



December 4, 2013

Via e-mail and first-class mail

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comment Letter - Pay Ratio Disclosure; File No. S7-07-13

Dear Ms. Murphy:

We are writing to provide comments on the Securities and Exchange Commission's proposed amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Section 953(b) requires the disclosure of the median worker to CEO pay ratio. Our comments reflect our own views and not those of the John L. Weinberg Center for Corporate Governance or any of our other professional affiliations. We have produced academic research related to this issue.¹ We have attached a copy of one of our recent papers as Attachment A. We do not wish to comment directly as to the specific merits of the rule or whether on balance it should have been included in the Dodd-Frank legislation. It is the law, and therefore we will present our view as to how the proposed disclosure requirements could collaterally and positively affect the roles, responsibilities, expectations and, potentially, the duties of the compensation committee. Done appropriately, this possible reformulation of board practice may produce significantly improved compensation-related decision making and have beneficial effects upon the perception of executive compensation by investors, shareholders and employees. The Commission should take this commentary into account while crafting and implementing this regulation.

How Executive Pay Practices Have Gone Wrong

Executive compensation has evolved in a manner which defies clear one-factor explanations. Likewise public perception and the ongoing debate over chief executive pay must be understood to be shaped by a complex, multi-factored environmental context. As such, we do not attempt a full and nuanced explanation. Rather, we will describe one cause which is, in our view, significant.

The problems with executive compensation result, paradoxically, from there being too much focus on executive compensation. That is to say: there is too much focus on CEO compensation in isolation and too little attention paid to the compensation structure of the organization as a whole. The design of effective executive compensation programs requires stereoscopic attention to both its correctness in

¹ See e.g., Charles M. Elson, *Director Compensation and the Management Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (link); Charles M. Elson and Craig K. Ferrere, *Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution*, 38 J. CORP. L. 487 (2013); Charles M. Elson and Craig K. Ferrere, *When Searching for a CEO, There's No Place Like Home*, WALL ST. J., October 29, 2012.

relation to internal wage and benefits structures and, concurrently, to its external competitiveness. The former consideration should properly serve as the overall guide to pay design, while the latter should operate only as a considered constraint. However, current board practices involve a near complete reliance upon an analysis of external pay competitiveness through the use of pay surveys and peer group benchmarking. This has, in effect, removed the determination of CEO and executive pay from the proper analytic context of the company's pay structure as a whole.

Legal, regulatory and investor pressure upon boards has resulted in the adoption of peer benchmarking as a reasonable assurance that pay practices are correctly and uniformly implemented. Accordingly, consultants are usually retained who then survey the pay practices at related companies to create a peer group. Within this peer group, percentile targets, or benchmarks, are selected. Pay packages are designed around these targets, which are almost always above the 50th percentile. Whatever pay structure or valuation method is chosen, the value of a package at the grant date will approximate this target. This process, uninfluenced by considerations of internal wage structures has created a separate, isolated pay structure.

As we state in our research, “[b]y basing pay on primarily 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.” With the implementation of and strict adherence to pay benchmarking, executive pay practices were situated on a very different trend line than that which would otherwise have resulted had due consideration to organizational context been given.

There are two related effects of benchmarking which together lead to a continuing escalation in CEO pay levels. The first is the ‘Lake Wobegon’ effect. When every CEO is paid at median or above, and no CEO is below median, then the obvious consequence is an upward ratcheting of CEO pay levels. The second effect is the ‘leapfrog’ effect. This occurs because when one CEO is given a raise which leapfrogs their pay over another CEO's median, that other CEO will also get a raise. Pay raises for one CEO, whether deserved or undeserved, can move the median for all other CEOs who have that individual in their referent group.

As a result of these effects, CEO pay levels have risen dramatically. This escalation has caused great dissension within organizations. Employee morale is negatively impacted by what are *perceived* to be extraordinarily outsized pay-packages which bear little relation to the executive's contribution or to the company's structure and values. Outside the organization, CEO pay largess has provoked longstanding and intense criticism which is only disruptive.

Recalibrating Board, Constituent and Shareholder Pay Analyses

The median worker to CEO pay ratio proposal has the potential to significantly reshape CEO pay practices for the better. Boards could respond to this new requirement by using it as an opportunity to undertake a more thorough, contextual, internally-based analysis of CEO compensation. Rather than approaching CEO pay as though it were merely an abstract, isolated number they could carefully consider its relation to the company's pay structure as a whole. This analysis has the potential to counteract the benchmarking induced upward ratchet. Additionally, it will encourage pay design that is perceived to be equitable and just by more company constituents. For shareholders, the benefit is likely to be greater than mere incremental savings on CEO compensation outlays because of the added employee productivity resulting from better morale.

This approach would require a reconceptualization of board and compensation committee function. Rather than focusing on CEO and top five executive pay alone, boards would concern themselves with organizational wage and benefits structures. How a company meters rewards (compensation) to employee contribution is one of the most important things it does. Only once a board is comfortable with their understanding of this should they attempt to analyze CEO pay. Because of this initial step, the analysis changes dramatically. Isolated focus on CEO pay and benchmarking suggested questions for boards such as whether the pay package was “competitive” with markets or could “attract and retain talent”.² When an internal, holistic approach is taken, however, boards might consider whether pay packages are consistent with company practices or aligned with company values. Boards might be concerned with how these packages impact company morale or perceptions of fairness. Additionally, they might consider the possible incentive effects of CEO pay levels. Market-based factors would be viewed only as loose restraints to pay design possibilities.

This approach would offer a structural analysis of wages and benefits. To employees and other constituents it will emphasize integrity all the way to the top. People understand that a senior manager is going to make more than his or her subordinates, what is bothersome is when he or she seems to be the recipient of special treatment and therefore appears unaccountable. Boards should take the opportunity provided by the new median-worker to CEO pay disclosure to explain why the CEO’s pay is consistent with the pay of all the other company employees’. From our experience with many numbers of committed and concerned directors, we are confident that such a discussion will prove to be not just rhetoric but a genuine change in approach. The new disclosure offers the chance to establish a new paradigm for CEO pay practices.

Thank you for the opportunity to provide these comments. Please feel free to contact us if you have any questions or if you wish to discuss this matter further. Charles Elson can be reached at (302) 831-6157 and Craig Ferrere can be reached at (302) 831-8246.

Sincerely,



Charles M. Elson
Director and Edgar S. Woolard, Jr., Chair in Corporate Governance



Craig K. Ferrere
Edgar S. Woolard, Jr. Fellow in Corporate Governance

² These are justificatory interpretations of pay benchmarking which we critique in our *Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution*, 38 J. CORP. L. 487 (2013).

ATTACHMENT A

Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution

Charles M. Elson and Craig K. Ferrere

38 Journal of Corporation Law 487 (2013)

University of Delaware
Newark, DE 19716

Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution

Charles M. Elson* and Craig K. Ferrere**

I. INTRODUCTION	488
II. PEER BENCHMARKING: THE PROCESS	494
A. <i>Historical Origins</i>	495
B. <i>The Problem with Peer Group Analysis</i>	497
III. EVALUATING MARKET-BASED PAY RATIONALIZATIONS.....	500
A. <i>Athletes, Musicians, and Corporate Superstars</i>	500
B. <i>The Firm and Industry Leaping Superstars</i>	504
C. <i>CEO Skills: The Generalist</i>	505
D. <i>Evidence on CEO Skill Transferability: Performance</i>	511
E. <i>Evidence on CEO Skill Transferability: Turnover</i>	513
IV. THIN LABOR MARKETS: ROOM FOR PEER GROUP INFLUENCE ON PAY	515
A. <i>The Definitive Peer Benchmark</i>	518
B. <i>Balancing Costs in Setting Pay</i>	519
C. <i>Board Guidance</i>	528
V. CONCLUSION	531

* Edgar S. Woolard, Jr., Chair in Corporate Governance and Director, John L. Weinberg Center for Corporate Governance, University of Delaware.

** Edgar S. Woolard, Jr., Fellow in Corporate Governance, John L. Weinberg Center for Corporate Governance, University of Delaware. The authors wish to thank the IRRC Institute for its generous financial support for the research culminating in this paper. Additionally, the authors thank the participants at faculty workshops at Arizona State University, Columbia Law School, the UCLA School of Law, the University of Delaware, and the University of Minnesota Law School for their helpful comments and criticism. The authors also wish to thank Stephen Bainbridge, Tom Bates, Fred Bereskin, Sanjai Bhagat, Jeff Coles, Jay Coughenour, Jeff Gordon, Claire Hill, April Klein, Alan Palmiter, Roberto Romano, Hillary Sales, Robert Thompson, and Charles Whitehead for their thoughtful reviews and discussions of earlier and much revised drafts. We are much obliged to Vineeta Anand, Stephen Brown, Jim Kristie, Graef Crystal, Mike Davis, Bruce Ellig, Xavier Gabaix, Scott Goebel, Bonnie Hill, Ira Kay, William Patterson, Jon F. Hanson, Leo I. Higdon, Jr., John P. Whittington, Edgar S. Woolard, Jr., Robert Rock, and Milton Rock for their perspective and experience in the area. We especially thank Ann Mulé for her continuing encouragement and helpful suggestions throughout the writing process.

I. INTRODUCTION

The dramatic rise in Chief Executive Officer (CEO) compensation over the past three decades has resulted in tremendous popular and shareholder discord.¹ 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.² The second describes the operation of an efficient market for scarce and valuable executive talent. The rising 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.³ In essence, the theories describe the capture of

1. For long-run trends in executive compensation levels, see Carola Frydman & Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN. ECON. 75, 80 (2010). During the period between the late 1940s and 1970s, executive pay remained modest and the trend was approximately flat. *Id.* After 1970, top executives' pay began a sustained dramatic growth. *Id.* During the 1990s, the annual growth rate in median pay reached about 10%. *Id.* The median compensation rose from a median level of \$2.3 million in 1992 to \$7 million by 2006. *Id.* A significant portion of corporate earnings are paid to top executives. See Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 297 (2005) (showing that the top five executives earned 5% of aggregate corporate earnings in the 1993 to 1995 period and up to 9.8% in 2001 to 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 (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 a [sic] international issue debated in Congress and routinely featured in front-page headlines, cover stories, and television news shows"); *Executive Pay—The Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 1 (2007) [hereinafter *Executive Pay*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg46535/pdf/CHRG-110hhrg46535.pdf> (discussing CEOs' rapidly rising pay in contrast to the declining value of an average worker's paycheck). 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 & Kevin J. Murphy, *Introduction to THE ECONOMICS OF EXECUTIVE COMPENSATION*, at ix (1998).

