy and Zábajník’s computational advantages theory of increasing general skills directly. They compared the performance of externally hired CEOs to that of internal successors over two successive periods and found no

⁹³ Richard A. Cazier and John M. McInnis, *Do Firms Contract Efficiently on Past Performance When Hiring External CEOs?* (Working Paper, 2010) (studying 192 external successions from 1993-2005 they find a negative correlation between excess compensation and future performance; paradoxically the superstars underperformed).

⁹⁴ Gregory L. Nagel, William G. Hardin III, *The Transferability of CEO Skills*, (Working Paper, 2007)

⁹⁵ Mark R. Huson, Paul H. Malatesta and Robert Parrino, *Managerial succession and firm performance*, 74 J. FIN. ECON. 237, 237 (2004) (finding that “the appointment of outside successors [is] not significantly related to post-turnover performance changes in [their] regression analysis.”)

⁹⁶ Chuck Lucier, Steven Wheeler, and Rolf Habel, *The Era of the Inclusive Leader*, 47 STRATEGY+BUSINESS (2007) (finding that “experienced CEOs”, though hypothesized to bring experience in dealing with stakeholders and shareholders actually underperformed).

⁹⁷ James S. Ang and Gregory L. Nagel, *The Financial Outcome of Hiring a CEO from Outside the Firm*, (Working Paper, 18, 34, 2011) (using a structural self-selection model to estimate counterfactual performance that would have been obtained if the firm hired an insider rather than an outsider and vice-versa, at all target levels of performance internal hires stochastically dominate outsiders).

increasing trend in the benefits to external succession.⁹⁸ Most evidence therefore, suggests that internal CEOs perform better than external CEOs, particularly when it comes to creating long-term shareholder value.

The evidence of negative or insignificant returns associated with an external succession strategy is contrary to what would be expected given theories of competitive markets for executive talent. If CEOs were distinguished from one another by only a certain general talent factor, firms should benefit from the larger pool of talent available when their boards decide to pursue external successors. Presumably, strong, independent boards stand to benefit from such an external strategy when the expected talent of outsiders exceeds that of insiders.⁹⁹ To the contrary, the empirical evidence suggests a negative expected benefit from going outside rather than pursuing an internal succession strategy, despite the ability to access an enhanced talent pool. In the aggregate, CEOs appear to be at their most effective only when they have made significant investments in firm-specific human capital.

E. Evidence on CEO Skill Transferability: Turnover

In a vigorous market for talented managers, consistent with the competitive theories of wages and labor markets (such as the “superstars” market theory described above), one should expect to see a flow of executives between companies, as each is successively revealed to be more or less able than previously believed. Once their ability is publicly known, good executives at small companies should be sought after and acquired by the large companies who have relatively less talented executives. Less able executives should sort to smaller companies. This should be done not only through a filtering process of successive hirings and firings but also through “raids” where an executive jumps immediately from one company to the next. This is simply because in equilibrium assignment models the externally determined reservation wage may very well exceed a talented executive’s marginal value at a smaller firm.¹⁰⁰ Likewise, consistent with retention concerns, underpaid executives should be either more likely to leave or be hired away. Where the market controls executive allocation through a wage as a pricing mechanism, managers should more often than not be hired externally where the broader pool of potential matches would allow for more efficient selection. These characteristics would

⁹⁸ James S. Ang and Gregory L. Nagel, *Outside and inside hired CEOs: a performance surprise*, (Working Paper, 2009) (finding that in the 1989-1995 period external successors underperformed by 0.57 percentage points and in the 1996-2005 period by a greater amount, 2.23 percentage points. Finding also that the decision to hire externally was associated with a 39.1% reduction in aggregate net income and a 25.4% reduction in net cash flow.)

⁹⁹ Benjamin E. Hermalin, *Trends in Corporate Governance*, 60 J. FIN. 2351, 2352 (2005) (“Because the board has the option to dismiss the CEO, it values uncertainty about the CEO’s ability (it enjoys the upside potential but can largely escape the downside risk)”)

¹⁰⁰ Gabaix, *Why has pay increased?* (2008) *supra* note 5.

suggest that the market for executives functioned in much the same way as any other traditionally defined markets and would allow for reasonably accurate neo-classical economic analysis.

Despite the lack of clear evidence of executive transferability of performance, boards often do seek CEO successors in the external labor market. But, though it is argued that this demand, and the changes in it, is driving the escalation in pay, it appears that few sitting chief executives actually fill that demand. Several explicit studies of executive turnover provide clearer guidance on this issue. Martijn Cremers and Yaniv Grinstein found results consistent with an increasing incidence of external successions (30% of new CEOs were outsiders) but only 32% of outside successors had previously been CEOs at other firms. Of that 32%, only 19% were previously public company CEOs (less than 2% of the total of all new CEOs). They found that the number of outsiders who were previously CEOs is trending upwards, but seems to be driven by the hiring of private sector CEOs.¹⁰¹ C. Edward Fee and Charles Hadlock examined the external promotion opportunities of sitting CEOs, or the validity of their threat to leave should they not be paid a sufficient amount. They compiled detailed data on management turnover and job “jumps” from one CEO position directly to another. In a sample of 1200 CEO changes between 1990 and 1998 there were 318 (27%) outside hires of which 43 (4%) were “raided” executives (those who jumped immediately from their old employer to their new employer). They found that the median ratio of the book value of assets of the hiring firm to the old employer to be 2.72 (mean of 4.51). The ratio for the second ranked executive had a median of only 0.29 (mean 0.48). In another sample, for the 500 S&P firms from 1993-1998, they found only six CEO “jumps” among this set of large distinguished firms. Of them, five took CEO positions at significantly larger firms; one took the number two position at a firm 16 times the size of his previous employer.¹⁰² Indeed, the position of CEO is a prize not casually forfeited and is often sought after by other non-CEOs even at the expense of downsizing expectations significantly by moving to smaller companies. Moreover, a significant size differential is needed to justify a CEO raid in the rare cases they occur.¹⁰³ Most significantly, it appears that the threat to go elsewhere is muted for a sitting CEO. Particularly for the large firms comprising the S&P 500, CEOs are rarely traded in any market for their talents.

¹⁰¹ Cremers, *Does Talent Explain Controversial Practices* (2011) *supra* note 69.

¹⁰² C. Edward Fee and Charles J. Hadlock, *Raids, Rewards, and Reputations in the Market for Managerial Talent*, 16 REV. FIN. STUD. 1315, 1330 and 1339 (2003), *see also*, C. Edward Fee and Charles J. Hadlock, *Management turnover across the corporate hierarchy*, 37 J. ACCT. & ECON. 3,11 (2004) (examining a sample of 443 firms over the period from 1993 to 1998, finding a similarly low incidence of CEO departures related to raids by other public companies only 2.93% of the 9.55% of annually departing executives). This is not to say that CEOs do not receive outside offers which are unobserved empirically. However, an executive likely prefers their current firm and the firm likely values the executive more than the firm making a competing offer. Together, these preferences serve to entrench managers with firm-specific skills, which support a divergence between outside opportunities and firm-manager productivity. We discuss the implications of this disparity later

¹⁰³ While this indicates that talent sorts to larger firms, the evidence suggests that the rigor and thus explanatory power of this process vis-à-vis pay is less significant than supposed.

