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## Have Boards Been Bargaining at Arm's Length?

The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own . . . cannot well be expected . . . [to] watch over it with the same anxious vigilance [as the owners themselves].

Adam Smith, 1776

**T**HE ARM'S-LENGTH CONTRACTING view recognizes that executives do not automatically serve shareholders. It concedes that executives might well act in ways that suit their own interests—a tendency that proper incentives and board oversight are supposed to curb. But the arm's-length model implicitly assumes that, unlike corporate executives, corporate directors can be relied on to serve shareholders.

Given that executives do not instinctively seek to maximize shareholder value, however, there is no reason to expect a priori that directors will act in this way. Directors' own incentives and preferences do matter. Directors have financial and nonfinancial incentives to favor, or at least to get along with, executives. A variety of psychological and social factors reinforce these incentives. Because directors hold only a tiny fraction of the firm's shares, their holdings are insufficient to outweigh their incentives and tendencies to side with executives. In any event, directors have thus far had neither the time nor the information necessary to serve shareholder interests when determining executive compensation.

The pay-setting process is, of course, better in some firms than in others. However, significant deviations from arm's-length contracting have been common in widely held public companies. And while recently adopted stock exchange requirements will probably somewhat improve pay-setting processes, they are unlikely to eliminate substantial and widespread deviations from arm's-length contracting.

## The Pay-Setting Process

We begin our exploration of the limitations of the arm's-length model with a brief description of the pay-setting process in large public corporations. The board of directors is responsible for determining the compensation of the CEO and other top executives.<sup>1</sup> Boards of large public companies delegate to compensation committees the task of working out the critical details of executive compensation arrangements.

The compensation committee has typically been composed of three or four directors.<sup>2</sup> For some time now, most directors serving on compensation committees have been "independent." Directors are generally considered independent if they are not current or former employees of the firm and are not affiliated with the firm other than through their directorship. The Investor Responsibility Research Center reported that 73 percent of the S&P 1500 compensation committees surveyed during 2002 were fully independent.<sup>3</sup>

Tax rules and court decisions have contributed to the widespread use of compensation committees made up exclusively of independent directors. Since 1994, the federal tax code has penalized corporations lacking such committees; publicly traded corporations have not been permitted to deduct pay in excess of \$1 million annually per executive unless the excess compensation either consists of options or is based on the achievement of performance goals that have been established by a compensation committee composed solely of independent directors.<sup>4</sup> Courts have generally upheld compensation arrangements recommended to the board by a compensation committee composed of independent directors. Thus, the use of such a committee has largely insulated board compensation decisions from judicial review.<sup>5</sup>

Although already very common, the presence of independent directors on boards and on compensation committees in particular is expected to grow because of the listing requirements adopted by the NYSE, NASDAQ, and AMEX and approved by the Securities and Exchange Commission (SEC) in 2003.<sup>6</sup> These new provisions require the boards of most publicly traded companies to have a majority of independent directors.<sup>7</sup> Under the NYSE rules, each company must have a compensation committee composed only of independent directors. Under the rules of the other two exchanges, the CEO's compensation must be determined or recommended to the board by a majority of independent directors or a compensation committee composed solely of such directors. The stock exchange requirements also establish standards for determining independence.

Although these new requirements have attracted a great deal of attention, it is important to keep in mind that they merely make mandatory a practice that most public companies already have been following for some time. Thus it seems unlikely that these new requirements, by themselves, will greatly change the relationship between executives and their boards. Indeed, there are good reasons to doubt that the mere presence of independent directors on the board and on the compensation committee can ensure a pay-setting process that approximates arm's-length bargaining.

### **Directors' Desire to Be Reelected to the Board**

A director receives a number of benefits from serving on a board. First, a board seat provides direct financial benefits. In most cases, these benefits are likely to be economically significant to the director. Like executive pay, director pay rose dramatically with the stock market. In 2002, director compensation averaged \$152,000 in the largest 200 companies and \$116,000 in the largest 1,000 companies.<sup>8</sup> There are often additional perks and indirect benefits; for example, directors of UAL Corp. (which owns United Airlines) can fly United free of charge, and directors of Starwood Hotels get complimentary nights in company hotels.<sup>9</sup> Moreover, a board seat often provides directors with prestige and with valuable business and social connections. The financial and nonfinancial benefits of holding a board seat give directors a strong interest in keeping their positions.

That directors have a desire to be reelected is clear. The question, then, is what incentives this desire provides. According to the official view, the desire to be reelected by shareholders should make directors attentive to shareholder interests; the better their performance, the argument goes, the more likely they are to win reelection.