2. For descriptions of management-dominated boards following Berle & Means, see generally MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (Beard Books 2006) (1976) (describing passive boards that are dominated by management); MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971) (delineating myth from reality regarding board conduct, and concluding that, at the time, the president exercised the real power of control while boards did very little substantive decision making). 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 took control of executive compensation, decoupling management's pay from their performance); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 939–42 (1993) (arguing that the compensation problem was "not responsive to a market-based solution" and that 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 to overcome the "captured board" syndrome). For a contemporary account of the management capture arguments, see generally LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (demonstrating the structural flaws in corporate governance and their resulting distortion of executive pay).

3. This Article 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

boards by overbearing management in the former, and by omnipotent markets in the latter.⁴ However, the cause of the escalation in pay, as this Article argues, is not fully susceptible to either explanation.⁵

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 & Kevin J. Murphy, *Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence*, 100 J. POL. ECON. 468, 471–78 (1992) (developing an explicit model of Professor Fama’s conception of the effects of a market’s valuation of current performance on future pay); Charles P. Himmelberg & R. Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* 3 (Mar. 6, 2000) (unpublished manuscript), 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, the CEO has few external options. For articles arguing for generalist CEOs who can be valued in exchange, see generally Kevin J. Murphy & 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, 1936–2003* (Nov. 18, 2005) (unpublished manuscript), available at http://web.mit.edu/frydman/www/frydman_market%20for%20executives.pdf. 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* 4–10 (Nat’l Bureau of Econ. Research, Working Paper No. 3542, 1990), available at http://www.nber.org/papers/w3542.pdf?new_window=1 (discussing allocation of managerial control in a market equilibrium); Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 93–94 (2008) (developing a competitive assignment model in which the growth in firm market capitalization explains the rise in CEO pay since 1980). See generally Steven N. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, 23 REV. FIN. STUD. 1004 (2010) (analyzing top corporate executive incomes along with the income earned by financial service employees, corporate lawyers, athletes, and entertainment stars). 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, 1 (2000); see also IRA T. KAY, EXECUTIVE PAY AT A TURNING POINT 15 (2013) (“There is no doubt that CEOs are paid well by the standards of ‘regular people’ The key questions that a board and shareholders must answer are whether there is a competitive market for CEO talent Our experience and research indicate that yes, companies compete for executive talent and that there is a fairly limited pool of talented executives . . .”).

4. 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 1990s and today, scholars have debated whether rising compensation was simply a market consequence or a symptom of a board failure to negotiate effectively. See, e.g., Elson, *supra* note 2, at 949 (discussing the inadequacy of the argument that regulation is unnecessary to correct the “compensation problem” because market forces will generate efficient outcomes). For contemporary reviews of these two competing theories, see Marianne Bertrand, *CEOs*, 1 ANN. REV. ECON. 121, 133 (2009); Robert J. Gordon & Ian Dew-Becker, *Controversies About the Rise of American Inequality: A Survey* 21 (Nat’l Bureau of Econ. Research, Working Paper No. 13982, 2008) (noting the inability of prior studies to fully account for increases in executive pay over the last two decades). 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), which states that “Bebchuk and Fried confront these titans [of contemporary financial economics] . . . [a]nd the titans have responded.” Compare Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 845–46 (2002) (noting the immense power managers have in determining executive compensation), with Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 868 (2002) (advocating a “perceived-cost view” to explain why executive compensation continues to soar).

5. We feel, obviously, that the level of compensation of U.S. executives is problematic. There are, of course, those who hold the opposite view. See, e.g., Randall S. Thomas, *Explaining the International CEO Pay*

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' personal and professional connections with the management inhibit the board from engaging in effective and autonomous oversight, and the board lacks a meaningful incentive to do so. The argument continues that executive compensation escalated unchecked because boards failed to negotiate rigorously with executives, but calls for reform in the early 90s from scholarly,⁶ professional, and popular commentators,⁷ and a concerted effort by institutional investors,⁸ regulatory agencies,⁹ and the Delaware judiciary¹⁰ led to the reformation of modern corporate boards. They called for equity holding, independent directors, and open elections. Many believed that these reforms would serve as a mechanism for improving board performance and corporate accountability while concomitantly remedying the executive compensation conundrum.

These reforms quickly became accepted standards of practice.¹¹ Nonetheless,

Gap: Board Capture or Market Driven?, 57 VAND. L. REV. 1171, 1261–67 (2004) (analyzing whether a policy response is truly appropriate to address the CEO pay gap, and suggesting that any downward shift in U.S. executive pay levels “would reflect economic or strategic forces, with economically desirable, or at least neutral, characteristics”); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 593–606 (2001) (presenting empirical research about the limited efficacy of derivative lawsuits on executive pay levels, and suggesting that shareholders may reach more efficient outcomes by exercising their economic, rather than legal, rights).

6. Elson, *supra* note 2, at 939–41 (“[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.”).

7. See, e.g., Richard C. Breeden et al., *The Fight for Good Governance*, HARV. BUS. REV., Jan. 1993, at 76 (presenting various authors’ assessments of the debate about executive compensation and competitiveness problems).

8. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1280–81 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 27–28 (1991). For a present day reflection on these efforts, see Lemma W. Senbet, *The Rise of Equity-Based Compensation: The Bright and the Dark*, in INSTITUTIONAL SHAREHOLDER’S SERVICES, OBSERVATIONS ON THE PAST, PRESENT, AND FUTURE OF CORPORATE GOVERNANCE 32–34 (2011).

9. See generally Ian L. Dew-Becker, *How Much Sunlight Does It Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation* (CESifo, Working Paper No. 2379, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1261795; Kevin J. Murphy, *The Politics of Pay: A Legislative History of Executive Compensation* (Univ. of S. Cal. Marshall Sch. of Bus., Working Paper No. FBE 01.11, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916358.

10. See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 667–88 (1995) [hereinafter Elson, *The Duty of Care*]; Charles M. Elson, *What’s Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68, 76 [hereinafter Elson, *What’s Wrong with Executive Compensation?*] (presenting Delaware Supreme Court Justice E. Norman Veasey’s position that if in exercising bad judgment in awarding executive compensation, “directors claim to be independent . . . [or are] disingenuous or dishonest about it, . . . [then] the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith”).

11. See generally NAT’L ASS’N OF CORPORATE DIRS., DIRECTOR PROFESSIONALISM—REPORT OF THE NACD BLUE RIBBON COMMISSION (2005) [hereinafter DIRECTOR PROFESSIONALISM], available at http://nacd.cambriasyurvey.com/auth/client/nacd/en-US/media/document/nacd_blue_ribbon_report_on_director_professionalism.pdf; BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2012); N.Y. STOCK

despite the promise that better boards would negotiate more reasonable remuneration, the rise in executive pay persisted.¹² We argue that the successes of such improvements in corporate governance were insufficient 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.”¹³ 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. Consequently, wages are seen merely to 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 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

EXCH., FINAL NYSE CORPORATE GOVERNANCE RULES (2003); COLUMBIA BUS. SCH. & THE WEINBERG CTR. FOR CORPORATE GOVERNANCE, BRIDGING BOARD GAPS—REPORT OF THE STUDY GROUP ON CORPORATE BOARDS (2011) [hereinafter BRIDGING BOARD GAPS].

12. Murphy, *supra* note 4, 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.”); Thomas, *supra* note 5, at 1198 (“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 Holmstrom, *Pay Without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 704 (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.”).

13. 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 & Xavier Gabaix, *Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories*, 15 EUR. FIN. MGMT. 486, 494 (2009) (arguing that simple models do not capture the complexities of real-life settings along with the rapid increase in pay including: 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 “[a]ll events form a chain in this, the best of all possible worlds.” VOLTAIRE, CANDIDE 93 (Theo Cuffe ed. trans., 2005).

power they claimed it possessed.¹⁴ 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 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.¹⁵ 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 are 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, it addresses the use of formal targeting of compensation to that of peer companies.¹⁶

14. Xavier Gabaix & 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. Towers Perrin principal, John England, as well as the Federal Reserve Chairman, Ben Bernanke referenced Gabaix and Landier’s article.); David Wessel, *With CEO Pay, Size Does Matter*, WALL ST. J., Nov. 2, 2006, <http://online.wsj.com/article/SB116242171357310677.html> (discussing Gabaix and Landier’s article and the associated popular reaction to its findings).

15. Thomas A. DiPrete et al., *Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay*, 115 AM. J. SOC. 1671, 1686 (2010) (arguing 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 et al., *Worth, Words, and the Justification of Executive Pay*, 18 J. ORGANIZATIONAL BEHAV. 641, 643–44 (1997) (examining the means by which compensation committees provide justification for their compensation practices to shareholders in regards to pay decisions and company returns).

16. Financial economists typically ask whether (1) the peer groups are manipulated so as to create an upward or aspirational bias, and (2) 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 et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 166 (2008) [hereinafter Bizjak et al., *Peer Groups*]; see Ana M. Albuquerque et al., *Peer Choice in CEO Compensation*, J. FIN. ECON. (forthcoming) (“Corporations commonly use peer companies to help determine compensation packages for CEOs, an approach known as benchmarking.”); Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups*, 96 J. FIN. ECON. 257, 260–62 (2010) [hereinafter Faulkender & Yang, *Inside the Black Box*] (examining the list of S&P compensation peer companies); IRRIC INST., COMPENSATION PEER GROUPS AT COMPANIES WITH HIGH PAY 24–25 (2010), available at <http://www.irricinstitute.org/projects.php?project=47> (reviewing “companies” self-selected compensation peers for systematic bias”); John Bizjak et al., *Are All CEOs Above Average? An*

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 that 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.¹⁷ In essence, this process creates a model of a competitive market for executives where it otherwise does not exist. The model may, in this case, drive the empirical results rather than the other way around. As we 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.

Both the academic and professional communities have observed 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 created a significant disparity between executives’ current pay and a level which would otherwise be appropriate compensation. This is not surprising. By basing pay primarily on external comparisons, this trend established a separate regime which was untethered from the actual wage structures of the rest of the organization. Over time, these disconnected systems were bound to diverge. Unfortunately, an executive’s pay 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 these costs, pay must be more consistent with internal corporate wage structures. An important step in that direction is to diminish the focus on external benchmarking.