If outside offers and the option to renegotiate are considered, it is clear that the peer groups are irrelevant. As the empirical evidence shows, it takes a significant misallocation of talent to overcome the frictions inherent in the firm specific nature of the job. CEO “jumps” occur where a relatively large company raids a significantly smaller company. For the exceptionally talented small firm CEO it appears unlikely that their original company could outbid the large firm given the scale and added prestige. Any targeted peer percentile would be insufficient to retain them. But, where a CEO has received an offer and did not leave, it is likely that they renegotiated their salary with the board. In this case, the compensation will truly be a negotiated outcome where opportunity costs are explicitly considered. The board will consider whether to match the offer or to pursue other options with either internal or external candidates. Likewise, the CEO will consider how attractive the other option is, including whether it is worth discarding their firm-specific capital. Again, in this instance, peer groups are irrelevant.

The peer grouping process has become the near-exclusive measure for setting CEO compensation. This process, though, is predicated on this notion of CEO transferability in competitive markets for talent. The lack of empirical and principal-based support for this proposition forces one to question the implied causation; that markets are driving the rise in compensation. Rather, the universal application of the peer grouping process has likely dictated the observed reality by unjustifiably injecting the notion of rigorous external markets into negotiations, where in fact, they do not exist¹⁰⁴. If we are to address outsized remuneration seriously, we must begin by focusing critically on both the setting in which pay is awarded and the peer grouping process by which it is set.

III. THIN LABOR MARKETS: ROOM FOR PEER GROUP INFLUENCE ON PAY

“Thin” labor markets, as the market for top executives can be described, are characterized by match-specific rents between the heterogeneous agents on both sides of the market. Heterogeneity in these markets means that no two firms are completely identical, nor managers wholly interchangeable. Firms, of course, differ in capital structures, resource endowments, competitive strengths and weaknesses, and hierarchical structures. Managers’ skills are highly tailored to the specific companies they run. As a result of this environment and the nature of executive skills, match-specific rents arise as surplus or earnings above outside opportunities. In reality, the market for CEOs takes a form which differs in an important way from the traditional, neo-classical view. As Alexander Kelso and Vincent Crawford argue:

In the customary view of competitive markets, agents take market prices as given and respond non-cooperatively to them. In this framework equilibrium cannot exist in general unless the goods traded in each market are truly homogeneous; heterogeneity therefore generally requires a very large number of markets. And since these markets are necessarily

¹⁰⁴ George P. Baker, Michael C. Jensen, Kevin J. Murphy, *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593 (1988).

extremely thin-in many cases containing only a single agent on each side-the traditional stories supporting the plausibility of price-taking behavior are quite strained.¹⁰⁵

A chief-executive, obviously, must earn¹⁰⁶ more than their next best alternative employment opportunity would pay them¹⁰⁷, but they also earn less than the full value of their firm-specific productivity; the firm's profit is similarly constrained between these payoffs. The precise determination of a wage (and firm profit) outcome must be determined within this flexible range through a complex bargaining process between the parties. Consider the compensation of Nabors Industries' former CEO Gene Isenberg. From, 2008-2010 the 81 year old executive received over \$100 million in compensation before retiring and receiving an exit package valued at \$126 million. It is obvious that the aging chief would have likely worked for less (rather than retiring or jumping to another firm). Nabors cited a 50-fold rise in the company's stock under his tenure as justification for the pay-package; they likely would have been willing to pay more for such stellar performance.¹⁰⁸ The actual compensation was somewhere in between these reservation wages and profits.

The constraints on this bargain, the firm's and the manager's next best alternative profits and wages, are known as threat points. The total rent, or the amount of the joint-payoff available to a firm and manager which exceeds the total of the two threat points, can be split between the agents into an innumerable number of different proportions. Generally, we may not define a theoretic solution to this bargaining problem which provides unique wage- and profit- payoff schedules without making assumptions about rent-sharing parameters such as "bargaining strength" or about the institutional arrangement. Nonetheless, however the rent is ultimately split, both parties will earn more than their outside opportunities. Therefore, the equilibrium match-allocation of managers to firms will be independent of how the rent is later shared. That is to say that, within the threat constraints, variations in bargaining strength should not affect the likelihood of a manager leaving for another firm. When a high degree of specialization in CEO skills is considered, it is reasonable to expect that the amount of flexibility in these negotiations is substantial¹⁰⁹.

¹⁰⁵ Alexander S. Kelso, Jr., and Vincent P. Crawford, *Job Matching, Coalition Formation, and Gross Substitutes*, 50 *ECONOMETRICA*-1483, 1483 (1982).

¹⁰⁶ Here meaning wages and other non-pecuniary benefits: total utility.

¹⁰⁷ Or, they would leave to that alternative job-opportunity.

¹⁰⁸ Gary Strauss, *CEOs' golden parachute exit packages pass \$100 million*, USA TODAY (November 8th, 2001).

¹⁰⁹ That the environment in which pay is set is economically indeterminate is clear from the empirical relationship identified between proxies for managerial power and pay levels. Such a relationship should not exist if pay were subject only to economic factors.

This analysis, however, does not tell us much about the sorting process by which firms and managers initially match in the labor market. In a sense, a disordered world is described above; the pairings may be incidental and random. However, in marriage, for example, we observe that likes and not dislikes attract: wealthy people couple with other wealthy people; intelligent spouses join with other intelligent spouses; and men who earn high incomes often marry women who are also high earners. Gary Becker sought to bring the analysis of sorting closer to this observed reality by introducing one-dimensional hierarchical types (e.g. agents were ordered by “attractiveness”).¹¹⁰ If there were complementarities between types, these matching markets would exhibit “positive assortative” patterning. Becker’s theory preceded the labor market theories of superstars of Sherwin Rosen and later Xavier Gabaix, Augustin Landier and Marko Tervio. According to these models, markets would order themselves positively around the one-dimensional characteristics of, “ability” or “talent” and “firm-size.” The best managers would run the largest companies and, therefore, also earn the most. This sorting is critical to these theories of superstar CEOs.

We would be mistaken, however, to consider markets for executives to therefore definitively set wages based on the mechanisms of matching and pairing along these one-dimensional contours. In reality, CEOs are invested heavily in the companies that employ them and firms likewise in the executives that lead them. Sorting takes place early in careers when the information about ability or talent is difficult to come by- it should hardly be expected that they be matched in a manner which would conform to the predictions of this theoretic market. It is unrealistic to assume that the most talented manager is assigned to the largest firm, the next best to the second, and so on- just as it would be to assume they were assortatively matched by SAT scores. By the time their ability is revealed clearly, they are already invested in their current company and to move wouldn’t likely be an option. It is more likely that a given firm is broadly representative of the market as a whole, and its top executives are naturally culled from this standard distribution. At any given time, which company currently has the next generation’s industry leading CEO in its talent pipeline is largely a matter of luck or of a carefully designed recruitment, development and retention program which aims to train and retain executives early in their career. Any general component to talent in a CEO is far outweighed in employment decisions by the importance of specific abilities built around it. This is why there is not as much turnover as would be expected in CEO markets.

It is appealing to refer to “talent” when describing pay, and then to describe CEOs as sorting amongst firms on the basis of this characteristic. Nonetheless, a certain degree of fortuitousness in executive allocation must be accepted. Jack Welch joined General Electric in 1960 as a Chemical Engineer earning \$10,500.¹¹¹ It would be absurd to say he did so with the realization that he would become Chairman and CEO twenty-one years later. He was, however, identified as a talented employee and encouraged to develop within the company. By the time he became CEO, leaving would never have been an option. As a

¹¹⁰ Becker, *Theory of Marriage* (1973) *supra* note 61.

¹¹¹ JACK WELCH (WITH JOHN A BYRNE), *Jack: STRAIGHT FROM THE GUT (Prologue)* (2003)

general rule, early company action helps to ensure a supply of able, homegrown, CEOs and not sorting between firms later in a career. As a result of this long-term commitment, CEOs, and potential CEOs are highly invested in their firms and firms are highly invested in them. Wages are therefore highly insulated from markets.