In reality, however, candidates placed on the company's slate by the board have been virtually assured of being reelected. Dissident shareholders contemplating putting forward their own director slate have confronted substantial obstacles.<sup>10</sup> As a result, the director slate proposed by the company has almost always been the only one on the ballot. In a recent empirical study of the seven-year period 1996–2002, we document that, outside the context of hostile takeovers, the incidence of electoral challenges to the board's slate was practically nonexistent—no more than two a year among firms with a market capitalization exceeding \$200 million.<sup>11</sup>

The key to a board position is, therefore, getting one's name on the

company slate. And, at least thus far, CEOs have had considerable and sometimes decisive influence over the nomination process.<sup>12</sup> Most boards have had a nominating committee, but while compensation committees have for some time been composed mostly of independent directors, this has not been true for nominating committees. Indeed, CEOs have often served on these panels.<sup>13</sup> A 2002 survey found that among the S&P 1500 firms that had a nominating committee, only 50 percent were fully independent.<sup>14</sup>

Even CEOs not formally serving on the nominating committee have had a significant influence on the nomination process.<sup>15</sup> Boards and nominating committees have been unlikely to nominate a director clearly opposed by the CEO. At a minimum, CEOs have had considerable power to block nominations. Thus, sparring with the CEO over executive compensation could have only hurt a director's chances of being renominated to the board. "Going along" with the CEO's pay arrangement has been a much safer strategy.

Under the NYSE's new listing requirements, the firm must have a nominating committee staffed solely with independent directors. NASDAQ's new listing provisions require that director nominees be selected or recommended either by a majority of the independent directors or by a nominating committee composed solely of such directors.<sup>16</sup> These requirements might significantly reduce CEOs' influence over the nomination process. But taking care not to upset the compensation apple cart may well remain the best bet for remaining on a company's slate.

Even if the CEO's power over director nomination declines, the CEO's wishes can be expected to continue to influence the decisions of the nominating committee; after all, the directors appointed to the board will have to work with the CEO. Indeed, experts interviewed by the *Wall Street Journal* have advised boards to consult with management on the independent nominating committee's choices. And, as a lawyer who has served on the boards of several public companies said, "I think as a practical matter, few new directors would accept without knowing that the CEO is enthusiastic about the decision. . . . No one likes to go to the boardroom thinking they've been imposed on the CEO."<sup>17</sup>

Even if the CEO had no influence over nominations, fighting with the CEO over the amount or performance sensitivity of compensation might be viewed unfavorably by independent directors on the nominating committee. These directors might prefer to exclude an individual whose poor relationship with the CEO undermines board collegiality. They might also

wish to avoid the friction and unpleasantness likely to accompany disputes over the CEO's compensation. Finally, the directors might side with the CEO for other reasons to be discussed below.

To be sure, the effect of the new stock exchange regulations boosting the role of independent directors in the nominating process will become clear only with time. At this stage, however, it appears likely that as long as the key to board appointment remains being on the company's slate, the safest strategy for directors wishing to keep their board seats will be to avoid challenging CEO compensation. This state of affairs would be likely to change, we believe, only under fundamental reforms that give shareholders a more meaningful role in the selection of directors.

### **CEOs' Power to Benefit Directors**

Putting aside the issue of reelection to the board, directors, including independent directors, have other economic incentives to be on good terms with the CEO. CEOs have a great deal of power apart from their influence over board nominations. They have substantial control over the firm's resources, and their position sometimes gives them significant influence outside the firm. CEOs can use this power to benefit individual directors directly or indirectly. In the past, CEOs have displayed considerable willingness to use their power to reward friendly directors in myriad ways. And the new stock exchange criteria for "independent directors," discussed in detail below, reduce but do not eliminate the CEO's ability to benefit independent directors.

### ***Current and Past Practices***

In the wake of the high-profile corporate scandals beginning in late 2001, evidence emerged suggesting that some CEOs had effectively bought off directors by providing them individually with special perks or monetary benefits.<sup>18</sup> While the practice of business dealings with directors has received much attention in the cases of companies tainted by scandal such as Enron, WorldCom, and Tyco, it has hardly been limited to such companies. Many other firms have also engaged directly and indirectly in such business dealings.<sup>19</sup> For example, Verizon's 2001 board included an executive director of Boston Consulting Group, which received \$3.5 million from Verizon for services in 2000; the CEO of a railroad that was paid \$650,000 by Verizon for services and products; and two attorneys from

law firms that provided Verizon with legal services. Bank of America's 2001 board included high-ranking officials from three property businesses that received \$3.47 million from the bank in rental fees the previous year.