This Article argues that: (1) 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; (2) 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 (3) the solution lies in avoiding the mechanistic and arbitrary application of peer group data in

Empirical Analysis of Compensation Peer Groups and Pay Design, 100 J. FIN. ECON. 538, 553 (2011) [hereinafter Bizjak et al., *Are All CEOs Above Average?*] (“The level of pay at the compensation peer group is one of the most important inputs for determining executive pay.”); ISS CORPORATE SERVS., EXECUTIVE PAY THROUGH A PEER BENCHMARKING LENS 7 (2011), available at http://www.isscorporateservices.com/White_Paper_Request (analyzing trends in pay benchmarking); Brian Cadman & Mary Ellen Carter, Compensation Peer Groups and Their Relation with CEO Pay 29–31 (May 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1349997 (providing “more refined tests of compensation peer selection and their role in setting CEO compensation”); Michael Faulkender & Jun Yang, Is Disclosure an Effective Cleansing Mechanism? The Dynamics of Compensation Peer Benchmarking 28–30 (Mar. 14, 2011) (unpublished manuscript) [hereinafter Faulkender & Yang, *Cleansing Mechanism*] (suggesting that “new regulations mandating disclosure of compensation peer companies did not mitigate opportunistic behavior in peer benchmarking”). These studies are referenced later in more detail.

17. See BRUCE R. ELLIG, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* 147–68 (2002) (describing how companies may take an aggressive strategy by positioning themselves in the 75th or 90th percentile).

arriving at executive compensation levels. Instead, the independent and shareholder-conscious compensation committee must develop internally consistent standards of pay based on the individual nature 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 easy to implement, 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.¹⁸

II. PEER BENCHMARKING: THE PROCESS

The boards of most U.S. public companies set executive compensation through a mechanistic process referred to as "peer grouping." Typically, boards engage compensation consultants who aid in designing a pay package that will be negotiated with the executive concerned.¹⁹ These consultants, advising the board's compensation committee, are asked to put the proposed pay package into some perspective vis-à-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 similar,²⁰ as selected by the compensation committee and consultants, often with varying degrees of input by management.²¹ The executive's proposed compensation is based on this comparison. Generally, after the peer group market analysis is completed, the board will choose to create a package that is usually targeted at the 50th, 75th,²² or 90th²³ percentile

18. For a related approach to board authority and an argument for "Director Primacy" in board and shareholder engagement, see Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003) (describing that 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 that 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) [hereinafter Bainbridge, *Executive Compensation*] (book review).

19. E.g., ELLIG, *supra* note 17, at 532 (discussing types of compensation consultants and their relation to boards and compensation committees).

20. 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 et al., *Are All CEOs Above Average?*, *supra* note 16 (analyzing explicit disclosure of company peer group composition following a 2006 Securities and Exchange proxy disclosure requirement); Faulkender & Yang, *Inside the Black Box*, *supra* note 16 (discussing that a company's compensation peers share a similar size, industry, visibility, and set of CEO responsibilities).

21. Murphy, *supra* note 1 (providing a thorough and authoritative discussion of the compensation-setting process and the elements of compensation).

22. E.g., Peter Whoriskey, *Cozy Relationships and 'Peer Benchmarking' Send CEOs' Pay Soaring*, WASH. POST, Oct. 3, 2011, http://articles.washingtonpost.com/2011-10-03/business/35417030_1_executives-at-similar-companies-executive-compensation-kevin-w-sharer (explaining that Kevin W. Sharer of Amgen's stock compensation was targeted at the 75th percentile of the peer group in 2011, and he received a 37% raise to \$21

of their target peer comparison group. Targeting levels below the 50th percentile is rarely, if ever, done.²⁴

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 standards²⁵ in the same way that the terms "better" and "best" are designed to enhance product differentiation.²⁶ In a similar sense, pay below the median would consequently signal "worse."

After the compensation committee selects the appropriate percentile level, the consultant designs a package to meet the specified numerical goal. This goal 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.

A. Historical Origins

The origins of this benchmarking process have been, unfortunately, obscured from the academic and popular commentary for some time. When asked, few either inside or outside the compensation industry could 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. All paths eventually led to Milton L. Rock,²⁷ the former managing partner of the Hay Group consulting firm—one

million in compensation in 2011 despite poor recent performance).

23. 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. *Id.*

24. Bizjak et al., *Peer Groups*, *supra* note 16, at 153 (stating that the "vast majority of firms that use peer groups target pay at or above the 50th percentile of the peer group").

25. Elson, *What's Wrong with Executive Compensation?*, *supra* note 10, at 72 (stating that Edgar S. Woolard, Jr., a former DuPont CEO, said "[m]ost 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*, Oct. 9, 2003, <http://www.economist.com/node/2119378> ("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 & Scott Schaefer, *CEO Pay and the Lake Wobegon Effect*, 94 *J. FIN. ECON.* 280, 280–82 (2009) (developing a model where CEO compensation serves as a signal effecting outsiders' perceptions of firm value by conveying information about the CEO's skill level).

26. 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 an executive's ability or talent.

27. Telephone Interview with Frederic W. Cook, Founding Dir., Frederic W. Cook & Co., Inc. (2011); Telephone Interview with Graef S. (Bud) Crystal, Former Comp. Consultant, Towers Perrin (2011); Telephone

of the original compensation consultancies.

In 1949, when Rock joined Edward N. Hay at his consultancy,²⁸ the Second World War had disrupted the traditional business environment. In earlier times, businesses operated in a more localized manner. Labor markets especially were locally oriented. In this environment, an employee would base comparisons of the relative standing and perceived equity of his compensation to what other local professionals were earning. The compensation of company presidents was determined in a similar localized context. However, 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 to facilitate broad comparisons.²⁹ This approach, called the Hay Point system, at one point was used in setting the compensation of a significant portion of the global managerial market. The Hay Point system ascribed points to jobs based on such categories as revenue, reporting employees, and industry groups. The point total 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.³⁰

From the Hay Point system, the framework of analysis evolved 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.

Consequently, Rock asked the top executives at his client companies to share their confidential compensation information with him to facilitate an exchange of information amongst the business executive community. The executives provided the data, and Rock's firm supplied 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

Interview with Michael Davis, Senior Vice President, Global Human Res., Gen. Mills (2011); Interview with Bruce R. Ellig, Retired Corporate Vice President, Emp. Res., Pfizer, Inc., in New York City, N.Y. (2011); Telephone Interview with Ira T. Kay, Managing Partner, Pay Governance, LLC (2011); Telephone Interview with Pearl Meyer, Founder, Pearl Meyer & Partners and Steven Hall & Partners (2011); Interview with Milton L. Rock, Retired Managing Partner, Hay Grp., in Philadelphia, Pa. (2011); Interview with Robert Rock, Chairman & Publisher, Dirs. & Bds., in Philadelphia, Pa. (2011); Telephone Interview with David Swinford, President & Chief Exec. Officer, Pearl Meyer & Partners (2011). We are grateful for their knowledge and assistance.

28. *Hay Group Through the Years: 1943–2008*, HAY GROUP, http://www.haygroup.com/downloads/ww/misc/hay_group_timeline_1943-2008.pdf (last visited Mar. 27, 2013).

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

30. Interestingly, the Hay Group never focused on the value of *individuals* in the labor markets, choosing rather to base comparisons on a job classification system that measured the relative worth and nature of similar jobs, *roles*, or *positions*. Arianne Minch, *Executive Compensation: Woolard Fellow Presents Research, Ignites Debate at Weinberg Center Event*, UDAILY (May 14, 2012), <http://www.udel.edu/udaily/2012/may/weinberg-compensation-051412.html> (“‘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.’”).

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.³¹ Further, the two major institutional investor voting advisory services, Institutional Shareholder Services (ISS) and Glass Lewis, recently began to create their own concurrent peer groups to aid in their evaluation of executive pay at the companies they rate for voting on compensation-based issues.³²

B. The Problem with Peer Group Analysis

While executive compensation levels have risen dramatically over the past several decades, the peer grouping process itself, by which pay is actually set, has remained largely unexamined. Rather, pay critics have focused their attention on what they termed the “management captured board,” which they believe is responsible for this phenomenon. Boards that were appointed and dominated by corporate management and advised by management-selected compensation consultants have 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 have called for changes in board composition³³ and the alignment of the compensation consultants with the boards that retained them.³⁴ 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.³⁵ In terms of legal standards, regulatory guidelines, and investor expectations, the boardroom 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.

31. Executive Compensation and Related Person Disclosure, Exchange Act Release No. 8732A (Aug. 29, 2006) (codified at 17 C.F.R. § 229.402) (stating that 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. Emily Chasan, *Watchdog Challenged over Pay Benchmarks*, WALL ST. J.: CFO J. (May 8, 2012), <http://blogs.wsj.com/cfo/2012/05/08/watchdog-challenged-over-pay-benchmarks/>.

33. E.g., JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICAN CORPORATE BOARDS 188–91 (1989) (advocating various board compositional reforms); Elson, *The Duty of Care*, *supra* note 10, at 685–86 (“Excessive compensation is the result of a passive bargaining process between board and executives.”).

34. THE CONFERENCE BD., EXECUTIVE COMPENSATION CONSULTING: A RESEARCH WORKING GROUP REPORT ON BEST PRACTICES 4 (2005); *Executive Pay*, *supra* note 1 (statement of Charles M. Elson, Dir., John L. Weinberg Ctr. for Corporate Governance, Univ. of Del.) (advocating independent compensation consultants).

35. E.g., N.Y. STOCK EXCH., LISTING STANDARDS (including all financial listing criteria); DIRECTOR PROFESSIONALISM, *supra* note 11 (offering a “foundation course for aspiring or new corporate directors”); BRIDGING BOARD GAPS, *supra* note 11 (reporting findings of a study group on corporate boards).

The underlying problem with the compensation process, which has remained 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 that 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 that is central to pay design today.

There are problems with this use of peer groups that have led to the ratcheting up of pay in a fashion that 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.³⁶ The higher the 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.³⁷ 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 Securities and Exchange Commission (SEC) peer group disclosure requirements and the recent Dodd-Frank independence mandates attempted to mitigate

36. For evidence of bias in the selection of larger and higher paying peer firms, see IRRG INST., *supra* note 16, at 2 (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 CORPORATE SERVS., *supra* note 16, at 1 (explaining a key takeaway is that companies biasedly select companies larger than themselves); Faulkender & Yang, *Inside the Black Box*, *supra* note 16, at 257 (explaining that firms choose highly paid peers to be a part of compensation peer groups); Bizjak et al., *Are All CEOs Above Average?*, *supra* note 16 (stating that peer groups are constructed in a manner that biases compensation upward); Matthew Pittinsky & Thomas A. DiPrete, Peer Group Ties and Executive Compensation Networks 34 (June 3, 2011) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2025384 (finding firms choose companies for benchmarking that are "larger and have better compensated CEOs than themselves"). Several studies have found either mixed or no evidence of biased selection. See Albuquerque et al., *supra* note 16 (manuscript at 31) (finding the need for talent is a more important factor than bias in CEO compensation); Cadman & Carter, *supra* note 16, at 30 (finding little evidence of bias). For earlier evidence of manipulation in the selection of performance peer groups, see Joseph F. Porac et al., *Industry Categories and the Politics of the Comparable Firm in CEO Compensation*, 44 ADMIN. SCI. Q. 112, 141 (1999) (explaining evidence of biased selection in group selection).