A. The Definitive Peer Benchmark

For executive compensation, there is then considerable room for the influence of normative considerations and flexible negotiations. In deriving bargaining solutions, economic theorists, in their models, typically rely upon a parameter for bargaining strength which apportions the match-specific rents between the two considered parties as a means of reconciling the ambiguous nature of the problem. Management capture hypotheses refer to this parameter when they describe the capture of rents. Managements' bargaining strength is increased by various factors which put boards of directors in a position of relative bargaining weakness, as modeled by this parameter. When management has co-opted the compensation committee or when the board members serve at the discretion of management (who then require their support, alliance, and leniency as a condition for continued service), for example, the balance of power in the negotiation is altered. These situations surely allow the "extraction of rent", but under the two-sided matching in heterogeneous markets framework a substantial amount of management compensation is rent anyway.¹¹² Board dynamics only alter how such rent is shared. Further, if bargaining strength is a positive function in part of the resources or energy a party commits to the negotiation, which is in turn an increasing function of the potential utility gain to be realized, then the negotiation is biased in favor of executives at the start. Because of decreasing marginal utility and fractional ownership, a million dollars in extra compensation will always be worth more in utility terms, and be fought harder for, than it is to either the company itself or to its directors. Shareholder activist approaches to reforming board dynamics hope to effect this bargaining strength parameter in order to create more reasonable compensation. Share-owning board members have more wealth to gain from strengthened negotiation; director independence further decreases the cost of engaging in this rigorous negotiation; and, pressure from investor groups increases the personal and reputational cost to board members of allowing favorable compensation outcomes for

¹¹² The board capture theory has been critiqued for not explaining why the supply of CEOs does not increase in response to the existence of this rent, Thomas, *International Pay Gap* (2004) *supra* note 13 at 1199 ("If there are huge rents available to American CEOs over the past twenty years, why don't we see a supply side reaction?"). We would argue that the specific nature of CEO skills precludes this, the supply has always been restrained by the number of junior executives employed. People cannot react to rents and drive down the pay of incumbent CEOs by simply training at a "CEO School" as increases in law students eventually drive down the rates lawyers may charge.

executives.¹¹³ Thus far, such reform efforts have proved inadequate, and have failed to stem the rise in pay.

The shareholder value movement has failed to bring about the expected rationalization of executive compensation. Notions of competitive markets wrongfully give this upward trend implicit approval. We favor a third explanation for the trend in pay, which relies on neither notions of omnipotent competitive markets nor malignant powerful managers but rather on the influence of the benign normative practice which determines how rents are divided between CEOs and shareholders in this uncertain and ambiguous bargaining environment, that is, the peer grouping process.

Peer grouping is the institutional structure which governs how executive compensation is determined.¹¹⁴ Institutional structures and decision-heuristics work to smooth uncertainty, lest we be marred in impossible analytics. They are often just rules of thumb. We don't attempt an analysis of a taxi-driver's merit and then dwell on the decision of how much to tip—did he take the best route, was she sufficiently amicable, do they deserve the additional compensation—we simply round up and add a dollar and the difficulty is simply settled. Negotiated interactions typically resolve themselves around these focal points of common understanding and efficient resolution. Gains are often split 50-50 for instance. Why? Because it's just easier that way. Just as institutional constructs create path dependency in the broader economic history, it is equally convincing that the rules, which are in fact quite formal, in which we set executive compensation both constrain and guide the outcomes (the oft lamented rising pay). This is true particularly because an indeterminate economic environment inhibits neo-classical market discipline as traditionally understood. Executive pay is high and rising, but we need to look no further than the rules and structure in which it is set to find the cause. There is a structural bias for rising pay in the peer group process which ultimately leads to its un-abating long-run escalation. It should be even clearer that so long as all are paid at previous period medians or higher, then pay cannot fall below current levels at least in nominal terms.

As we have previously discussed, there are several problems with the use of peer grouping which mechanistically lead to higher pay: (I) Given the lack of subjective criteria for peer inclusion, the group is easily manipulated in their composition, (II) the practice of above median targeting creates upward bias which leads to the popularly referenced "Lake Wobegon Effect", and (III) structurally, they allow systemic effects to propagate through the constructed networks, creating a situation where the unrelated high pay and performance

¹¹³ Lucian Arye Bebchuk and Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPECTIVES 71 (2003). The "outrage" constraint he mentions throughout the paper works through this mechanism by imposing an additional cost on excessive management rent extraction.

¹¹⁴ Douglass C. North, *Some Fundamental Puzzles in Economic History/Development*, Washington University, St. Louis, 2, 3 (September 13, 1995) (providing a definition of institutions as follows: they are "the rules of the game--both formal rules and informal constraints (conventions, norms of behavior and self-imposed codes of conduct)-- and their enforcement characteristics", their purpose is to "provide the structure that humans impose on human interaction in order to reduce uncertainty", they function to "define the way the game is played.")

of one executive may drive up wages for many others (so called leap-frogging).¹¹⁵ The explanation that high CEO pay is primarily a market consequence does not hold and therefore does not absolve boards' responsibility for its rising trend; a significant mechanism for its ascent is the peer grouping process which most boards utilize. This process is based on the false assumption of easy transferability of executive talent. While perhaps innocuous at first, the accumulated effect has been an unacceptable increase in the proportion of corporate earnings going to management rather than shareholders.¹¹⁶ This is a material concern- it is draining invested capital out of companies and straining the companies' and the country's social fabric.

B. Balancing Costs in Setting Pay

There is significant ambiguity and flexibility involved in determining the appropriate level of pay to award an executive. The determination of compensation is settled in a negotiation or bargain where a broad range of possible outcomes between either's outside opportunity are possible. Nonetheless, simply targeting pay at the median is not then a satisfactory resolution. We should rarely expect a problem requiring complex analysis to resolve itself in the most effective manner by the application of a simplistic rule of thumb.¹¹⁷ Heterogeneous companies demand a more tailored approach, which relies less on general principles.¹¹⁸ It is not surprising then that the simplistic application of a peer-based median targeting process should have unintended consequences; peer group analysis has led to a structural bias for a continuous upward ratcheting in pay. We should, however, exercise caution when discarding or reforming long-standing practices, lest the potential gains in efficiency from a new approach are outweighed by the consequences which result from the change itself.

We believe, however, that there is a corporate entity in place which is well situated to balance and negotiate the myriad and countervailing costs and benefits which must be

¹¹⁵ See *supra* note 44 and the related in text discussion.

¹¹⁶ Bebchuk and Grinstein, *Growth in Pay supra* note 3

¹¹⁷ Rules of thumb are by definition general, rough-and-ready principles which do not take into account the full spectrum of available information. For the specific heuristic technique employed by median targeting, and a possible consequences, see Amos Tversky and Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 SCI. MAGAZINE 1124, 1128-1130 (discussing a systematic heuristic error occurring when judgments are anchored to an initial reference point which results from a partial computation and then are insufficiently adjusted with the imputation of additional information. Even an arbitrary starting point, such as 'Company ABC pays \$X so we should as well', systematically biases the final decision).

