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Book Notes: Pay Without Performance: The Unfulfilled Promise of Executive Compensation, by Lucien Bebchuk and Jesse Fried

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BOOK NOTES

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, BY LUCIEN BEBCHUK & JESSE FRIED. CAMBRIDGE: HARVARD UNIVERSITY PRESS, 2004. Pp. xii + 278. $21.66 hardcover.

BY GEOFF MOWATT

This book contributes to the understanding of current compensation arrangements as shaped by managerial power and influence—the subject of increasing debate in the past few years due to recent corporate governance scandals. By examining the shortcomings in the current compensation landscape, the authors critically evaluate active corporate governance reforms that focus on increasing board independence, and also put forth their own reforms involving increased director accountability to shareholders.

The authors provide a comprehensive discussion of executive compensation by first addressing the traditional view, whereby the board operates at arm's length from executives and devises pay arrangements with an increase in shareholder value in mind—known as the "arm's-length bargaining" approach. Part I of the book introduces this paradigm—characterizing it as neat, tractable, and reassuring—but also discusses its limited malleability to deal with "anomalies" that are found in actual firm practices. Notably, the author's own analysis reveals that, in reality, market forces are insufficient to constrain boards to comply with executive pay similar to that produced through arm's length bargaining.

Part II discusses how managerial governance that permits substantial executive power can be correlated to higher compensation, while less sensitive to performance. This is limited by shareholder perception, based on what the authors term "outrage" costs. The authors provide evidence of camouflaging practices in managerial approach to executive pay to legitimize such compensation, thereby minimizing shareholder dissatisfaction. In part III, the authors use the concept of camouflage to explain the decoupling of executive pay and performance. In this context, for example, equity-based compensation has been an avenue by which managers reap substantial rewards despite mediocre or poor performance. According to the authors, it is not the amount of compensation they take issue with, but believe whatever pay arrangement is in place should, through its incentive effects, serve shareholders.

Finally, in part IV, the authors assess the implications of their analysis. They assert that, although recent reforms to enhance board independence from executives are beneficial, there must also be an increase in director dependence on shareholders. This can be accomplished by removing arrangements that entrench directors and insulate them from shareholders.