Companies expend billions of dollars annually on charitable contributions,<sup>20</sup> and CEOs have used their power to direct contributions to benefit directors. It has been common practice for companies to make charitable contributions to nonprofit organizations that employ or are headed by a director. Verizon contributed hundreds of thousands of dollars annually to the National Urban League, whose head sat on Verizon's board.<sup>21</sup> Oracle, which has on its board three Stanford University professors and a Stanford alumnus who is active in the university's affairs, has been making large contributions to the university.<sup>22</sup> Furthermore, to reward directors who are not employed by charities, CEOs have used their power to direct contributions to those directors' favored charitable organizations.<sup>23</sup> Enron, for example, donated millions of dollars to some of its directors' favorite causes.<sup>24</sup>

### *The New Independence Standards and Their Limits*

The listing standards adopted by the stock exchanges in 2003 will in the future place some limits on CEOs' ability to reward independent directors.<sup>25</sup> However, these standards leave CEOs with substantial power in this area. To begin with, the rules do not prohibit a firm from giving directors compensation on top of their director fees; rather, they only limit the amount of such compensation. Under the NYSE listing standards, for example, directors can still be considered independent even if they receive up to \$100,000 a year in such additional compensation, hardly a negligible amount for many directors.<sup>26</sup> Moreover, under the NYSE requirements, compensation given to an immediate family member who is a nonexecutive employee of the company would not count toward this \$100,000 limit.<sup>27</sup>

Similarly, the new stock exchange requirements limit but do not prohibit business dealings between a company and a firm associated with one of its independent directors. Under the NYSE standards, a director who is an officer or an employee of another business is presumed to be independent as long as the other business receives from the company less than \$1 million annually (and less than 2 percent of the other firm's gross revenues).<sup>28</sup> Business dealings below this ceiling might well be economically significant for many directors. Consider a partner in a large New York law firm who is both a director of a company and one of its outside

lawyers, for which the partner's law firm receives \$900,000 each year. This amount of business might well matter to the director, even if it represents less than 2 percent of his or her law firm's gross revenues.

Now consider a member of a company's board who is a partner in a law firm that is not currently providing services to the company. This lawyer still has an economic incentive to remain on good terms with the CEO because the company could be a future client. Fighting with the CEO over compensation is hardly a good way to get the company's legal business. Of course, if the company ends up giving a large amount of business to the lawyer's firm—say, work on acquisitions with many millions in fees—then the partner will no longer be able to qualify as an independent director. The point, however, is that the possibility of such future business might affect the lawyer's economic incentives even while the lawyer is still an independent director. This point also highlights how difficult it is to prevent directors who have ties to a business from being influenced by the CEO's power over the company's resources.

As for charitable contributions, the NYSE standards make it clear that the \$1 million limit on business dealings does not apply to charitable contributions. A director who is an officer or employee of a charitable organization can still be considered independent even if the firm on whose board the director sits contributes more than \$1 million to that organization. The only requirement is that the contributions be disclosed.<sup>29</sup> And even disclosure is not necessary when the firm contributes to a charitable organization at the suggestion of a director who is not an officer or an employee of that organization.

Should the above problems be addressed by tightening the tests of director independence? When we examine the subject of future reforms in the concluding chapter, we argue that even complete director independence from executives would be insufficient to ensure board accountability to shareholders; some dependence on shareholders is essential. For the purpose of understanding the current landscape of executive compensation, however, it is important to recognize that director independence has in the past been compromised by CEOs' ability to confer significant rewards on directors, and that recent reforms diminish but do not eliminate their ability to do so.

### *Interlocks*

When a director is an executive at a firm on whose board the CEO sits, the CEO has another channel for rewarding the director. In this case, the

CEO can benefit the director by using whatever influence the CEO has as a member of the other company's board.

The considered case—usually referred to as “interlocking directors”—is not as rare as one might imagine. According to one study, in approximately one out of every 12 publicly traded firms, the board is “current CEO–interlocked”—that is, the CEO of Firm A sits on the board of Firm B, and the CEO of Firm B sits on the board of Firm A.<sup>30</sup> The study also finds that, as might be expected, CEO pay has been larger in companies with interlocking directors.

The new stock exchange requirements reduce but do not eliminate the potential influence of interlocks on independent directors. Under these requirements, a director of Firm A who is an executive of Firm B cannot be considered independent if A's CEO (or any other of its executives) serves on B's compensation committee. However, the director of Firm A can be considered independent if A's CEO serves on Firm B's board but not on B's compensation committee. The presence of Firm A's CEO on Firm B's board might well still have an effect on the director's interests; A's CEO could be an important voice on B's board either for or against decisions favored by the director. For this reason, we expect that the practice of interlocking directors will continue to provide CEOs with another source of influence over certain directors.

### *Director Compensation*

Directors have a natural interest in their own compensation, which CEOs may be able to influence. As the company leader, usually as a board member, and often as board chair, the CEO has some say over director compensation. Although recommendations concerning director compensation are usually made by the compensation committee, the CEO can choose to either discourage or encourage director pay increases. Independent directors who are generous with the CEO might reasonably expect the CEO to use his or her bully pulpit to support higher director compensation. At a minimum, generous treatment of the CEO contributes to an atmosphere that is conducive to generous treatment of directors.