¹¹⁸ "A government must be fitted to a nation as much as a coat to an individual...What may be good at Philadelphia may be bad in Paris and ridiculous at Petersburg," Alexander Hamilton, THE PAPERS OF ALEXANDER HAMILTON 404 (1969) from Thomas Sowell, INTELLECTUALS AND SOCIETY (2012).

accounted for when setting pay in absence of the reliance upon a peer benchmarking analysis – the board of directors. Only they may be sufficiently informed so as to weigh the potential consequences and benefits which may accrue to higher or lower compensation. The calls for reform in executive compensation can and must be addressed by them. To do so they must abandon the near-exclusive reliance on the misdirected peer process and focus more on other, internal, factors. Clearly, the problem of setting compensation levels is of a complex and onerous nature. It is, however, tractable if considered from the perspective of what is best for the corporation in regards to its internal pay and incentive structure, as opposed to exclusively looking externally. Certainly the contemplation of an external benchmark analysis as a general principle may be justified, but it should only be given cursory attention. The level of pay determined by a board of directors to be necessary and appropriate must be allowed to deviate freely from any median-targeted levels so as to best accommodate the specific needs of the organization in question. A borrowed analogy is helpful in this context,

Consider the design of suspension bridges. The Newtonian physics they embody is beautiful both in mathematics and in steel, and college students can be taught to derive the curves that describe the shape of the supporting cables. But no bridge could be built based only on this elegant theoretical treatment, in which the only force is gravity, and all beams are perfectly rigid. Real bridges are built of steel, and rest on rock and soil and water, and so bridge design also concerns metal fatigue, soil mechanics, and the force of waves and wind.¹¹⁹

A bridge is built by engineers, who take into account these idiosyncratic factors in their design, and adjust the theoretic models accordingly. A director must do the same in regards to setting pay, adjusting where appropriate what a peer group model would suggest. In this section, we shall lay out the various considerations which a board must address and carefully weigh in the process of arriving upon a determination of the appropriate amount to pay a chief executive.

The practice of median targeting, within the peer grouping process, is a reflection of the desire to pay executives fairly. Though retention and market needs are most often cited as justification for the use of benchmarking, its most essential use is merely to satisfy an executive's desire to be rewarded as well as his or her peer CEOs. If a board were to award lower than expected pay by compensating below median (market), it is understandable that there may be psychological consequences as a result of perceived inequitable treatment, because

¹¹⁹ Alvin E. Roth, Elliott Peranson, *The Redesign of the Matching Market for American Physicians: Some Engineering Aspects of Economic Design*, 89 AM. ECON. REV. 748, 752 (1999).

[e]nvy, for better or worse, is a fundamental part of the human condition. Whether we admit it or not, most of us take a keen interest in the financial status of our neighbors. Few aspects of existence in contemporary society create more anger, resentment and dissension than how much we are compensated for our daily toils in comparison to what our fellow workers earn.¹²⁰

Theories of pay equity suggest that when paid less than one's peers, a person may seek redress through the withdrawal of effort. Maintaining executive pay alignment with external market rates is, in this context, seen as an integral component of a well-designed incentive structure.¹²¹ Concern for an executive's emotional well-being in this respect may be merited, but an analysis which stopped here does a disservice to the company. That is the problem with overreliance on the peer group. For many reasons, compromise between this and other more important concerns is necessary.

Human capital theory tells us, also, that high executive compensation provides a necessary incentive for workers to engage in the costly task of investing in and acquiring skills¹²². The question of which firm offers the best return for such efforts certainly bears upon the decisions of employees.¹²³ But, again, it must be emphasized that the process of

¹²⁰ Elson, *Executive Overcompensation* (1993) *supra* note 3 at 937. A theory of social comparison in social psychology has sought to understand how the self-evaluations of individuals are shaped through references to the traits and abilities of their peers; Leon Festinger, *A Theory of Social Comparison Processes*, 7 HUMAN RELATIONS 117 (1954) (developing his 'theory concerning opinion influence processes in social groups'). This theory was naturally developed into a theory of wages within organizations and of CEO compensation; see Robert H. Frank, *Are Workers Paid their Marginal Products?*, 74 AM. ECON. REV. 549 (1984) (presenting evidence to support his view that egalitarian wage structures arise in organizations due to equity considerations); Charles A. O'Reilly III, Brian G. Main, and Graef S. Crystal, *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257 (1988) (finding a strong correlation between the CEO pay and the compensation levels of outside directors).

¹²¹ Being at the top of the corporate hierarchy, a CEO has no relevant peers within the company. A Vice President, e.g., could base their perceptions of equity on other Vice Presidents within the organization, who are perceived to be peers, but for a CEO the most obvious referent peer group is external; other company CEOs, Taekjin Shin, *Fair Pay or Power Play?* *supra* note 45. In contrast, others suggest that comparisons also tend to be directed inward, Carol T. Kulik and Maureen L. Ambrose, *Personal and Situational Determinants of Referent Choice*, 17 ACAD. MGMT. REV. 212 (1992)

¹²² Derek Neil and Sherwin Rosen, *Theories of the Distribution of Labor Income* in HANDBOOK OF INCOME DISTRIBUTION (1999).

¹²³ This is an ex ante participation constraint. After a period of successful employment, a utility maximizing employee is prejudiced towards the expected future wages at their current employer over quitting and accepting those at another company. This is another possible manifestation of the frictions characterizing labor markets. Conditioned on employment success (raises or promotions) or even simply continued employment, the value of a current job-match is biased upward compared to fresh employment at alternative firms.

executive development begins within the company long before an executive becomes the CEO.¹²⁴ The possibility of ascension to the top of the hierarchy is likely to be particularly remote, distant, and little valued in expectation at the time when most are hired and over much of the time period during which skills are developed. Perhaps, from this capital investment perspective though, the institution of peer benchmarking provides a means for the company to credibly commit to paying compensation on par with competitors at some distant future time of an employee's human capital investment's pay off.¹²⁵ Just like any other employee, an executive, or one in training, is vulnerable to the whims of their employer, however capricious or opportunistic they may be. Benchmarking may provide an external assurance from current and future boards of fair and equitable compensation which enables complex long-term contracting to take place between boards and executives. Deviation from peer grouping norms may signal that a board is likely to advantageously make use of their power to set compensation.¹²⁶ However, other similar but internal standards may similarly accomplish the same objective, such as paying a CEO at a constant multiple of the next highest paid employee. Or, very simply, the clearly enforceable standard that one will always make more as a CEO than they did before as a junior executive may be sufficient to motivate employees. Also, people are not likely to think in such strictly economic, pecuniary terms. There is much more utility linked intrinsically to a position of such influence and esteem. It must be remembered that the position, within bounds, is desirable regardless of the financial interest in acquiring it.

¹²⁴ Edward P. Lazear and Kathryn L. Shaw, *Personnel Economics: The Economist's View of Human Resources*, 21 J. ECON. PERSP. 91 (2007) (stating that the best time to sort workers [by ability, tastes, temperment, etc.] is when they are young. They reference tenure reviews and promotions to partner). To sort at or near the CEO level would be inefficient.

¹²⁵ From a contracting perspective, the dominant strategy for employers may be to expropriate the work products of their managers after they have made costly investments. Such a strategy is ultimately efficiency-reducing because rational employees would avoid such investments in the first place if they expected the returns to be usurped by the firm's owners. As a result, institutions and external enforcement are often required; not just for the protection of employees, but as a means by which owners can make a credible commitment to not act opportunistically. A classic example of this is given by Thomas Shelling: a kidnapper wishes to set his victim free, but fears he will go to the police; the victim would most certainly exchange his freedom for the promise not to go to the police, but of course both realize that once freed it is no longer beneficial to keep his promise; how can they both get what they desire? Blackmail, the victim may disclose an offence which is blackmailable, Thomas C. Schelling, *THE STRATEGY OF CONFLICT* (1960) in Robert H. Frank, *If Homo Economicus Could Choose*, 77 AM. ECON. REV. 593 (1987). See also, Bengt Holmstrom, *The Firm as a Subeconomy*, 15 J. L. ECON. & ORG. 74 (1999). For an empirical analysis of credible commitments with controlled firms and hostile takeovers, see Dino Falaschetti, *Golden Parachutes: credible commitments or evidence of shirking?*, 8 J. CORP. FIN. 159 (2002).