37. In 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. Interview with Michael Faulkender, Assoc. Professor, Univ. of Md., in Newark, Del. (May 18, 2012).

this opportunistic peer selection.³⁸

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, boards typically gravitate in fixing 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.³⁹ This dynamic is popularly referred to as the “Lake Wobegon” effect.⁴⁰ 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 the executive’s motivation. Market-based theories of executive pay assert that such adjustments are necessary for retention. For example, Mahmoud Ezzamel and Robert Watson found that asymmetric responses⁴¹ to pay anomalies resulting from these external pay surveys resulted in a “bidding-up” of executive cash compensation in U.K. companies that 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 that market surveys suggest preclude even independent and effective boards from avoiding this “ratchet effect.”⁴²

Though the pay of other executives may provide a beneficial indicator of the outside compensation opportunities potentially available, the external references can have perverse systemic effects on the aggregate level of compensation where 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

38. Faulkender & Yang, *Cleansing Mechanism*, *supra* note 16, at 15 (finding evidence that manipulation became more severe following the SEC mandate).

39. The theoretical literature on this effect is sparse, but see Hayes & Schaefer, *supra* note 25, at 280 (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.

40. Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N.Y. TIMES, Nov. 26, 2006, http://www.nytimes.com/2006/11/26/business/yourmoney/26peer.html?pagewanted=all&_r=0.

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

42. Mahmoud Ezzamel & 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 et al., *Peer Groups*, *supra* note 16, at 153 (finding that CEOs paid below the median receive pay raises that are \$1.3 million more than those with above median pay and concluding that the asymmetric adjustments are consistent with retention objectives rather than rent-seeking executive behavior).

affects all the connected firms for which it is a peer.⁴³ 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. An individual executive may deliver phenomenal performance and be likewise compensated, but that individual's contribution to their company should not be relevant to another individual's actions at another company.

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."⁴⁴ Any executive compensation reform must start there.

III. 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 Part, 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 for either 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 drives up pay without reference to either alternative theory of rising pay. Regardless of board intentions, as long as boards continue to rely on peer group analysis, 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 thus 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 the trend towards the concentration of output and income in a small selection of individuals in certain occupations.⁴⁵ He described and

43. DiPrete et al., *supra* note 15, at 1706; *see also* Jerry Kim et al., Executive Compensation, Fat Cats and Best Athletes 6 (Apr. 24, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948531 (finding empirical support for network contagions through peer groups). This effect has been theorized to occur even within perfectly competitive executive markets. *See* Gabaix & Landier, *supra* note 14, at 50 (theorizing this contagion could affect CEO pay); *see also* Frederick L. Bereskin & David C. Cicero, *CEO Compensation Contagion: Evidence from an Exogenous Shock*, J. FIN. ECON. (forthcoming Jan. 31, 2012) (providing empirical evidence of this compensation contagion effect).

44. Geoffrey Colvin, *The Great CEO Pay Heist*, FORTUNE, June 25, 2001, http://money.cnn.com/magazines/fortune/fortune_archive/2001/06/25/305448/ (outlining the way corporate structure causes higher pay).

45. *See generally* Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981) (examining the pay structure for "superstars").

gave economic justification for this “phenomenon of superstars.”⁴⁶ During this time, it became increasingly apparent that a relatively small proportion of the population, comprised of the most talented market participants, was dominating the markets for their respective professions and thus receiving a substantial and growing amount of the total rewards in the market. Other individuals were seemingly left out of what was later described as the winner-take-all society.⁴⁷ Rosen’s key insight was that joint consumption technology combined with imperfect substitution in demand together enabled this development, and indeed the outcome was, economically speaking, efficient.⁴⁸ In other words, the ability of musicians (or athletes) to sell their product, a performance or recording, to a large audience with little additional effort, combined with the consumers’ preference for hearing the best musicians (or seeing the best athletic performers), to the exclusion of lesser 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 with regard to mass media, 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 The few who produced them were thus able to receive tremendous rewards.

Some argue that this phenomenon of superstars is similar to the economic dynamics of the market for executives. Indeed, the rapid growth in their compensation levels as well as the increasing skew suggested such a dynamic.⁵⁰ Scholars argued that a chief executive’s talent for implementing corporate operations, providing inspiring leadership, or for pursuing effective investment strategies is made more valuable by the fact that his actions can “roll out” to affect 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 his 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

46. *Id.*

47. ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US* 5 (1995).

48. Rosen, *supra* note 45, at 857.

49. Recent evidence suggests, however, that in the movie industry the ability of movie stars to exclude lesser substitutes has waned. See Michael Cieply, *For Movie Stars, the Big Money Is Now Deferred*, N.Y. TIMES, Mar. 3, 2010, at A1, available at <http://www.nytimes.com/2010/03/04/movies/04stars.html> (describing the change in movie stars’ salaries); Dorothy Pomerantz, *Death of the Movie Star? Sandler and Cruise Flop at the Box Office*, FORBES (June 17, 2012), <http://www.forbes.com/sites/dorothypomerantz/2012/06/17/death-of-the-movie-star/> (discussing recent changes to the pay structure in Hollywood). Low-budget films with lesser known and significantly cheaper actors are able to achieve Oscar and box office success. Cieply, *supra*; Pomerantz, *supra*. 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. Cieply, *supra*; Pomerantz, *supra*. We suggest later that the excludability of CEO talent may also be recently diminishing.

50. *E.g.*, Kaplan & Rauh, *supra* note 3, at 1029.

51. Alex Edmans et al., *A Multiplicative Model of Optimal CEO Incentives in Market Equilibrium*, 22 REV. FIN. STUD. 4881, 4882 (2009).

retrieval substantially broadened the executive's potential sphere of influence and enhanced this "scale of operations" effect.⁵² Executives were then seen as 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, executives 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 this multiplicative production function, the growth in firm size could explain the coincident increase in compensation since the 1970s.⁵⁴

However, as Robert Gordon and Ian Dew-Becker argue, this analysis is not obviously applicable to CEO and managerial compensation.⁵⁵ Rosen's original paper specifically addressed top billing comedians, classical musicians, textbook authors, and the like to which Gordon and Dew-Becker were comfortable adding investment bankers, consultants, and lawyers. Gordon and Dew-Becker distinguished these occupations, where compensation is clearly market driven, from the compensation of executives, where pay levels are determined by non-market based considerations.⁵⁶ The indubitable operations of a market determine the rewards for the former group. 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 professions are dependent on the preferences of consumers, derived from their resultant demand and subject to a related market-driven discipline. An aggregate of individual consumer preferences determines the value of their talent—how many CDs, movies, or billable hours are sold and at what price. Although one may disagree as to who is most talented in a particular field, executives' *ex post* economic value is 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, executives' marginal productivity is not so unambiguously separable from the organization they run. While an athlete, musician, author, or lawyer's time is the product, which is central to a multibillion-dollar industry, an executive's role is less direct, being charged with such tasks as organization, motivation, or the responsibility for strategic decisions. Rather than being a direct factor of production, an executive directs and organizes other factors. This ambiguity 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 its attendant biases, limitations of faculty, and common

52. Luis Garciano & Esteban Rossi-Hansberg, *Organization and Inequality in a Knowledge Economy*, 121 Q.J. ECON. 1383, 1394–1403 (2006) (presenting an equilibrium model of wages and organization where knowledge is levered through hierarchical management structures).

53. Kaplan & Rauh, *supra* note 3, at 1044–45.

54. Gabaix & Landier, *supra* note 3, at 49.

55. Robert J. Gordon & Ian Dew-Becker, *Selected Issues in the Rise of Income Inequality*, BROOKINGS PAPERS ON ECON. ACTIVITY, 2007, at 169, 176–77.

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.").

misunderstandings.

Nonetheless, the market is often still seen to be critical to understanding the level of, and the trends in, executive compensation. Demand for scarce human capital dictates a competitive outcome, and many believe this explains most observed compensation practices.⁵⁷ Through the operation of a market, scholars argue, wages are bid up to an executive's outside opportunities. Actual wages are simply the product of the board of directors' need to retain and motivate an executive.⁵⁸

Casual inference should inform us otherwise. When buying goods and services, consumers concurrently consider both price and quality. A consumer may prefer a lesser quality product 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 the CEO 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 that 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 the peer process used subsequently in setting pay. In a CEO succession, the board picks the next executive 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 selected,⁶² and largely without regard for the additional cost of inducing a move. In contrast to other markets, equalizing differences are not allowed to promote price competition. Finally, the board uses peer analysis to determine pay level. 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 structures.⁶⁴ The reason why executive compensation does not conform to market-

57. Edmans & Gabaix, *supra* note 13, at 493.

58. See Paul Oyer, *Why Do Firms Use Incentives That Have No Incentive Effects?*, 59 J. FIN. 1619, 1621–25 (2004) (presenting a model of equity compensation that focuses on participation constraints rather than incentive compatibility by introducing the assumption that outside opportunity wages are correlated with firm performance).

59. Henry L. Tosi et al., *How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies*, 26 J. MGMT. 301, 301 (2000); accord KAY, *supra* note 3, at 52 chart 2.7 (discussing the “5-Year Pay Opportunity Percentile vs. 5-Year TSR Percentile”).

60. David R. Roberts, *A General Theory of Executive Compensation Based on Statistically Tested Propositions*, 20 Q.J. ECON. 270, 271 (1956).

61. Jon Lukomnik, Managing Partner, Sinclair Capital, LLC, Speech at the University of Delaware Conference: Punting Peer Groups (May 14, 2012) (transcript available at the Weinberg Center for Corporate Governance, University of Delaware).

62. See Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain for?*, 63 WASH. & LEE L. REV. 231, 236 (2006) (discussing the process of negotiating executive employment contracts and severance packages).

63. George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 610 (1988) (“Results from widely accepted compensation surveys are ultimately self-perpetuating . . .”).