A study by Ivan Brick, Oded Palmon, and John Wald finds that companies with higher CEO compensation have had higher director compensation as well.<sup>31</sup> To be sure, high CEO and director compensation may reflect the fact that a firm is particularly difficult to run, that there is a

shortage of people capable of running it, or that the firm is doing so well that the board believes both the CEO and its own members should be rewarded. But this study rejects these alternative explanations after finding that excess CEO and director compensation has been negatively associated with firm performance. This finding leads the researchers to conclude that collusion between directors and CEOs has driven the link between high director pay and high CEO pay.

## **Social and Psychological Factors**

Putting aside economic incentives and the desire to be renominated to the board, there are various social and psychological factors that encourage directors to go along with compensation arrangements that favor the company's CEO and other senior executives. These social and psychological factors reinforce the economic incentives to favor executives and can also affect directors who are not significantly influenced by such economic incentives. Most directors are likely to be subject to at least some of the social and psychological factors discussed below.

### ***Friendship and Loyalty***

Let us start with social and psychological factors that operate on directors as soon as they begin serving on the board. Many independent directors have some prior social connection to, or are even friends with, the CEO or other senior executives.

Even directors who did not know the CEO before their appointment may well have begun their service with a sense of obligation and loyalty to the CEO. The CEO often will have been involved in bringing the director onto the board—even if only by not blocking the director's nomination. With such a background, directors often start serving with a reservoir of good will toward the CEO, which will contribute to a tendency not to bargain aggressively with the CEO over pay. This kind of reciprocity is expected and observed in many social and professional contexts. Not surprisingly, Brian Main, Charles O'Reilly, and James Wade find that compensation committees whose chairs have been appointed after the CEO takes office have tended to award higher CEO compensation.<sup>32</sup>

### *Collegiality and Team Spirit*

The directors who negotiate with the CEO over compensation also work closely with the CEO, who is generally a fellow member of the board and often its chair. Whether or not a particular director was appointed during the CEO's reign, that director is likely to develop a personal relationship with the CEO as well as with other directors who may be even closer to the CEO.

In addition, except perhaps in times of crisis, the members of the board are expected to act collegially toward one another. According to a director who has served on the boards of several public companies, including Marriott Corporation, "It is hard to explain to a person who is not a director. It is in many ways a club."<sup>33</sup> While each board may have slightly different social rules, these norms tend to foster board cohesion. As Rakesh Khurana observed in his study of CEO hiring, there is on boards "a strong emphasis on politeness and courtesy and an avoidance of direct conflict and confrontation."<sup>34</sup>

Perhaps once or twice a year, members of the compensation committee must take off their hats as colleagues of the CEO and put on their hats as arm's-length bargainers with the CEO over his or her compensation. This switch is likely to be difficult even for well-meaning directors attempting to represent shareholders' interests in these negotiations. Evidence indicates that individuals working within a group feel pressure to placate group members, often at the expense of interests not directly represented at the table.<sup>35</sup> There is no reason to believe that the members of the compensation committee are immune to such pressure.

### *Authority*

The CEO is not merely a colleague of the directors. The CEO is the most important figure in the corporation—the leader whose decisions and vision have the most influence on the future direction of the firm. Thus, directors naturally tend to treat the CEO with respect. They accept the CEO's authority on many corporate matters and may even look up to the CEO.

Furthermore, on many decisions for the company, board members tend to defer to the CEO even when they have a different view. On many issues, the directors' role is to provide strategic advice and serve as a sounding board but not to overrule the CEO or make decisions for the

company. As long as the directors wish the CEO to remain, it makes sense not to force their views on the CEO but rather to let the CEO be in the driver's seat. And when some directors cannot in good faith continue to support a CEO who has the support of the rest of the board, they are expected to step down.<sup>36</sup>

Again, switching hats to bargain with the CEO over compensation is difficult. Directors who otherwise tend to treat the CEO with respect and deference will find it difficult to assume a true arm's-length bargaining posture when negotiating the CEO's pay.

### *Cognitive Dissonance*

In staffing compensation committees, companies have made substantial use of executives and former executives. In 2002, 41 percent of the directors on compensation committees were active executives, with about half of them active CEOs. Furthermore, another 26 percent of the members of compensation committees were individuals who had retired from their primary employment, and these retirees were for the most part former executives.<sup>37</sup>

The compensation decisions of directors who are or were executives themselves are likely to be affected by cognitive dissonance.<sup>38</sup> Individuals are known to develop beliefs that support positions consistent with their self-interest. These beliefs enable individuals to avoid the discomfort of enjoying benefits that they believe to be undeserved.