¹²⁶ On the other hand, reputational concerns and repeated interactions make this also a sub-optimal strategy for boards, and it is likely that commitment is not necessary.

The human capital theory is likely to overstate the intentionality of an employee's investment in skills—except in obvious cases such as education, accepting lower paying jobs in agencies such as the SEC as a career building investment in skills, or the very limited pay concessions taken while training.¹²⁷ In acquiring skills, a junior employee does not consciously distinguish between those which are likely to benefit them in the future as a manager or CEO and those which will not. Valuable skills are acquired through experience, as an unconscious byproduct of other work-related responsibilities. They are not so much an investment as a prerequisite to continued employment.¹²⁸ One studies the sales data for one division because it is one's job to do so. Increased familiarity is an unintentional consequence which may or may not serve one well in later tasks. An employee who sought to discriminate between tasks in an intentional manner would neglect many essential job tasks along the way, would be less successful in their current position and would therefore fail to be promoted anyway. "Chief Executive Skills" are useless to one who languishes at the lower levels of the hierarchy. In this manner, human capital theory may fail to provide adequate descriptions of the incentives for skill development or for effort in the executive market context. General skills may occasionally be "bought" intentionally, through university schooling, for example, or by temporarily taking lower paying jobs which offer greater experience and opportunities for learning, but specific-knowledge is less an investment than an incidental product of experience.

A "tournament theory" of wages provides clearer insights into the effects of incentive structures on effort within corporations. It begins with the very intuitive assumption that the potential for pay raises within an organization provides a bounty or "prize" which incentivizes employee effort by inducing a competition to win the promotion.¹²⁹ This internal incentive structure differs markedly from others which encourage productivity by paying wages directly for observed output in a piece-rate, or a pay-for-performance related manner.¹³⁰ The wages or "prizes" within an organization, in the context of this tournament, may exceed the marginal product of the employee or the executive being paid.¹³¹ Wages are pegged to jobs at different levels of the organizational

¹²⁷ In fact, it is usually the company who bears the cost of training, see Joseph Walker, *School's in Session at Google*, WALL ST. J. B1 (July 5, 2012) (U.S. businesses spent \$171.5 billion on learning and development in 2010.)

¹²⁸ This diminishes or eliminates the "Prisoners Dilemma" because no intentional action is directed teleologically towards the acquisition of specific skills. Rather, the end is continued employment.

¹²⁹ See Edward P. Lazear and Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981).

¹³⁰ Though both purport to offer incentive compatibility; and may achieve the same theoretical incentive structure.

¹³¹ See Lazear, *Personnel Economics* (2007) *supra* note 118.

hierarchy as opposed to the individuals occupying that position.¹³² The wage derives its utility not from ensuring the retention of productive workers but rather by eliciting the effort of other employees at lower levels of the organization. High CEO compensation, it is argued, is not wasteful in so much as it is useful in increasing productivity elsewhere in the organization.

This conception of a corporate wage structure provides valuable insight into the effects of relative wages within an organization- for example, if a potential raise is too “steep”, or the prize is too large, it may serve to incentivize team-based collusion or sabotage rather than productive effort. But, necessarily, the internal tournament model fails to draw conclusions about how relative wages between organizations provide incentives. This is almost necessarily so. The theory describes a means of eliciting effort outside of the incentives structures provided by an open marketplace. Upon review of the evidence and literature, Brian Baker and Bengt Holmstrom conclude that wages and careers in internal labor markets are “partly shielded from the vagaries of external labor markets,” and that this fact “seems well accepted”.¹³³ In an open market, wages are determined by trading off the relative skills and characteristics of firms through the pricing mechanism. Labor markets within a firm are designed as an alternative means of economic organization. On the borders or margins of the firm external labor prices should certainly encroach upon the domain of the firm, with its total employment shrinking and growing as a result, but infra-marginally the internal allocative structures dominate. If they did not, we would have no use for the firm.¹³⁴ A CEO, with years of acquired firm-specific capital, is certainly an infra-marginal factor of production. Further, the theory suggests that allowing outside succession is antithetical to the tournament design and function because it would dilute its effectiveness.¹³⁵ An efficient wage structure is, therefore, almost entirely indigenous to the company at which it is implemented. Its precise character depends upon a firm’s idiosyncratic nature- its specific cost of monitoring effort, measuring output, and the

¹³² *Id.* at 130

¹³³ See George Baker and Bengt Holmstrom, *Internal Labor Markets: Too Many Theories, Too Little Evidence*, 85 AM. ECON. REV. 255 (1995).

¹³⁴ Richard A. Posner, *Essay: Are American CEOs Overpaid, and, If So, What if Anything Should Be Done About It?*, 58 Duke L. J. 1017, 1013 (the pricing mechanism “does not ‘work’ as the control mechanism within a firm- if [they] did, one would not need firms, just individual contractors.”)

¹³⁵ William Chan, *External Recruitment versus Internal Promotion*, 14 LABOR ECON 555, (1996) (“Requiring a firm’s employee to compete against not only her colleagues but also any number of external applicants drastically reduces the employee’s chance of winning, and with it her incentive to exert and complete.”)

characteristic worker desired.¹³⁶ The appropriate CEO compensation at one company could be wholly inappropriate at another; pay comparisons cannot therefore be wholly dispositive.

The tournament theory does not itself justify the use or necessity of peer comparisons in setting pay. Additionally, it overtly concerns a principle which strongly suggests that peer comparisons are an insufficient means of analysis; the pay of a chief executive has a profound impact on the incentive structure, and hence productivity of those below, and in turn of the firm as a whole. Despite what peer comparisons may indicate about how pay will affect the incentive of the particular executive concerned, notions of internal equity may override such concerns of external equity as far as a firm's total productivity is concerned.¹³⁷ The pay of an executive affects more than just their own individual output. A Chief Executive must work closely with a team of other executives. The level of compensation they receive affects the dynamics of this work relationship. This, in turn may affect the relationships of those team members with their subordinates, and them with theirs.

The tradeoff between higher and lower CEO pay can be illustrated in a simple hypothetical.¹³⁸ For a planned CEO succession there may be three junior executives competing for the job and accompanying raise. The board has communicated that one of them will get the position- an outside hire would likely underperform one of the internal candidates, while also diluting the internal incentive to put forth effort to win the job (knowing it could be snatched away).¹³⁹ All three junior executives are currently earning \$1 million dollars a year. Presumably this amount exceeds their next best option-- quitting, foregoing the million dollars in annual earnings while searching for alternative employment (if unsolicited job offers are not forthcoming), and the wages and other utility they could expect to receive if successful.¹⁴⁰ We know that the raise received by whoever wins the competition for promotion cannot simply reflect the value of that executive's human capital

¹³⁶ See Barry A. Gerhart, George T. Milkovich, Brian Murray, *Pay, Performance, and Participation* in NEW FRONTIERS IN RESEARCH, IRRA (1992).

¹³⁷ Tournament theory compensates relative, not absolute, ability or performance: that is, performance relative to others within the organization.

¹³⁸ Or, what is more likely, a cheap rhetorical trick.