64. The pay-size correlation is a long established relationship, predating the widespread use of compensation surveys, which was originally attributed to a structural necessity. Herbert A. Simon, *The Compensation of Executives*, 20 SOCIOLOGY 32, 34 (1957) (“[S]alaries 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.”). Pay surveys are likely to have only reinforced this relationship.

based expectations and that these alternative institutions are utilized is simple: executives cannot acquire the necessary skills to successfully run a company except through actual experience at the company, therefore, executives do not typically move between firms. Hence, simple market-pricing mechanisms are ineffective.

B. The Firm and 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 reach their efficient levels with executive wages equating 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 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, observers now view boards as being captive to the market. Market conditions force boards to participate as "price takers" in a market where the cost of talent is invariably bid up to an executive's marginal productivity. Effectively, the market has removed boards from the equation. Pay increases 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 demands by matching a CEO's compensation to the economic environment that the company is in. Scholars have defended the use of peer (competitive) benchmarking along these lines. The process seems to be 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 Bengt Holmstrom and Steven Kaplan best express this view: "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 that is

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

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

67. Bizjak et al., *Peer Groups*, *supra* note 16, at 152 ("[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 & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 8, 35 (2003).

firmly rooted in market-based theories of executive compensation. Take, for example, the language that compensation consultants use to describe targeted pay packages in relation to market surveys; they usually refer to pay below the median as “below market” as opposed to “competitive.”⁶⁹

The potential mobility of a CEO is of course influenced by the transferability of the CEO’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 executives are essentially stuck with their current employers, 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 suggest that the cause of rising executive compensation is, in fact, a market-driven process that 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 a manager’s productivity within his specific firm exceeds that of working for other firms, 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 a 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 levels but, as we argue, between which there is wide range for board discretion. There is no mechanism to guide prices to fundamental values that do not exist in the first place.

C. CEO Skills: The Generalist

The importance of general CEO talent or abilities as opposed to specific skills should facilitate an active market for executives.⁷¹ General abilities are universally valuable across companies, and as a result, companies can exchange and value such abilities in central markets. General abilities are the same as the general one-dimensional “talent” or “ability,” which is used by scholars’ competitive assignment models and in 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.

69. Michael C. Jensen et al., *Remuneration: Where We’ve Been, How We Got to Here, What Are the Problems, and How to Fix Them* 56 (Harvard Bus. Sch., Working Paper No. 44/2004, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305.

70. Dale T. Mortensen & Christopher A. Pissarides, *New Developments in Models of Search in the Labor Market*, in 3 HANDBOOK OF LABOR ECONOMICS 2567, 2569 (1999).

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

But, what of the depth of specific knowledge regarding the company's competitive positioning within the market environment that 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 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 her ability to manage *any* modern corporation successfully.⁷² These skills are applicable across organizations and are not specific to a given organization.⁷³ 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.⁷⁴ They argue further that advances in information technology and data storage allow unfettered access to a vast accumulation of firm-specific knowledge that was previously deeply embedded in the organization and inaccessible to an outside CEO.⁷⁵ This trend, they argue, coincides with the increases in pay starting in the 1970s.⁷⁶ 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, it is 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.⁷⁷

As evidence for this conjecture, they found that companies increasingly hired CEOs externally. About 15% of CEO successions involved the appointment of an outside executive in the 1970s and 1980s, the proportion rose to about 25% in the 1990s, and almost to a third in the early 2000s.⁷⁸ In recent years, the proportion of S&P 500 companies hiring outside CEOs has been about 22%.⁷⁹ Murphy and Zábajník interpret

72. Kevin J. Murphy & Ján Zábajník, *Managerial Capital and the Market for CEOs* 2 (Queen's Econ. Dep't, Working Paper No. 1110, 2007), available at qed.econ.queensu.ca/working_papers/papers/qed_wp_1110.pdf.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 1.

77. Murphy & Zábajník, *supra* note 72.

78. *Id.* at 3 (using data from the *Forbes* annual surveys, they found 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 & Yaniv Grinstein, *Does the Market for CEO Talent Explain Controversial CEO Pay Practices?* 4 (3d Annual Conference on Empirical Legal Studies, Working Paper No. 09-11, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108761 (discussing the results from an Execucomp sample from between 1993–2005 that are consistent with those cited above); Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265, 2265 (2001) (discussing results from their study from 1971–1994).

79. SPENCER STUART, 2012 CEO TRANSITIONS (Dec. 31, 2012), available at <http://www.spencerstuart.com/research/articles/1637/> (finding that for the years 2007 to 2012, the proportion of

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 to 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 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.⁸⁰ It is important to note that even the downward revision leaves a substantial tenure; 24 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 generalizing 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 U.S. economic history more broadly. Following a serious recession, a wave of corporate restructurings dramatically altered the economic landscape.⁸¹ 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.⁸² 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

S&P 500 CEOs hiring externally ranged from 20–27%).

80. Frydman, *supra* note 3, at 21–24 (discussing the data set, which 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*).

81. See generally ALBERT J. DUNLAP, *MEAN BUSINESS* (1996).

82. See Peter Cappelli & Monika Hamori, *The Path to the Top: Changes in the Attributes and Careers of Corporate Executives, 1980–2001*, at 6 (Nat'l Bureau of Econ. Research, Working Paper No. 10507, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=552303 (describing the economic climate of the 1980s).

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 change in a firm's environment or a decision to make a dramatic change in the firm's internal structure."⁸³ For this type of "organizational disruption," an outsider is thought to be needed to either bring with him abilities and skills that are not inherent to a company's current human capital structure or to override existing organizational or institutional inertia.⁸⁴ In related research, a Booz-Allen report identified mergers and buyouts as an important driver of turnover trends and levels.⁸⁵ They also find that outsider successions are associated with a higher likelihood of an acquisition but substandard long-term performance,⁸⁶ indicative of a restructuring oriented skill set rather than the organizational development type abilities that enable a manager to produce long-term growth. A distinct set of turnaround specialists have the ability, which is not necessarily found in the CEO markets in general.⁸⁷ A company under duress may seek an outside executive as a means of restructuring an organization 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 that were acquired at a company that 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.⁸⁸

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 studied the effectiveness of such an "external labor market strategy" and found that CEOs who have spent a smaller fraction of their career in their current organization

83. See Anup Agrawal et al., *Are Outsiders Handicapped in CEO Successions?*, 12 J. CORP. FIN. 619, 635 (2006) (citing the reasons for bringing in an outside executive).

84. See Rakesh Khurana & Nitin Nohria, *The Performance Consequences of CEO Turnover* 6 (Mar. 15, 2000) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=219129 (discussing turnover and executive performance).

85. See Chuck Lucier et al., *The Era of the Inclusive Leader*, 47 STRATEGY+BUSINESS 1, 4 (2007) (stating that 11% of departing CEOs left because of a change in control in 2003, 18% in 2005, 22% in 2006, and in their data set, all executives who had once sold a company had also sold every other company they had run).

86. *Id.*

87. *Id.*

88. See 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.").

had taken longer to be promoted to the top of the corporate hierarchy.⁸⁹ They then sampled executives at the 500 largest corporations in 22 European countries and the 500 largest U.S. corporations. They tracked their career histories from entry level to the CEO post, as Frydman had done.⁹⁰ On average, a CEO who had been a lifetime employee at his firm took 23.1 years to get to the top of his organization; those with 6 or more prior employers took 26.75 years.⁹¹ It would seem that the years spent acquiring “general” experience rather than a firm-specific expertise were unproductive.

General Electric (GE) has long been an example of superb internal management development. It trained its managers in-house by rotating them across corporate divisions. Its executive development program meant to give its future managers a strong foundation of general management experience to groom them for higher positions of more responsibility through frequent job changes.⁹² However, according to a recent Wall Street Journal article, this policy has changed.⁹³ Its corporate development strategy is now to promote individuals through specific divisions, particularly its engineering and energy divisions. It hopes to develop managers with a deep knowledge and mastery of their respective fields rather than broad and shallow understanding of many areas 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.⁹⁴ The CEO, Jeffrey Immelt, explained: “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 as a company can’t just take the generic approach here. We have to be viewed as the specialist.”⁹⁵ GE seems to have discovered the inherent futility in 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. Some state 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.⁹⁶ It is argued that we, society, have heretofore discovered the sound

89. See Monika Hamori & Maria Kakarika, *External Labor Market Strategy and Career Success: CEO Careers in Europe and the United States*, 48 HUMAN RESOURCES MGMT. 355, 364 (2009) (describing the study about effectiveness of “external labor market strategy”).

90. *Id.*

91. *Id.*

92. See Carola Frydman, *Learning from the Past: Trends in Executive Compensation over the 20th Century*, 55 CESINFO ECON. STUD. 458, 467–71 (2009) (giving a background of GE’s executive structure).

93. See Kate Linebaugh, *The New GE Way: Go Deep, Not Wide*, WALL ST. J., Mar. 7, 2012, <http://online.wsj.com/article/SB10001424052970204571404577257533620536076.html> (explaining GE’s changes with its executive program).

94. *Id.*

95. *Id.*

96. 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.

principles of enterprise management. As a result, the corporate executive is to 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 that 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.⁹⁷ The corporate executive today must navigate a shifting topography of technology, consumer preferences, and costs—all the while striving to stay abreast of those at every corner of the market who possess the increased means to compete through their likewise improved access to capital and information that has driven down the barrier to entry in many industries.⁹⁸ Regardless of what this development suggests as to the returns to skilled labor, the CEO of a large company must know his specific business well. A focused expertise is absolutely necessary to sustain a competitive advantage in this difficult environment. Reliance upon general managerial skills, principles, and techniques will not suffice.⁹⁹ 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 a CEO to be successful—a singular focus on the development of those particular skills that will enable his success—if only within his limited area of expertise. Otherwise, his 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.”¹⁰⁰ As General Electric has determined, without the intimate specific knowledge gained through years of experience, such efforts would be futile.¹⁰¹

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. However, 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,

97. The points contained in this part harken back to earlier arguments concerning the virtue of corporate conglomerates, as Stephen Bainbridge thoughtfully pointed out to us. The conglomerate, following performance problems, fell out of popularity years ago.

98. Thomas, *supra* note 5, at 1223 (“[I]ncreased 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.”).

99. Barry M. Staw & 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 systematic knowledge of people and organizations, nor are there clear-cut discoveries of principles for motivating and 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.”). The authors find no positive economic performance related to the use of such popular methods of management.

100. Roland N. Stromberg, *The Deconstructive 1980s*, in EUROPEAN INTELLECTUAL HISTORY SINCE 1789, at 326 (1994) (quoting A.J. Toynbee).