An executive or former executive who has benefited from generous and favorable pay arrangements is thus likely to have formed a belief that such arrangements are desirable and serve shareholders. For example, an executive who has benefited from, say, a conventional option plan is likely to support the view that such plans are an efficient form of compensation. Similarly, an executive who has or had a compensation agreement with generous severance provisions is unlikely to support the view that such provisions are undesirable or even counterproductive. Thus, the presence on the compensation committee of well-paid executives is likely to lead to higher pay. Indeed, Brian Main, Charles O'Reilly, and James Wade find a significant association between the compensation level of outsiders who serve on the compensation committee and CEO pay.<sup>39</sup>

Finally, cognitive dissonance might lead even independent directors who are not executives themselves to hold beliefs that are conducive to granting generous executive compensation. Directors will tend to err on

the positive side in assessing how well the company is doing relative to its industry peers, how capable their CEO is relative to the CEO's peers, and so forth. To be sure, cognitive dissonance may also impair the thinking of individuals who are the sole owners of their own firms. But such owners will bear significant personal costs if they let themselves be overly influenced by cognitive dissonance. In contrast, for most independent directors of public companies, the personal cost of favoring executives is rather small.

### **The Small Cost of Favoring Executives**

Economic incentives and psychological and social factors, we have seen, all lead independent directors to favor executives. The question, then, is whether there are countervailing forces that make favoring executives prohibitively costly for directors. Unfortunately, the potential costs to most directors of favoring executives are rather small. These costs can take two forms: (1) reduction in the value of any shares that the directors own in the corporation and (2) reputational costs to the directors.

#### *Reduction in the Value of Directors' Holdings*

Although stock-based compensation for independent directors has become the norm,<sup>40</sup> the fraction of the company's shares held by independent directors is commonly insignificant.<sup>41</sup> John Core, Robert Holthausen, and David Larcker found that half of the directors in their study owned 0.005 percent or less of the companies on whose boards they sat.<sup>42</sup> While these amounts might go up in the future,<sup>43</sup> most directors are likely to remain holding only a tiny fraction of the company's shares.<sup>44</sup>

As a result, directors commonly bear only a negligible fraction of the cost imposed by flawed compensation arrangements. Consider, for example, a director who owns 0.005 percent of the company's shares. And suppose that the director is contemplating whether to approve a compensation arrangement requested by the CEO that would reduce shareholder value by \$10 million. Given the director's fraction of total shares, the reduction in the value of the director's holdings that would result from approval of the CEO's request would be only \$500. Such a cost, or even one several times larger, is highly unlikely to overcome the various factors exerting pressure on the director to support the CEO's request.

Of course, although the cost of favoring executives is negligible for

most independent directors, it might not be so trivial for independent directors who own (or are appointed by those owning) a large block of shares. Such directors will bear more of the cost associated with distorted compensation arrangements and will be more likely to oppose them. This fact probably accounts for the evidence that CEO pay is lower, and the sensitivity of CEO pay to firm performance is higher, when compensation committee members hold a large amount of stock.<sup>45</sup>

### *Reputational Costs*

In theory, directors who approve compensation arrangements that benefit managers at the expense of shareholders could suffer a reputational cost. Prominent financial economists Eugene Fama and Michael Jensen have argued that independent directors have an incentive to safeguard shareholder interests in order to preserve and enhance their reputations as expert decisionmakers.<sup>46</sup> Fama and Jensen apparently have in mind those independent directors who are CEOs or hold other decision-making positions. For such directors, the value of their human capital would depend on their decision-management reputation. According to the Fama-Jensen view, by being effective guardians of shareholder value, independent directors can signal their expertise in decision control and boost the value of their human capital in their primary careers. Furthermore, it can be argued that developing a reputation as an effective guardian of shareholder interests will improve a director's chances of landing directorships in other companies.

We agree that directors' reputations and human capital, both in their primary positions and in the market for directors, could suffer should the board approve compensation arrangements that are subsequently regarded as egregious. For example, following the Enron scandal, outrage was directed against members of the Enron board.<sup>47</sup> There were calls for Dr. John Mendelsohn, one former Enron director, to step down from his position as head of the M. D. Anderson Cancer Center. There was also opposition to the reelection of another former Enron board member, Frank Savage, to the boards of Lockheed Martin and Qualcomm. In the end, Mendelsohn remained head of the M. D. Anderson Cancer Center, and Savage was reelected to both boards, although he eventually resigned from Qualcomm's. Perhaps anticipating similar battles, former Enron directors Wendy Gramm, Robert Jaedicke, and Herbert Winokur Jr. simply resigned from other board positions after the scandal broke.<sup>48</sup>

Although concerns about reputational costs arising from egregious compensation might place some limits on how far directors will be willing to go, these limits are hardly tight. As long as the pay arrangements approved by the board are within the range of what is considered conventional and acceptable, directors are unlikely to bear reputational costs. Consider a director who also is a CEO or executive of another firm. The compensation decisions of the board on which the director serves are unlikely to influence, or even be noticed by, those who might in the future seek to appoint the director to an executive position. Prospective employers are unlikely to have much information about the contribution of a particular independent director to a company's compensation arrangements. More important, prospective employers would likely focus on directors' performance in their primary, full-time executive positions rather than on their performance in an independent directorship.