¹³⁹ See Anup Agrawal, Charles R. Knoeber and Theofanis Tsoulouhas, *Are outsiders handicapped in CEO successions?*, 12 J. CORP. FIN. 619 (2006)

¹⁴⁰ Mortensen, *Models of Search* (1999) *supra* note 69

in the market. The company was able to retain them before the raise, and one's value does not increase substantially immediately upon signing a CEO contract.¹⁴¹ The raise may, nonetheless, represent an adjustment for increased job risk¹⁴² or increased effort demands¹⁴³, with an unaffected certainty equivalent wage. But the marginal increase in these factors is not substantial in going from a CEO to junior manager. The other side of the utility tradeoff must also be considered. The CEO job title may be valuable for the prestige¹⁴⁴ or status¹⁴⁵ of the position and the increased outside opportunities to serve on boards, consult, attend functions and the other related accoutrements of the office. Given this, it is entirely possible that one of the competing executives would be willing to actually purchase the position from the company.¹⁴⁶ Given the dramatic overnight raise in pay and total utility given to newly appointed CEOs, the wage accompanying a promotion must in some respects represent a prize meant to provide incentive for workers other than that CEO, rather than strictly compensation for marginal value.

¹⁴¹ Lazear, *Personnel Economics* (2007) *supra* note 118 at 96 (“In standard human capital theory, wages are determined by skills, and no conceivable story would allow [a promoted executive’s] skills to increase dramatically a few minutes before [they] were promoted”)

¹⁴² See *cf.* C. Edward Fee and Charles J. Hadlock, *Management turnover across the corporate hierarchy*, 37 J. ACCT. & ECON. 3 (2004) (“The rate of forced turnover for non-CEOs is at least as great as that for CEOs, but the sensitivity of turnover to firm performance is smaller for non-CEOs.”)

¹⁴³ Brian J. Hall and Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* (Nat’l Bureau Econ. Research Working Paper, 9, 1998) (“given that CEOs are a self-selected group of high-effort, overachieving individuals, it may be that lack of effort is not a first-order agency issue in this population”). The same is likely to hold for junior executives, Bainbridge, *Executive Compensation* (2005) *supra* note 19 at 1633 (“slackers will rarely climb to the top of the greasy pole.”) Therefore effort is likely to be maximized for most top-executives regardless of incentive structures. Any market-based explanation is likely to accept that this holds for all executives not just CEOs, see Edman, *A Survey of Optimal Contracting Theories* *supra* note 14 at 494 (“If the firm is sufficiently large, the benefits of effort (which are proportional to firm size) swamp the costs [which are proportional to CEO pay], and so maximum effort is always optimal”).

¹⁴⁴ Ernst G. Maug, Alexandra Niessen-Ruenzi and Evgenia Zhivotova, *Pride and Prestige: Why Some Firms Pay Their CEOs Less* (Working Paper, 2012) (finding that on average compensation is 9% lower amongst firms in Fortune’s ranking of America’s most admired companies).

¹⁴⁵ Frank, *Marginal Product?* (1984) *supra* note 114 at 551 (“when wage schedules are less steep than the standard textbook wage schedule, there results a clear, positive relationship between a worker’s status in the income hierarchy of his firm and the extent to which his wage understates his marginal product.”)

¹⁴⁶ See, Marko Tervio, *Superstars and Mediocrities: Market Failure in the Discovery of Talent*, 76 REV. ECON. STUD. 829 (2008)

How much should the raise be? The proper amount which will appropriately balance the costs and benefits depends on an evaluation of the tradeoff between countervailing effects. Incentives for effort increase with the amount of the wage spread while direct wage costs also increase.¹⁴⁷ As the marginal product of effort decreases, the incentive to gain further advantage through cheating, sabotage¹⁴⁸, collusion¹⁴⁹, manipulating performance measures, or by peddling influence¹⁵⁰ increases. The likelihood of cooperative action in team based production also decreases with the amount of the promotion wage spread¹⁵¹, as does the employees' loyalty to the company.¹⁵² People base their feelings of equitable treatment on how their rewards compare to those of other referent peers, more so than they do the absolute amount of the reward.¹⁵³ After an executive is promoted and receives a raise, others may feel inequitably treated by their now relatively low pay. Dysfunction, disloyalty and workforce instability can result. In reaction to inequitable rewards, people are likely to respond to their dissatisfaction by either decreasing their input (effort, or participation) or increasing their effective compensation through theft or other means (perk consumption).¹⁵⁴

¹⁴⁷ Lazear, *Rank-Order Tournaments* (1981) *supra* note 123

¹⁴⁸ Edward P. Lazear, *Pay Equality and Industrial Politics*, 97 J. POL. ECON. 561 (1989).

¹⁴⁹ Ronald A. Dye, *Inside Trading and Incentives*, 57 J. BUS. 295 (1984).

¹⁵⁰ Paul Milgrom and John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. 154 (1988); Canice Prendergast and Robert H. Topel, *Favoritism in Organizations*, 104 J. POL. ECON. 958 (1996).

¹⁵¹ Jeffrey Pfeffer and Nancy Langton, *The Effect of Wage Dispersion on Satisfaction, Productivity, and Working Collaboratively: Evidence from College and University Faculty*, 38 ADMIN. SCI. Q. 382 (1993) (finding that increased wage dispersion was related to diminished cooperation and productivity); Edward P. Lazear, *Pay Equality and Industrial Politics*, 97 J. POL. ECON. 561 (1989) (pay differences should be minimized "when workers have the ability to affect each other's output"); Donald C. Hambrick, *Fragmentation and the other problems CEOs have with their top management teams*, 37 CALIF. MGMT. REV. 110 (1995) (describes top management team fragmentation which results in a tendency to focus on individual rather than organizational objectives)

¹⁵² Matt Bloom and John G. Michel, *The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover*, 45 ACAD. MGMT. J. 33 (2002) (finding that pay dispersion was related to lower tenure and a higher likelihood of turnover)

¹⁵³ James B. Wade, Charles A. O'Reilly III, and Timothy G. Pollock, *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, 17 ORG. SCI. 527 (2006) (arguing that a CEO's salary is a key referent for employee determination of fairness); Frank, *Marginal Product?* (1984) *supra* note 114 (considering equity concerns in relation to his exposition on status, suggesting how they may be valued).

¹⁵⁴ See J. Stacy Adams, *Inequity In Social Exchange*, 2 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 267 (1966)

Baker and Holmstrom found an average wage premium of about 18-47% between hierarchical organizational level, but because wage patterns exhibited significant serial correlation, the immediate jump in pay was only about 7%.¹⁵⁵ The spread between the pay of CEOs and the next highest paid executive is much greater; S&P 500 CEOs earn, on average, 2.4 times as much as the next highest compensated executive at the firm.¹⁵⁶ These symptoms of an unbalanced pay spread can result in underperformance, likely because of strained team dynamics, excessive turnover, or poor incentives. James Wade, Charles O'Reilly, and Timothy Pollock found a cascading effect where CEO overpayment led to overpayment at the lower levels in the organization. Employees who were underpaid *relative* to the CEO were more likely to leave as well.¹⁵⁷ This “ripple” effect of high wages was anticipated by Robert Frank, who, while not addressing CEOs, considered it a reason why highly valued geologists or some junior executives started their own firms rather than work within a larger corporation.¹⁵⁸ Other studies have shown that wage dispersion has a negative effect on the performance of individuals lower in the pay distribution,¹⁵⁹ and dispersion in top management compensation has been linked to lower firm performance and other unfavorable outcomes. These studies find strong association between high pay

¹⁵⁵ George Baker and Bengt Holmstrom, *Internal Labor Markets: Too Many Theories, Too Few Facts*, 85 AM. ECON. REV. 255 (1995)

¹⁵⁶ Subodh Mishra, *Bridging the Pay Divide: Trends in C-Suite Pay Disparities*, ISS CORPORATE SERVICES, WHITE PAPER (November 2, 2011). Relative pay increases may be expected to remain constant throughout an organization, Herbert A. Simon, *The compensation of executives*, 20 SOCIOMETRY 32, 33 (1957) (“an executive’s salary “should” be *b* times the salary of his subordinates, no matter what his level... the “rule of proportionality” receives prominent attention in most discussions of executive compensation, and its correctness as a norm is excepted more or less as a truism.” He suggests the appropriate multiple at the time was between 1.25-2). We are left to wonder why such a disparity exists between the increase given to CEOs and that given throughout the organization. This disconnect is also evident in international pay comparisons, Thomas, *International Pay Gap* (2004) *supra* note 13 at 1183 (While U.S. CEOs are paid more than twice as much as international CEOs, when “looking at lower level managers, this pay gap shrinks.)