101. See *supra* text accompanying notes 88–89 (describing a shift in General Electric's policy from generalized management to more specialized leadership).

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

Geoff Colvin, *Fortune*'s senior editor at large, surveyed top performers who have achieved tremendous success in their fields.¹⁰² He sought out the common denominator amongst a wide array of individuals, from Tiger Woods to Mozart.¹⁰³ 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 relevant 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 that were able to make the transformation from good performers to great industry leaders.¹⁰⁴ He carefully drew a sample of eleven companies that 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."¹⁰⁵ 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;"¹⁰⁶ Colman Mockler, started at the Gillette Company in 1957 as a staff assistant and had worked his way up to become CEO of the company in 1976;¹⁰⁷ George Cain, who revitalized the family-controlled Abbott Laboratories, was an 18-year insider.¹⁰⁸

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.¹⁰⁹ He finds the widespread belief in charismatic, high-profile corporate saviors problematic.¹¹⁰ 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

102. See generally GEOFF COLVIN, *TALENT IS OVERRATED: WHAT REALLY SEPARATES WORLD-CLASS PERFORMERS FROM EVERYBODY ELSE* (2008).

103. *Id.*

104. See generally JIM COLLINS, *GOOD TO GREAT: WHY SOME COMPANIES MAKE THE LEAP . . . AND OTHERS DON'T* (2001).

105. *Id.* at 10.

106. *Id.* at 17.

107. *Id.* at 23.

108. *Id.* at 31.

109. Rakesh Khurana, *The Curse of the Superstar CEO*, HARV. BUS. REV., Sept. 2002, at 60, 64.

110. *Id.* at 61.

generality—transferability. Richard Cazier and John McInnis found that while externally hired CEOs averaged \$5.5 million in excess compensation, there was no significant relation between performance at their prior company and at their new job.¹¹¹ 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.¹¹² While they found evidence that some CEO skills are 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.¹¹³ In their sample, the externally hired CEOs underperformed both multi-CEOs and internal hires.¹¹⁴ 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.¹¹⁵ Additionally, Chuck Lucier, Steven Wheeler, and Rolf Habel found that “experienced” CEOs, those who were formerly chief executives, underperformed.¹¹⁶ 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 to 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.¹¹⁷ 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 increasing trend in the benefits to external succession.¹¹⁸ Most evidence, therefore, suggests that internal CEOs

111. Richard A. Cazier & John M. McInnis, Do Firms Contract Efficiently on Past Performance When Hiring External CEOs? 4 (Dec. 30, 2010) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1732754 (studying 192 external successions from 1993 to 2005, they found a negative correlation between excess compensation and future performance; paradoxically the superstars underperformed).

112. See generally Gregory L. Nagel & William G. Hardin III, The Transferability of CEO Skills (Oct. 5, 2007) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019413.

113. *Id.* at 30.

114. *Id.* at 6.

115. Mark R. Huson et al., *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”).

116. Lucier et al., *supra* note 85 (finding that “experienced CEOs,” though hypothesized to bring experience in dealing with stakeholders and shareholders, actually underperformed).

117. James S. Ang & Gregory L. Nagel, The Financial Outcome of Hiring a CEO from Outside the Firm 18, 34 (Mar. 14, 2011) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1657027 (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).

118. James S. Ang & Gregory L. Nagel, Outside and Inside Hired CEOs: A Performance Surprise 6 (Nov.

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.¹¹⁹ 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 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, as an executive’s “talent” is revealed, the externally determined reservation wage may very well exceed a talented executive’s marginal value at a smaller firm.¹²⁰ 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 suggest the market for executives functions in much the same way as any other traditionally defined markets and would allow for reasonably accurate neoclassical 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

6, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1501024 (finding that in the 1989 to 1995 period, external successors underperformed by 0.57%, and in the 1996 to 2005 period by a greater amount, 2.23%; 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).

119. 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).”).

120. Gabaix & Landier, *supra* note 3, at 89.

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, and 19% were previously public company CEOs (less than 5% of the total of all new CEOs). They found the number of outsiders who were previously CEOs is trending upwards but seems to be driven by the hiring of private sector CEOs.¹²¹ One other study, which looked at most of the Execucomp data set for the period from 1993 to 2009, found only 27 instances of “CEO job hopping.”¹²² C. Edward Fee and Charles Hadlock examined the external promotion opportunities of sitting CEOs, or the validity of their threat to leave should their firm not pay them 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 of 0.48). In another sample, for the 500 S&P firms from 1993 to 1998, they found only six CEO “jumps” among this set of large distinguished firms. Of those CEOs, five took CEO positions at significantly larger firms; one took the number two position at a firm sixteen times the size of his previous employer.¹²³ 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.¹²⁴ Most significantly, it appears 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.

If outside offers and the option to renegotiate are considered, it is clear 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 his

121. Cremers & Grinstein, *supra* note 78, at 11.

122. Huasheng Gao et al., Labor Market Competition, Executive Job-Hopping, and Compensation (Jan. 2013) (unpublished manuscript), available at www3.ntu.edu.sg/home/hsgao/GLT20120130112.pdf. The study defined a “job hop” as an instance where a CEO took another CEO position within three years of leaving their prior position. *Id.*

123. C. Edward Fee & Charles J. Hadlock, *Raids, Rewards, and Reputations in the Market for Managerial Talent*, 16 REV. FIN. STUD. 1315, 1330, 1339 (2003); see also C. Edward Fee & Charles J. Hadlock, *Management Turnover Across the Corporate Hierarchy*, 37 J. ACCT. & ECON. 3, 11 (2004) [hereinafter Fee & Hadlock, *Management Turnover*] (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 that 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.

124. 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.

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 he renegotiated his 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 his 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 may have much to do with trends in pay levels. To the extent that the companies that are studied conform to market expectations, the cause may simply be that those companies rely on surveys of “market” compensation.¹²⁵ 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.

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

“Thin” labor markets, the markets for top executives, are characterized by match-specific rents between the heterogeneous agents on both sides of the market.¹²⁶ Because of heterogeneity in these markets, 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 that differs in an important way from the traditional, neoclassical 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 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.¹²⁷

Clearly, CEOs must earn¹²⁸ more than what their next-best-alternative employment

125. George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 610 (1988) (“[R]esults from widely accepted compensation surveys are ultimately self-perpetuating . . . consistent with the hypothesis that surveyed firms use the survey results to structure their own pay levels.”).

126. Alexander S. Kelso, Jr. & Vincent P. Crawford, *Job Matching, Coalition Formation, and Gross Substitutes*, 50 ECONOMETRICA 1483, 1484–85 (1982).

127. *Id.* at 1483.

128. Referring to total utility—wages and other non-pecuniary benefits.

opportunity offers to pay them.¹²⁹ However, CEOs also earn less than the full value of their firm-specific productivity. Accordingly, the firm's profit is constrained between these two 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 to 2010, the 81-year-old executive received over \$100 million in compensation before retiring and received 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 compensation.¹³⁰ In addition, they likely would have been willing to pay more given their perception of his performance.¹³¹ The actual compensation turned out to be somewhere in between his reservation wages and their profits.

The constraints on this bargain, the firm's and the manager's next-best-alternative profits and wages, are known in the relevant literature as threat points. The total rent, or the amount of the joint-payoff available to a firm and manager that exceeds the total of the two threat points, can be split between the agents into numerous proportions. Although this bargaining problem provides unique wage- and profit-payoff schedules, one generally does not define a theoretical solution without making assumptions about the institutional arrangement or rent-sharing parameters such as "bargaining strength."¹³² Nonetheless, however the rent is ultimately split, both parties will earn more than their outside opportunities.¹³³ Therefore, the equilibrium allocation of managers to firms will be independent of how the managers and firms later share this rent. Thus, 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 substantial.¹³⁴

This analysis, however, does not inform 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 similar people attract: wealthy people often couple with other wealthy people, intelligent spouses typically marry other intelligent spouses, and men that earn high incomes often marry women that are also high earners. Gary Becker

129. Or, they would leave for that alternative job opportunity.

130. Gary Strauss, *CEOs' Golden Parachute Exit Packages Pass \$100 Million*, USA TODAY, Nov. 8, 2011, 5:57 PM, <http://usatoday30.usatoday.com/money/companies/management/story/2011-11-07/100-million-dollar-chairman/51116304/1>.

131. *Id.*

132. Mortensen & Pissarides, *supra* note 70, at 2575 ("Given the existence of these quasi-rents, the 'market wage' is not unique in this environment. Any division that satisfies individual rationality is a formal possibility.")

133. *Id.* ("Unlike competitive theory without friction, [in models of search equilibrium], an existing match will always command quasi-rents ex-post because it is costly in time and resources for either party to seek the next best alternative.")

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

further analyzed this theory by introducing one-dimensional hierarchical types (e.g., agents ordered by “attractiveness”).¹³⁵ If there were complementarities between types, these matching markets exhibited “positive assortative” patterning. Becker’s theory preceded the labor market theories of superstars by Sherwin Rosen, Xavier Gabaix, Augustin Landier, and Marko Terviö. 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 earn the most. This sorting is critical to these theories of superstar CEOs.

Despite the ability to set wages based on the mechanisms of matching and pairing along these one-dimensional contours, markets for executives do not necessarily do this. 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. Thus, it should hardly be expected that CEOs and executives be matched in a manner that would conform to the predictions of this theoretical 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 unrealistic to assume they were assortatively matched by LSAT scores. By the time their ability is revealed clearly, they are already invested in their current company and moving would likely not 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. An additional factor affecting sorting is that at such an early point in one’s career, sorting is driven by the full distribution of expected pay-outs rather than just the CEOs (i.e., one may aim to be CEO and end up as a vice president). At any given time, the company that has the next generation’s industry-leading CEO in its talent pipeline is largely a matter of luck. However, this also occurs because of carefully designed recruitment, development, and retention programs that aim to train and retain executives early in their careers. 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 are fewer turnovers than 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, we must accept a certain degree of fortuitousness in executive allocation. Jack Welch joined General Electric in 1960 as a chemical engineer earning \$10,500.¹³⁶ It would be unrealistic to think that he did so with the realization that he would become chairman and CEO 21 years later.¹³⁷ He was, however, identified as a talented employee and encouraged to develop within the company. By the time he became CEO, Welch would never have considered leaving the company. Thus as a general rule, early company action helps to ensure a supply of able, homegrown CEOs that do not sort between firms later in their 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 their CEOs. Wages therefore are highly insulated from markets.