The performance of an individual independent director would probably be of most interest to those considering appointing the director to the board of another corporation. Here, however, earning a reputation for challenging CEO compensation has been unlikely to help, and if anything has been likely to hurt the director's prospects of securing appointments to other boards. Recall that the key to a board seat is being included on the company's slate, which is put together by the board and its nominating committee. A reputation for challenging CEO compensation is likely to be viewed as a minus, not as a plus, by other firms' nominating committees.

The absence of reputational incentives to guard shareholder interests in the compensation context is thus a product of the director-selection process. In chapter 16, we suggest reforms that would give shareholders meaningful opportunities to select directors. Such reforms could create incentives for directors to develop a reputation for serving shareholders rather than executives. For now, however, we cannot count on the reputational mechanism to counter directors' economic incentives and natural inclinations to side with executives.

## **Insufficient Time and Information**

Even independent directors who for some reason wished to serve shareholders' interests in bargaining over the CEO's pay have usually lacked the time and information to do so.<sup>49</sup> Most independent directors have their own full-time careers. Independent directors have typically spent

little time focusing on the performance of the corporations on whose boards they sit. Surveys of board practices prior to the wave of corporate scandals that began erupting in late 2001 indicated that independent directors devoted only about 100 hours a year to each board.<sup>50</sup> Indeed, as Rakesh Khurana documents in his book on CEO hiring, boards have spent surprisingly little time even on the critical task of selecting a new CEO.<sup>51</sup>

In the last several years, the time that independent directors devote to their directorships has been increasing significantly. According to one estimate, in 2002 directors at Fortune 1000 companies spent about 190 hours on board service,<sup>52</sup> and the number of hours is expected to rise further. But one should keep in mind that the Sarbanes-Oxley Act and the increased formalization of board processes have also created additional demands on directors' time. Part-time independent directors will still be expected to spend a rather limited amount of time on the design and approval of complex compensation arrangements. A "best practices calendar" for corporate boards that one prominent law firm issued recently to its clients suggested that the compensation committee meet three days during the year, two days in January and one day in November.<sup>53</sup>

In addition to facing time constraints, many directors do not have the knowledge and expertise needed to properly evaluate the compensation arrangements they are asked to approve. Jeffrey Sonnenfeld, associate dean of Yale's School of Management, observed: "I work with several compensation committees, and I know that a lot of the time board members don't understand the complexity of the documents they're reviewing. People don't want to look foolish by asking how some of the instruments work."<sup>54</sup>

In reaching compensation decisions, independent directors have generally had to rely on information and advice provided by the firm's human resources department and by compensation consultants hired by the department; this reliance has further tilted matters in favor of executives.<sup>55</sup>

## Compensation Consultants

Directors have economic incentives and psychological tendencies that would probably produce outcomes favorable to executives even if the information and advice provided to the directors came from individuals focusing solely on shareholder interests. But the providers of information

and advice themselves have their own incentives to favor executives. This has been true not only for firms' human resources departments, which are subordinate to the CEO, but also for compensation consultants. Compensation consultants have faced strong incentives to please, or at least not to anger, the CEO. As Warren Buffet remarked, compensation consultants "had no trouble perceiving who buttered their bread."<sup>56</sup>

Typically, consultants have been hired through a firm's human resources department, and CEOs have often been involved in the selection process.<sup>57</sup> Even if the CEO has not been involved, the chosen consultant has understood that a recommendation that displeases the CEO may preempt the consultant's future employment. Moreover, executive pay consultants have usually worked for consulting firms that derived most of their income from other services to firms' human resources departments. The consulting firms often had, or at least could expect to get in the future, other assignments with the hiring company. One compensation consultant commented: "There are two classes of clients you don't want to offend—actual and potential."<sup>58</sup>

Finally, because their incomes have not been linked to shareholder value, compensation consultants have not borne any of the costs that favoring managers has imposed on shareholders; consultants could only benefit from using their discretion to favor the CEO. Two directors interviewed by *Fortune* under conditions of anonymity described the overall incentive structure of consultants in a rather blunt way:

I would say that it is unusual to find a consultant who does not end up, at the least, being a prostitute. The consultants are hired by management. They're going to be rehired by management.

Any other kind of consultant you can think of is brought in to try to cut costs. [However], the basic goal of compensation consultants is to justify whatever it is the CEO wants to make. After all, who's going to recommend these consultants to other CEOs?<sup>59</sup>

Compensation consultants' incentives are important because they have substantial discretion in performing their tasks. Consultants provide the data that underlie directors' compensation decisions. They also frame the issues and present the menu of choices. The limited time that directors have to devote to compensation decisions, and their lack of information and expertise, lead them to rely heavily on consultants' input. Thus, a tilt in favor of executives on the part of compensation consultants could

produce outcomes favorable to executives even if directors themselves did not have any incentives and tendencies to favor executives.