¹⁵⁷ James B. Wade, Charles A. O'Reilly III, and Timothy G. Pollock, *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, 17 ORG. SCI. 527 (2006).

¹⁵⁸ Frank, *Marginal Product?* (1984) *supra* note 114.

¹⁵⁹ Jerald Greenberg, *Equity and workplace status: a field experiment*, 73 J. APPLIED PSYCH. 606 (1988) (a group of employees assigned to a lower status office lowered their performance while those assigned to a higher status office increased their performance); Matt Bloom, *The Performance Effects of Pay Dispersion on Individuals and Organizations*, 42 ACAD. MGMT. J. 25 (1999) (greater pay dispersion had a negative effect on the performance of baseball players at lower levels in the pay distribution. Compressed pay dispersions were positively related to both individual and team performance).

and lower firm value.¹⁶⁰ Lucian Bebchuk, Martin Cremers, and Urs Peyer examine the “CEO Pay Slice,” (CPS) or the proportion of the aggregate top-five compensation which is awarded to the CEO. A higher CPS is associated with lower firm value as measure by Tobin’s *q* and stock returns.¹⁶¹ Another study, by Michael J. Cooper, Huseyin Gulen, P. Raghavendra Rau, found a negative relation between pay and subsequent stock performance. An executive being paid in the top ten percent predicted future *negative* abnormal stock returns. In their sample, the companies employing such executives underperformed over the next five years by 13%.¹⁶² The costs to excessive pay are likely orders of magnitude higher than would be suggested by a mere analysis of the comparatively low amounts transferred to CEOs personally. While inducing competition is healthy for the incentive structure, the risk of creating incentive for misbehavior should be considered. For this reason, pay spreads should be moderated.

Just as paying the CEO less than they would expect may result in bad reactions by an executive, it is clear that paying more could result in bad reactions from other employees.¹⁶³ These two potential costs ultimately must be balanced. But, it must be recognized also that while boards have it within their power to prevent such problematic conduct on the part of an executive by careful monitoring and discipline, when such conduct is pervasive throughout the organization it is a much more pernicious problem.

¹⁶⁰ E.g., James W. Fredrickson, Alison Davis-Blake, WM. Gerard Sanders, *Sharing the wealth: social comparisons and pay dispersion in the CEO’s top team*, 31 STRATEGIC MGMT. J. 1031 (2010) (finding that TMT pay dispersion was negatively related to firm performance); Mason A. Carpenter and WM. Gerard Sanders, *Top management team compensation: the missing link between CEO and firm performance?*, 23 STRATEGIC MMT. J. 367 (2002) (finding that firms in which executives other than the CEO were underpaid had lower performance); Douglas M. Cowherd and David I. Levine, *Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory*, 37 ADMIN. SCI. Q. 302 (1992) (finding that pay dispersion negatively related to product quality in manufacturing firms).

¹⁶¹ Lucian A. Bebchuk, K.J. Martijn Cremers, and Urs C. Peyer, *The CEO Pay Slice*, 102 J. FIN. ECON. 199 (2011).

¹⁶² Michael J. Cooper, Huseyin Gulen, P. Raghavendra Rau, *Performance for pay? The relationship between CEO incentive compensation and future stock price performance* (Krannert Graduate School of Management, Working Paper, 2009); Matt Bloom and John G. Michel, *The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover*, 45 ACAD. MGMT. J. 33 (2002) (finding evidence that high wage dispersion leads to lower managerial tenure and more turnover); Jeffrey Pfeffer and Nancy Langton, *The Effect of Wage Dispersion on Satisfaction, Productivity, and Working Collaboratively: Evidence from College and University Faculty*, 38 ADMIN. SCI. Q. 382 (1993) (finding evidence that faculty productivity and collaboration are adversely affected by wage dispersion in universities).

¹⁶³ A large pay gap often results in negative evaluations by external constituents as well, GMI Rating AGR score and the scores given by credit ratings agencies are adversely effected by a large difference between CEO pay and that of the next highest paid employee; GMI Ratings, *Sample Report* (2012) (available at <http://www3.gmirathings.com/wp-content/uploads/2012/04/agr-esg-combined.pdf>) (including internal pay equity as an accounting and governance risk factor); *Analysing Credit and Governance Implications of Management Succession Planning* Moody’s Corporate Governance 4 (May, 2008) (a lack of internal pay equity is associated with CEO succession risk).

The ability to ferret out such misconduct is seriously constrained when it affects the entire company.

A board must consider all the costs of high CEO pay to the company. It must recognize that what may seem an almost immaterial transfer of wealth, a few additional millions to the CEO, can have a much more significant effect on the organization as a whole. By disrupting the internal incentive structure, which is essential to the performance of the company, the costs borne as a result of high pay may be both intolerably high and difficult to mitigate.

C. Board Guidance

As we have discussed, the chief executive's pay profoundly affects the entire incentive structure of the organization and must be carefully considered. A board which neglects to take into account these many complex costs in determining appropriate compensation has not functioned appropriately. Sole consideration of the executive's need to be paid at the level of their peers, to the neglect of the other factors, through a sole reliance on the assurances of the peer benchmarking process surely does not address these concerns. A simple peer group analysis is insufficient.

As this benchmarking process has become universally accepted and applied, even the most independent, shareholding boards can and do utilize such comparative metrics in setting pay. But, as we have discussed, not only is this reliance unjustified, as the historical and theoretic underpinnings of the process are questionable, but exclusive use has led and will continue to lead to the steady increase in compensation- whether applied by a model board or not. The judicial, legislative, regulatory, and investor communities must recognize this fact and respond appropriately. When asked to review compensation courts typically examine the process by which boards have reached their compensation decisions.¹⁶⁴ Because the compensation levels which result from the near-exclusive use of a peer process are problematic and somewhat arbitrary, judicial acquiescence or approval of such a process must be reconsidered. As we have demonstrated, boards which rely exclusively upon these metrics in setting CEO compensation levels have not properly and sufficiently informed themselves about the internal demands of the organization in question. A more nuanced approach should be encouraged by the courts, regulators and investors.

Ultimately, setting compensation should not be mechanistic. It is, correctly determined, the product of objective factors and nuances. The key to an effective process is a group of directors who are appropriately objective and motivated so as to consider the money involved their own and reach a reasoned conclusion as to the amount of

¹⁶⁴ Charles M. Elson, *The Duty of Care* (1994) *supra* note 11; Randall S. Thomas and Kenneth J. Martin, *Litigating Challenges to Executive pay: An Exercise in Futility?*, 79 Wash. U L. Q. 569, 603 (“monitoring of compliance with contractual terms and processes is often done by judges.”)

appropriate pay. Shareholders elect directors for their good and objective judgment, not the mechanical and rote application of some formula—otherwise why engage directors? In an invigorated process, benchmarks should be seen as merely a single data point amongst many other necessary factors which must be considered by directors.