135. Becker, *supra* note 65, at 823–36.

136. JACK WELCH WITH JOHN A. BYRNE, JACK: STRAIGHT FROM THE GUT, at xii (2003).

137. *Id.*

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 that 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 that 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.¹³⁸ 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 from the start. Because of decreasing marginal utility and fractional ownership, \$1 million 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 that reform board dynamics hope to affect this bargaining strength parameter 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; pressure from investor groups increases the personal and reputational cost to board members of allowing favorable compensation outcomes for executives.¹³⁹ Thus far, such reform efforts have proven 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. This explanation relies on the influence of the benign normative practice that 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 that governs how executive compensation

138. The board capture theory has been critiqued for failing to explain why the supply of CEOs does not increase in response to the existence of this rent. Thomas, *supra* note 5, 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?" *Id.* at 1198–99. The specific nature of CEO skills precludes this; the number of junior executives employed has always restrained the supply. People cannot react to rents and drive down the pay of incumbent CEOs by simply training at a "CEO School" as increases in the number of law students can potentially drive down the rates lawyers charge.

139. Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 71–92 (2003). The "outrage" constraint he mentions throughout the article works through this mechanism by imposing an additional cost on excessive management rent extraction. *Id.* at 76.

is determined.¹⁴⁰ Institutional structures and decision heuristics work to smooth uncertainty, lest we be marred in impossible analytics. They are often just rules of thumb. We do not 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 he sufficiently amicable, does he 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 is 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 neoclassical 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 unabating 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 that mechanistically lead to higher pay: (1) given the lack of subjective criteria for peer inclusion, the group is easily manipulated in their composition; (2) the practice of above median targeting creates upward bias that leads to the popularly referenced “Lake Wobegon Effect”; and (3) structurally, they allow systemic effects to propagate through the constructed networks, creating a situation where the unrelated high pay and performance of one executive may drive up wages for many others (so-called leap-frogging).¹⁴¹ 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.¹⁴² 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

140. Douglass C. North, *Institutions*, 5 J. ECON. PERSP. 79, 79 (1991) (noting that humans have devised institutions “to create order and reduce uncertainty in exchange” and clarifying the existence of “both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)”).

141. See *supra* note 43 and accompanying text (providing empirical support for the various effects).

142. Bebchuk & Grinstein, *supra* note 1.

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.¹⁴³ Heterogeneous companies demand a more tailored approach, that relies less on general principles. 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 that 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 of countervailing costs and benefits, which must be 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 that 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 task of setting compensation levels is complex and onerous. 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 a board of directors determines 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.¹⁴⁴

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 Part, we lay out the various considerations that a board must address and carefully weigh in the process of arriving upon a determination of the appropriate amount

143. Rules of thumb are by definition general, rough-and-ready principles that do not take into account the full spectrum of available information. For the specific heuristic technique employed by median targeting and possible consequences, see Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. MAG. 1124, 1128–30 (1974) (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).

144. 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, 749 (1999).

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 their 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

[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.¹⁴⁵

Theories of pay equity suggest that when paid less than one's peers, a person may seek redress through the withdrawal of effort.¹⁴⁶ Maintaining executive pay alignment with external market rates is, in this context, seen as an integral component of a well-designed incentive structure.¹⁴⁷ Concern for an executive's emotional well-being in this respect may be merited, but an analysis that stops 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 skills.¹⁴⁸ The question of which firm offers the best return for such efforts certainly bears upon the decisions of employees. But, again, we emphasize that the process of executive

145. Elson, *supra* note 2, at 937. A theory of social comparison in social psychology 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, 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 AMERICAN ECONOMIC REVIEW 549, 549 (1984) (presenting evidence to support his view that egalitarian wage structures arise in organizations due to equity considerations); Charles A. O'Reilly III et al., *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMINISTRATIVE SCIENCE QUARTERLY 257, 257 (1988) (finding a strong correlation between the CEO pay and the compensation levels of outside directors).

146. See Kent Romanoff et al., *Pay Equity: Internal and External Considerations*, 18 COMPENSATION & BENEFITS REVIEW 17, 23 (1986) ("In such circumstances [where inequity is perceived] employees are likely to take one of the following actions: Ask for a raise, reduce effort on the job, seek to reduce the pay of others (that is, complain), or leave the company.>").

147. Being at the top of the corporate hierarchy, a CEO has no relevant peers within the company. A vice president, e.g., could base his perceptions of equity on other vice presidents within the organization, whom are perceived to be peers, but for a CEO the most obvious referent peer group is external: other company CEOs. In contrast, others suggest that comparisons also tend to be directed inward. See Carol T. Kulik & Maureen L. Ambrose, *Personal and Situational Determinants of Referent Choice*, 17 ACAD. MANAGEMENT REVIEW 212, 212 (1992) (describing the choice of references between personal and situational variables).

148. Derek Neal & Sherwin Rosen, *Theories of the Distribution of Earnings*, in HANDBOOK OF INCOME DISTRIBUTION 400-12 (Anthony B. Atkinson & Francois Bourguignon eds., 1999).

development begins within the company long before an executive becomes the CEO.¹⁴⁹ 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 payoff.¹⁵⁰ Just like any other employee, an executive, or one in training, is vulnerable to the whims of his employer, however capricious or opportunistic he may be. Benchmarking may provide an external assurance from current and future boards of fair and equitable compensation that 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.¹⁵¹ 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 he 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.

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.¹⁵² In acquiring skills, a junior employee does not consciously distinguish between those that are likely to benefit them in the future as a manager or CEO and those that will not. Valuable skills are acquired through

149. See Edward P. Lazear & Kathryn L. Shaw, *Personnel Economics: The Economist's View of Human Resources*, 21 J. ECON. PERSP. 91, 99 (2007) (stating that the best time to sort workers by ability, tastes, temperament, etc. is when they are young and referencing tenure reviews and promotions to partner at the beginning of workers' careers as an application of this principle). To sort at or near the CEO level would be inefficient.

150. 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. See Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1590 (2005) (“Tournaments can induce employees to [make firm-specific investments], however, by allowing firms to credibly commit themselves ex ante to attaching a higher wage to jobs that employees will attain if promoted.”); see also Bengt Holmstrom, *The Firm as a Subeconomy*, 15 J.L. ECON. & ORG. 74, 74–76 (1999) (analyzing the internal and external controls firms use in markets with asymmetric information). For an empirical analysis of credible commitments with controlled firms and hostile takeovers, see generally Dino Falaschetti, *Golden Parachutes: Credible Commitments or Evidence of Shirking?*, 8 J. CORP. FIN. 159 (2002).

151. 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.

152. 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., July 5, 2012, at B1 (stating “U.S. businesses spent \$171.5 billion on learning and development in 2010”).

experience as an unconscious byproduct of other work-related responsibilities. They are not so much an investment as a prerequisite to continued employment.¹⁵³ One studies the sales data for one division because it is one's job to do so. Increased familiarity is an unintentional consequence that may or may not serve one well in later tasks. An employee who seeks to discriminate between tasks in an intentional manner will neglect many essential job tasks along the way and will be less successful in his current position. Thus, this employee would not 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. People may occasionally "buy" general skills intentionally, through university schooling, for example, or by temporarily taking lower-paying jobs that offer greater experience and opportunities for learning. However, 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 that incentivizes employee effort by inducing a competition to win the promotion.¹⁵⁴ This internal incentive structure differs markedly from others that encourage productivity by directly paying wages piece-rate for observed output, or in another pay-for-performance related manner.¹⁵⁵ 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.¹⁵⁶ Wages are pegged to jobs at different levels of the organizational hierarchy as opposed to the individuals occupying that position.¹⁵⁷ 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 for 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. However, the internal tournament model fails to draw conclusions about how relative wages among organizations provide incentives. This is necessarily so. The theory describes a means of eliciting effort outside 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

153. This diminishes or eliminates the "Prisoners Dilemma" because no actions need to be intentionally directed towards the acquisition of specific skills. Rather, the end is continued employment and the skills are acquired without added cost.

154. Lazear & Shaw, *supra* note 149, at 94–95.

155. Both methods purport to offer incentive compatibility and may theoretically achieve the same theoretical incentive structure.

156. See Lazear & Shaw, *supra* note 149, at 94 (discussing the fact that employees are compensated based on job title rather than skill in many firms).

157. *Id.*

fact “seems well accepted.”¹⁵⁸ 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.¹⁵⁹ 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.¹⁶⁰ An efficient wage structure is, therefore, almost entirely indigenous to the company in which it is implemented. Its precise character depends upon a firm’s idiosyncratic nature—its specific cost of monitoring effort, measuring output, and the characteristic worker desired.¹⁶¹ 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 that 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, as well as 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 concerns of external equity as far as a firm’s total productivity is concerned.¹⁶² The pay of an executive affects more than just his 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.

A simple hypothetical can illustrate the tradeoff between higher and lower CEO pay. 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

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

159. See Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1017 (2009) (stating that the pricing mechanism “does not ‘work’ as the control mechanism within a firm—if it did, one would not need firms, just individual contractors”).

160. William Chan, *External Recruitment Versus Internal Promotion*, 14 J. LAB. ECON. 555, 556 (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 compete.”).

161. See Barry A. Gerhart et al., *Pay, Performance, and Participation*, in RESEARCH FRONTIERS IN INDUSTRIAL RELATIONS AND HUMAN RESOURCES 178 (David Lewin et al. eds., 1992) (discussing factors involved in choosing an efficient wage structure).

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

snatched away).¹⁶³ All three junior executives are currently earning \$1 million a year. Presumably, this amount exceeds their next best option—quitting and foregoing the million dollars in annual earnings while searching for alternative employment (if unsolicited job offers are not forthcoming), as well as the wages and other utility they could expect to receive if successful, otherwise they would not be currently employed. We know that the raise received by whomever wins the competition for promotion cannot simply reflect the value of that executive's human capital in the market. The company was able to retain the person before the raise, and one's value does not increase substantially immediately upon signing a CEO contract.¹⁶⁴ The additional pay may, nonetheless, simply compensate for increased job risk¹⁶⁵ or increased effort demands.¹⁶⁶ However, the marginal increase in these factors is not likely to be substantial between a CEO and a junior managerial position. Thus, the other side of the utility tradeoff must also be considered. The CEO job title may be valuable for the prestige¹⁶⁷ or status¹⁶⁸ of the position as well as the increased outside opportunities to serve on boards, consult, attend functions, and the other related advantages of the office. Given these benefits, it is entirely possible that one of the competing executives would be willing to actually purchase the position from the company.¹⁶⁹ With the dramatic overnight pay raise and the 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.