Among other things, consultants can favor the CEO by generating a mass of compensation data that “objectively” justifies the desired pay plan. For example, they have tended to design surveys to focus on comparative data that help make the case for higher pay.<sup>60</sup> When a firm did well, consultants pushed for high compensation, arguing that pay should reflect performance, and should therefore be higher than the industry average and certainly higher than the pay of CEOs who are doing poorly. When a firm did poorly, the consultants looked not to performance but rather to peer group pay norms to argue that the salary of the CEO should be higher to reflect prevailing compensation levels.<sup>61</sup>

In the future, compensation consultants may well be hired formally by compensation committees rather than by human resources departments. The NYSE’s new listing requirements require that the charter of the compensation committee provide it with the sole authority to retain the compensation consultant assisting it in evaluating executive compensation.<sup>62</sup> However, the human resources department may be a source of recommendations for such a consultant. And given that consultants make most of their money providing services to human resources departments, they will continue to have strong incentives to make a favorable impression on the human resources department and to avoid annoying the CEO. Thus the reforms might reduce, but not eliminate, the additional tilt produced by compensation consultants.

In any event, giving the compensation committee sole authority to hire the compensation consultant can at most make consultants pay attention to the wishes of the committee and not to those of the executives. The compensation consultants cannot be expected to have direct incentives to focus on the interests of shareholders. Thus, to the extent that directors continue to have incentives and tendencies to favor executives, consultants can be expected to assist them in doing so.

## Newly Hired CEOs

Boards approve CEO compensation both when the CEO is hired and during the CEO’s tenure. In a critique of our earlier work, Kevin Murphy claimed that incoming CEOs are unlikely to have much power over the board when they negotiate their first pay package. Even if there is no arm’s-length bargaining between boards and continuing CEOs, Murphy

argued, such bargaining takes place when CEOs are first hired, especially when they are hired from outside the company.<sup>63</sup> In our view, although negotiations with outside CEO candidates may have been closer to the arm's-length model than negotiations with incumbent CEOs, they still have deviated substantially from that model.

To be sure, some of the social and psychological factors leading directors to favor incumbent executives are absent when directors negotiate compensation arrangements with prospective outside hires. The CEO candidate was not involved in appointing any of these directors to the board. Therefore, the directors will not feel the sense of obligation and loyalty that they would feel to a CEO who supported their appointment to the board. In addition, the familiarity and collegiality that come with serving together on a board will not yet have developed.

It is nevertheless likely that bargaining over the compensation of outside CEO candidates has commonly been far from arm's length. Given that the CEO candidate will be the next CEO if the negotiations are successful, directors still have considerable incentive to please the candidate. The incoming CEO will have influence over the directors' reelection prospects and over the level of director compensation. The CEO will also be in a position to reward the directors.

Further, some of the social and psychological factors that cause directors to favor incumbent CEOs are equally present in compensation negotiations with an incoming CEO. Since directors will anticipate working closely and collegially with the incoming CEO, they will naturally want to get things off to a pleasant start. The self-serving cognitive biases that lead directors who themselves are well-paid executives to be generous with CEOs will apply equally in the case of a newly hired CEO. And, because directors typically own only a small fraction of the firm's stock, the financial cost to them of being generous to their new colleague and leader remains extremely low.

Finally, the time and information constraints that limit the abilities even of well-intentioned directors to bargain with incumbent CEOs have applied equally to board negotiations with outsiders. As Rakesh Khurana documents, directors are far from thorough even when selecting a new CEO.<sup>64</sup> The choice of CEO is often a more important factor for the future performance of the firm than is the particular pay arrangement with which the CEO starts. If directors put little effort into choosing the new CEO, they are unlikely to put much effort into bargaining over the CEO's compensation.

Furthermore, as in the case of incumbent CEOs, time constraints force directors considering a new CEO's pay to rely on the information and advice provided by the firm's human resources department and compensation consultants. Members of the department know that the person for whom they are designing the plan soon will be their boss. Compensation consultants have known that the incoming CEO would influence the decision of whether to continue using their services. Thus, both human resources departments and consultants have had an incentive to use their discretion to favor the new CEO.

Lastly, given the negative scrutiny that will be applied to the board if it fails to hire a replacement CEO in a timely fashion, it is in directors' interests to sacrifice hard bargaining to expedience. Acceding to the candidate's compensation demands minimizes the risk of offending the candidate or creating the impression that the board will be a tough taskmaster, thereby increasing the chances that the candidate will accept the offer. The board will not want to appear to have bungled the search by "losing" the person it thought was best suited for the job. In addition, directors will wish to complete the search process as quickly as possible to reduce the burden on them. At the same time, the cost to directors of giving in to a CEO candidate's extravagant compensation demands is trivial given their tiny stakes in the firm. Thus, directors personally have little to gain and much to lose from being a tough bargainer. In contrast, CEO candidates have every incentive to hold out for higher and less performance-sensitive pay in order to ensure that they will be well paid even when their own performance is poor. The combination of these factors operates to the benefit of newly hired CEOs.