But how should the process function? Setting pay is an art not a science. In commissioning a work of art or music, one does not attempt to replace the artist's judgment with their own- dictating the precise technique or form. Likewise, our suggestions for setting pay propose only general guiding principles so as not to unduly constrain the art or judgment of the directors, who are most informed on the matter, by overly prescriptive rules. Directors should be prepared to build their analysis around the following principles, in order to best meet the needs of their particular company.

As a starting point, the board should be properly comprised and incented so as to ensure their ability to effectively negotiate with management over pay. They must be independent of management and possess a personally meaningful equity stake to ensure that compensation is negotiated in earnest. An improved board-level review of executive pay must begin with this fundamental foundation. Additionally, the flexibility inherent in the negotiation must be recognized. The risk of a chief executive actually departing because of a compensation issue is less than usually suggested by the "competitive" benchmarking rhetoric or the executives themselves. An over-reliance on peer group analysis and median targeting then invites an unwarranted complacency. Given the flexibility involved, directors have an obligation to exercise their discretion effectively.

Boards are currently predisposed to bias pay upward; a few million dollars more to meet an executive or peer group demand, seems immaterial to a large corporation. This assessment is superficial. The expense borne far exceeds the visible payment; the effects upon the organization's cost and incentive structure can be difficult to mitigate and substantial in total. The bias should be in the other direction, for lower not higher pay. An executive who is disappointed by their pay is a problem which is visible and easily managed by a board, while the damage to morale and motivation from excessive CEO compensation is borne throughout the organization and difficult to resolve.

Review of an executive's compensation should be done within the context of the organization as a whole. The executive is, after all, an employee of the corporation. Their pay should be considered as an extension of the infrastructure which governs the rest of the company's wage structure. Internal consistency, or pay equity, throughout the organization, up to and including the CEO, should be a natural and reasonable objective. Their pay should not be considered as separate from the structures which govern that of other employees but should be built upon the same foundations and precepts. Participation in bonus pools in kind with other employees may be helpful in inducing this mindset. If approached from this perspective, full consideration of both the overt and the hidden costs to CEO compensation will result. Board ratification of the executive's contract should not be viewed singularly; it is an implicit examination and approval of the entire organization's wage and incentive structure. The most effective contract is one which is consistent with the structure and values of the corporation. Current peer grouping practice assumes that

internal consistency must succumb to market pressure when setting CEO pay. We believe these market concerns are overblown; internal consistency can and should be restored.

For many years, the DuPont Company was well known in compensation circles for its highly regimented internal pay equity plan for its CEO's compensation. Edgar S. Woolard, Jr., the Chairman and CEO, writing several years ago described the approach taken: "We're going to look at the people who run the businesses, who make decisions on prices and new products with guidance from the CEO—the executive vice presidents—and we're going to set the limit of what a CEO in this company can be paid at 1.5 times the pay rate for the executive vice president." This very simple and intuitive approach seemed equitable to him.¹⁶⁵ The company was successful at both retaining executive talent and returning shareholder value. This balanced approach to CEO pay formulation is certainly worth serious consideration.¹⁶⁶

Typically, CEO compensation is renegotiated annually. It may be appropriate to adjust the level of pay for the changing circumstances. Some general yearly accretion in CEO compensation is necessary, just as for any other employee. Adjustments must be made for inflation, wealth effects, and changes in external marketability. Inflation erodes the value of compensation levels and may diminish it below previously bargained for amounts. Inflation adjustments are generally advisable. As wealth increases the utility of leisure (from retirement or shirking) increases, and the opportunity cost of effort increases in turn. As a CEO's tenure and accumulated wealth increase, additional compensation may be necessary to induce them to continue supplying full-effort and to allow for more powerful incentives. Also, a prior-track record of successful performance may increase the external marketability and the outside opportunities of the executive, conditional on the factors we have previously mentioned. Marginal increases to pay may be appropriate in this situation and especially necessary where a credible outside offer has actually been received.

How past performance should effect executive compensation is an issue which, again, calls for careful evaluation by a board. Much of an executive's prior performance has previously been rewarded through compensation in accordance with prior contractual commitments. When objectives are met, bonuses are paid. When stock price accretion is achieved the value of an executive's equity holdings increase in turn. A board is not obligated to reward performance further by increasing the level of compensation in the next period. The prior contractual arrangement was beneficial to both parties and, with the exception of the general adjustments mentioned above, there should be no problem with entering into a similar agreement upon the level and structure of pay again. However, performance which far exceeds expectations may not be adequately compensated for

¹⁶⁵ Edgar S. Woolard, Jr., *The Myths of Executive Compensation*, DIRECTORS AND BOARDS: BOARDROOM BRIEFING 6 (Winter 2005).

¹⁶⁶ Of course, a universal application of this standard is equally mechanical. There is however, no dirt in practice or academe of potential methods of compensation determination, *see* Michael Abramowicz and M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 U. NOTRE DAME L. REV. 1343 (2007). We leave it to the board of directors to determine the most appropriate approach.

within the previously agreed upon contractual limits. In such instances increasing compensation levels as further reward is certainly acceptable, so long as the reward is related to ensuring the proper motivation and incentive of the executive. An executive who went beyond the call of duty and delivered results beyond expectations must be given assurances that further exceptional efforts will be rewarded in kind.

Performance should be measured and evaluated on the basis of both internal and external considerations. Internal data points make reference to performance in relation to historic company, and the achievements of milestones and targets deemed necessary towards broader corporate strategic objectives. For example, a board who views customer satisfaction as integral to their future competitive strength and has stressed its importance to the CEO may take the results of customer surveys into consideration. Where, as a result of the executive's initiative, a marked improvement upon past trends is seen in these survey results the board should take note and reward the executive accordingly. Other internal performance metrics involved in setting expectations and evaluating results include revenue growth, cash flow, or various measures of return, to name a few. Bonuses and incentive pay-outs, as initially contracted, should reward the achievement of various objectives related to these factors. Where expectations are exceeded, additional reward through adjusting compensation levels may be warranted in accordance with achievement over short and extended periods.

Additionally, external references may be important to evaluating an executive's achievement of the continuing or improving competitiveness of the enterprise and be relevant to the provision of additional compensation. While we find peer targeting to be problematic, performance peer groups are necessary to a rigorous evaluation. Of course, they must be honestly and objectively constructed. Such external evaluations are important in determining relative success or merit. Where internally directed analysis may be helpful in determining the extent of an executive's success, a relative comparative judgment must often be made as well. If Pepsi's performance far exceeded that of Coca-Cola, their CEO certainly may deserve more generous compensation. Appropriately utilized, external metrics are helpful to a board.

CONCLUSION

The external benchmarking of executive compensation has contributed significantly to the problem of high and rising pay in the United States. It is increasingly apparent that the pay awarded to chief executives is becoming profoundly detached from not just the pay of the average worker, but also from the companies they run. Offsetting the external focus, which is so heavily relied upon today, with internal metrics and internal benchmarking may help to curb the persistent escalation. We hope that if directors are no longer constrained by notions of “competitive” pay, which are driven by the false belief that CEOs are interchangeable, they may have the space to rationalize the upward spiraling pay ratchet and deliver what is more shareholder acceptable compensation. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.

A hard and honest focus on the company itself and the accomplishments of the executive in question by the board, rather than blithely looking externally to other organizations, will best serve the company’s and the shareholder’s interests. Through this careful focus, any potential difficulties and costs can be mitigated. Likewise, regulators and the courts must recognize the dangers inherent in over-reliance on the flawed peer process by boards and adjust their approaches to the pay issue accordingly. Deemphasizing the peer group process in setting pay may not prove the comprehensive cure to the overcompensation problem, but the costs of pursuing this approach are minimal and it is a good beginning.