How much should the raise be? The proper amount that will appropriately balance the costs and benefits depends upon an evaluation of the tradeoff between countervailing effects. Incentives for effort increase with the amount of the wage spread while direct

163. See Agrawal et al., *supra* note 83, at 620 (discussing the reasons why firms prefer to hire insiders rather than outsiders).

164. Lazear & Shaw, *supra* note 149, at 94 (“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 he was promoted.”).

165. See Fee & Hadlock, *Management Turnover*, *supra* note 123 (stating that while the turnover rate for CEOs and non-CEOs is similar, the retention of CEOs is more sensitive to firm performance).

166. It is likely that both CEOs and junior executives are, as a group, highly motivated individuals for who it may be counterproductive to elicit further effort (i.e., their productivity may already be maximized over effort regardless of whether they are the CEO or the next in line). See Bainbridge, *Executive Compensation*, *supra* note 18, at 1632 (noting, “slackers will rarely climb to the top of the greased pole”). Therefore, effort is likely to be maximized for most top executives regardless of their job position. Any market-based explanation is likely to accept that this holds for all executives, not just CEOs. See Edmans & Gabaix, *supra* note 13 (“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 . . .”).

167. Ernst G. Maug et al., *Pride and Prestige: Why Some Firms Pay Their CEOs Less 1* (Dec. 19, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2008877 (finding that on average, compensation is nine percent lower amongst firms in *Fortune*'s ranking of America's most admired companies).

168. Frank, *supra* note 145, 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.”).

169. See Marko Tervio, *Superstars and Mediocrities: Market Failure in the Discovery of Talent*, 76 REV. ECON. STUD. 829, 929–30 (2008) (discussing how the ability to “purchase” one’s job could lead to an efficient allocation of more junior executives to CEO positions).

wage costs also increase.¹⁷⁰ As the marginal product of effort decreases, the incentive to gain further advantage through cheating, sabotage,¹⁷¹ collusion,¹⁷² manipulating performance measures, or by peddling influence¹⁷³ increases. The likelihood of cooperative action in team-based production also decreases with the amount of the promotion wage spread,¹⁷⁴ as does the employee's loyalty to the company.¹⁷⁵ People base their feelings of equitable treatment on how their rewards compare to those of their peers, more so than they do the absolute amount of the reward.¹⁷⁶ 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).¹⁷⁷

Baker and Holmstrom found an average wage premium of about 18–47% between hierarchical organizational levels, but because wage patterns exhibited significant serial correlation, the immediate jump in pay was only about 7%.¹⁷⁸ The spread between a CEO's pay 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.¹⁷⁹

170. Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841, 863 (1981).

171. See Edward P. Lazear, *Pay Equality and Industrial Politics*, 97 J. POL. ECON. 561, 562 (1989) (discussing how competition “can lead to outright sabotage”).

172. See Ronald A. Dye, *Inside Trading and Incentives*, 57 J. BUS. 295, 298 n.7 (1984) (providing a brief discussion of a multi-agent model and the lessened possibility of a manager short selling and ruining the firm).

173. See Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. 154–55 (1988) (discussing the benefits and costs influence activities bring to an organization); Canice Prendergast & Robert H. Topel, *Favoritism in Organisations*, 104 J. POL. ECON. 958, 965–66 (1996) (discussing the influence of favoritism on compensation).

174. See Jeffrey Pfeffer & Nancy Langton, *The Effect of Wage Dispersion on Satisfaction, Productivity, and Working Collaboratively: Evidence from College and University Faculty*, 38 ADMIN. SCI. Q. 382, 382–87 (1993) (finding that increased wage dispersion was related to diminished cooperation and productivity); Lazear, *supra* note 171, at 563 (explaining that 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, 115–19 (1995) (describing top management team fragmentation that results in a tendency to focus on individual rather than organizational objectives).

175. Matt Bloom & John G. Michel, *The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover*, 45 ACAD. MGMT. J. 33, 37–39 (2002) (finding that pay dispersion was related to lower tenure and a higher likelihood of turnover).

176. James B. Wade et al., *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, 17 ORG. SCI. 527, 534–41 (2006) (arguing that a CEO's salary is a key referent for employee determination of fairness); Frank, *supra* note 145, at 569–70 (considering equity concerns in relation to his examination of status, suggesting how they may be valued).

177. See J. Stacy Adams, *Towards an Understanding of Inequity*, 67 J. ABNORMAL & SOC. PSYCHOL. 422, 427–30 (1963).

178. Baker & Holmstrom, *supra* note 158, at 257.

179. Subodh Mishra, *Bridging the Pay Divide: Trends in C-Suite Pay Disparities*, ISS CORP. SERVICES, WHITE PAPER, at 3 (Nov. 4, 2011). One may expect relative pay increases to remain constant throughout an organization. Herbert A. Simon, *The Compensation of Executives*, 20 SOCIOMETRY 32, 33 (1957) (stating that “an executive's salary should be *b* times the salary of his subordinates, no matter what his level . . . this ‘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”). Mishra suggests the appropriate multiple at the time was

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.¹⁸⁰ 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 start their own firms rather than work within a larger corporation.¹⁸¹ Other studies have shown that dispersion in top management compensation has been linked to lower firm performance and other unfavorable outcomes. These studies find strong association between high pay and lower firm value.¹⁸² Lucian Bebchuk, Martijn Cremers, and Urs Peyer examine the “CEO Pay Slice” (CPS), or the proportion of the aggregate top-five compensation going to the CEO. A higher CPS is correlated with lower firm value as measured by Tobin’s *q* and stock returns.¹⁸³ 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, corporations should moderate pay spreads.

Just as paying the CEO less than he would expect may result in bad reactions by an executive, it is clear that paying more could result in bad reactions from other employees.¹⁸⁴ Boards ultimately must balance these two potential costs. However, it also

between 1.25–2. *Id.* at 4. 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, *supra* note 5, at 1183 (explaining that while U.S. CEOs are paid more than twice as much as international CEOs, when “looking at lower level managers, this pay gap shrinks”).

180. Wade et al., *supra* note 176, at 539–40.

181. Frank, *supra* note 145, at 567.

182. See, e.g., James W. Fredrickson et al., *Sharing the Wealth: Social Comparisons and Pay Dispersion in the CEO’s Top Team*, 31 STRATEGIC MGMT. J. 1031, 1045–46 (2010) (finding that pay dispersion amongst the top management team was negatively related to firm performance); Mason A. Carpenter & WM. Gerard Sanders, *Top Management Team Compensation: the Missing Link Between CEO and Firm Performance?*, 23 STRATEGIC MGMT. J. 367, 373–74 (2002) (showing the interrelation between top management team pay, CEO pay, and subsequent performance).

183. Lucian A. Bebchuk et al., *The CEO Pay Slice*, 102 J. FIN. ECON. 199, 219–20 (2011); see also Michael J. Cooper et al., *Performance for Pay? The Relationship Between CEO Incentive Compensation and Future Stock Price Performance 26–27* (Dec. 2009) (unpublished manuscript), available at <http://online.wsj.com/public/resources/documents/CEOpformance122509.pdf> (finding that firms who pay CEOs higher incentives earn negative abnormal returns over a five-year period); Bloom & Michel, *supra* note 175 (finding evidence that high wage dispersion leads to lower managerial tenure and more turnover); Pfeffer & Langton, *supra* note 174, at 387 (finding evidence that faculty productivity and collaboration are adversely affected by wage dispersion in universities).

184. A large pay gap often results in negative evaluations by external constituents as well; the GMI Rating AGR score and the scores credit ratings agencies are adversely affected by a large difference between CEO pay and that of the next highest paid employee. GMI RATINGS, SAMPLE REPORT 23 (Apr. 4, 2012), available at <http://www3.gmiratings.com/wp-content/uploads/2012/04/agr-esg-combined.pdf> (including internal pay equity as an accounting and governance risk factor); *Analyzing Credit and Governance Implications of Management Succession Planning*, Moody’s Corp. Governance 4 (May 2008), available at http://papers.ssrn.com/sol3/papers/cfm?abstract_id=1285082 (explaining that a lack of internal pay equity is associated with CEO succession risk).

must be recognized 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. The ability to ferret out such misconduct is seriously impaired 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 the board must carefully consider it. A board that 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 his peers, to the neglect of the other factors, through an exclusive 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.¹⁸⁵ Because the compensation levels that 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 that 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. Courts, regulators, and investors should encourage a more nuanced approach.

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 and reach a reasoned conclusion as to the amount of 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 singular data points amongst many other necessary factors that directors must consider.

185. Elson, *The Duty of Care*, *supra* note 10, at 682; Thomas & Martin, *supra* note 5, at 603 (“[M]onitoring of compliance with contractual terms and processes is often done by judges.”).

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 her 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 build an analysis around the following principles 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 about 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 the “competitive” benchmarking rhetoric, or the executives themselves, usually suggest. 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 his pay is a problem that is visible and that the board can manage, 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. His pay should be considered as an extension of the infrastructure that 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. The board should not consider executive pay separately from the structures that govern compensation of other employees, rather its design should be structured 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 that 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; boards can, and should, restore internal consistency.

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.¹⁸⁶

This very simple and intuitive approach seemed equitable to him.¹⁸⁷ 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.¹⁸⁸

Typically, the board renegotiates CEO compensation 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. The board must make adjustments 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 him 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 previously mentioned. Marginal increases to pay may be appropriate in this situation and especially necessary where the executive has received a credible outside offer.

How past performance should effect executive compensation is an issue that, 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 increases 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 that far exceeds expectations may not be adequately compensated 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 averages and the achievements of milestones and targets deemed necessary towards broader corporate strategic objectives. For example, a board who

186. Edgar S. Woolard, Jr., *The Myths of Executive Compensation*, DIRS. & BDS.: BOARDROOM BRIEFING, Winter 2005, at 6, available at www.directorsandboards.com/BoardroomBriefing5Final.pdf.

187. *Id.*

188. Of course, a universal application of this standard is equally mechanical. There is however, no dearth, in practice or academe, of potential methods of compensation determination. See Michael Abramowicz & M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 NOTRE DAME L. REV. 1343, 1406 (2007). We leave it to the board of directors to determine the most appropriate approach.

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, its CEO certainly may deserve more generous compensation. Appropriately utilized, external metrics are helpful to a board.

V. 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 not just from 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 compensation that is more acceptable to shareholders. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.

Focusing 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 to be the comprehensive cure to the overcompensation problem, but the costs of pursuing this approach are minimal and provide a good starting point.