### **The (Infrequent) Firing of CEOs**

The incidence of board firing of CEOs in the 1990s was somewhat higher than in earlier decades. This change has been attributed to the increased role of independent directors.<sup>65</sup> The willingness of some boards to fire poorly performing CEOs has received a fair amount of attention and has been regarded as a sign of improved corporate governance.<sup>66</sup>

Critics of our earlier work, such as *Wall Street Journal* columnist Holman Jenkins, have suggested that the increased willingness of boards to fire CEOs provides evidence that boards do in fact deal with CEOs at arm's length.<sup>67</sup> If boards are willing to go as far as firing CEOs, it is argued, surely they are capable of negotiating at arm's length over com-

pensation. But the phenomenon of forced CEO resignations fails to demonstrate the existence of an arm's-length relationship between managers and boards.

It is important to keep in mind that the incidence of firing is still extremely low. A study of more than 1,000 companies found that between 1993 and 1999, fewer than 1 percent of all CEOs resigned or were forced out each year because of poor performance.<sup>68</sup> Another study reports that the turnover of CEOs of public firms is significantly less sensitive to performance than the turnover of CEOs of corporate subsidiaries.<sup>69</sup> CEOs of public firms usually have to perform dismally or abuse their power in order to be fired. For the board to take such a step, there must usually be substantial outside pressure of the kind produced by a highly significant and visible managerial failure or unethical behavior.

Moreover, in the rare cases where CEOs are asked to resign, the board often provides them with gratuitous goodbye payments—payments and benefits on top of those required by the CEO's contract—to sweeten the departure. We discuss these gratuitous payments in detail in chapter 7. Whether these gratuitous payments are necessary to overcome some directors' resistance to do anything that would hurt the CEO, or whether they serve to alleviate the board's discomfort with forcing out the CEO, their frequent use in cases where CEOs are asked to leave suggests that directors are not dealing with the CEO at arm's length.

Even if some boards can make detached decisions to fire CEOs in "crisis" situations, this hardly implies that boards regularly make detached decisions about "business as usual" matters, such as pay arrangements. When a corporation performs dismally, there may be substantial outside pressure on directors to solve the problem. Directors may fear that doing nothing would be such a clear and visible dereliction of duty that it would invite embarrassing public criticism or perhaps even a proxy contest. When the personal stakes are that high, the incentives to fire the CEO can overcome the social, collegial, and psychological factors that normally make directors reluctant to displease the CEO. There is, however, little risk of such outrage when the board is asked to approve compensation that is not visibly excessive.

### **Better and Worse Pay-Setting Processes**

Although the pay-setting process has departed from arm's-length bargaining in most widely held public companies, this process has likely

worked better in some companies than in others. The myriad factors impeding arm's-length bargaining—managers' influence over director appointment, managers' ability to reward cooperative directors, the social and psychological forces leading directors to favor managers, the limited costs to directors of favoring executives, and directors' lack of sufficient time and information—vary from company to company. The stronger these factors are in aggregate, the larger will be the departure from arm's-length bargaining. In chapter 6, we discuss evidence that CEO pay is higher and less sensitive to performance when the CEO has relatively more influence over directors.

In the same way that the magnitude of departures may vary among companies, it may also change over time. The factors impeding arm's-length contracting are in part a product of legal rules and corporate practices. With the rules and practices that we have had to date, directors have been subject to a myriad of incentives and forces that have prevented them from bargaining at arm's length with the CEO over pay.

The future, of course, may differ from the past. Indeed, some take the view that, even though the pay-setting process until now has not been characterized by arm's-length negotiation, the 2003 stock exchange listing requirements regarding independent directors will move this process sufficiently close to the arm's-length ideal. As we have seen, however, the modifications of stock exchange listing requirements will weaken but fail to eliminate the various factors that have until now led directors to favor executives at the expense of shareholders.

Notwithstanding the changes in the listing requirements, independent directors will still find avoiding conflict with the CEO to be the safest strategy for being reelected to the board and otherwise rewarded by the CEO through the various channels that remain at the CEO's disposal. The social and psychological factors of friendship, collegiality, loyalty, team spirit, and natural deference to the firm's leader will continue to operate on many directors. And there will be little to counter these incentives and tendencies, given the small personal cost that favoring executives imposes on most directors.

Corporate governance experts writing in the late 1990s suggested that the increased dominance of independent directors during that decade had already made boards effective in overseeing CEO performance.<sup>70</sup> As we have seen, however, substantial deviations from arm's-length contracting have remained. Current predictions that the new stock exchange requirement will restore arm's-length bargaining, we believe, are also unwar-

ranted. In chapters 15 and 16, we propose reforms that could considerably reduce CEOs' power over their boards. For now, however, we conclude that the executive compensation landscape has been very much shaped, and without additional reforms will continue to be significantly affected, by CEOs' influence over corporate directors.