GENERALLY SPEAKING, AMERICANS are of two minds about those who earn a good salary. On the one hand, it comports with our national sense of fairness, according to Pace Law Professor Andrew C.W. Lund, a leading authority on executive compensation. We believe talented, hard-working managers should be rewarded for revving up business and driving shareholder value. A heroic CEO, like a heroic athlete, may deserve, well, a heroic payday. On the other hand, many can’t imagine that anyone is “worth” the amount of pay some managers receive. So, is CEO compensation broken? The public and scholars who study the matter differ over what this question means. “The debate within academia is far removed from the one being held at water coolers,” Lund says, adding that the debate in law reviews and finance journals is different in important ways from the debate being played out on MSNBC or even in the Wall Street Journal. Academics care less about absolute pay levels, so long as they’re structured to reflect a fully functioning market. “In the law and finance world, it’s mostly not about how much is [CEO pay]; it’s more about is it driving managers to promote firm value in the best way?” Lund says. “Is it incentivizing them to raise shareholder value?” He adds, “That’s a different argument from what you see in the popular press: are these people paid too much?” Making money might be as American as apple pie. But CEOs with incentive pay packages appear to be eating too much. To corporate finance academics, pay structure matters most, regardless of how high compensation might soar. The right proportions of fixed salary, stock options, etc. are crucial, and the devil is thought to be in the details. With the staggering amounts that CEOs are getting paid, Lund and other scholars have their
work cut out for them. CEOs are raking in great wealth. In fiscal year 2010, they netted a median 27% increase in compensation. While average U.S. workers’ pay dwindled, perks to S&P 500 CEOs rose 11%.

Of course, none of this is really surprising. Articles on outlandish compensation and the extravagant lifestyles of tycoons have earned public disapprobation for years. Not long ago, the press lambasted Robert Nardelli, whose $240 million compensation as CEO of The Home Depot and his $210 million severance package sparked investor outrage; and Dennis Kozlowski, the former CEO of Tyco, which allegedly paid for his $30 million New York apartment. He is now serving prison time for receiving $81 million in purportedly unauthorized bonuses, among other crimes.

The legacy continues. John H. Hammergren, CEO of McKesson, a health care services firm, was the nation’s highest paid CEO in 2010, with total compensation of $145.26 million. His base salary was $1.6 million, and some 80% of his income was due to stock options he exercised. However, McKesson’s stock did increase more than 117% in the decade since he was named CEO. In 2011, he earned $32.46 million in total compensation, bringing his six-year average compensation to $50.34 million, according to Forbes. In the event of his termination, Hammergren would receive $469 million as severance, according to a GMI pay survey.

Such brazen payouts are regarded by John Q. Public, who’s struggling to bounce back from the Great Recession, as obscene and practically immoral – emblematic of greed. Some business writers have tried to put a positive spin on greed, saying it rid companies and the marketplace of inefficiencies, builds profits and drives market success. But many people hold onto an old-fashioned view of greed as one of the seven deadly sins; and they regard Gordon Gekko types as just the sort of devils the Occupy Wall Street movement is sworn to dethrone.

Lund’s take is balanced and infinitely more nuanced, and he is breaking new ground in the field.

He joined the Face faculty after leaving the New York City firm Sullivan & Cromwell LLP, where he specialized in executive compensation, employee benefits, and mergers and acquisitions. He has spent the last decade studying the structure of compensation packages, and he teaches courses in corporate finance, corporations and partnerships, and advanced corporate governance.

His articles, published in leading law journals – including a critique of the federal “Say on Pay” rule providing shareholders with an advisory vote on executive compensation, which was published in the Kentucky Law Journal – have attracted wide attention. But his 2011 paper, “The Diminishing Returns of Incentive Pay in Executive Compensation Contracts,” has created a stir. It goes against the tide of scholarly opinion in both law and financial economics. In it Lund (and his co-author, Gregg Polsky, from the University of North Carolina School of Law) blasts incentive pay orthodoxy for many shortcomings.

The orthodoxy is based upon a presumption, one that’s seconded by business managers and the firms they represent: tying executive compensation to performance will increase productivity and share prices, and make shareholders happy. Thus, caring about the actual level of pay is beside the point.

Lund makes three points in response: a) newly evolved corporate governance mechanisms now have the same positive effect as incentive pay, thus making such pay structures “redundant,” b) the costs of incentive pay (as opposed to straight salary) are high and often overlooked, and c) attempts to improve company performance by restructuring incentive pay can backfire by distorting executives’ behavior “in value-diminishing ways.”

Incentive pay orthodoxy has taken root, and is difficult to reform, in part because incentive-laden contracts are now the status quo, and are synonymous for “good governance.” Moreover, influential voices in the field are staunch incentive pay proponents who benefit by overstating its effectiveness: executives stand to earn greater compensation, boards will bear less responsibility over executive pay outcomes, and the demand for compensation consultants and proxy advisors will continue to rise.

Lund drives home his points by focusing first on benefits of incentive pay and the widely held assumption among scholars that they exceed its costs by “several orders of magnitude.” In fact this remains an open question despite decades of research into the subject. In the 1990s, the paradigm of incentive pay – the greater the financial incentives for CEOs, the greater the
financial returns to corporate operations—was developed only as a theoretical proposition; it wasn’t backed by empirical statistical research. But the theory took root.

How did this happen? Before the advent of incentive pay, it was thought that managers had too many opportunities to exploit firms and that their interests were inconsistent with those of shareholders. CEOs lived grand lifestyles, unmonitored, and unchecked by boards. CEOs also were insulated from the market pressures of corporate control when poison pills were adopted, and many executives had gold parachute clauses in their contracts.

Something had to be done to hold CEOs accountable, to align their interests with shareholders.

The solution: offer them even more by pegging their earnings to performance. Incentive pay, a corporate law innovation, was born.

In a sense it was like dangling the opportunity to become superrich before the rich. CEOs were offered pay packages with large amounts of incentive pay, in the form of stock options, stock grants, and performance-based bonuses. The result: new executive compensation dwarfed fixed salaries and benefits. Pay ceilings were obliterated, and CEOs practiced minted vast fortunes.

Now, according to Lund, “The incentive pay orthodoxy is no longer warranted.” The orthodoxy has never been subjected to ongoing, rigorous cost-benefit analysis, he says. Instead, it became entrenched in the psyches of boards of directors, compensation consultants, governance experts, policymakers, the press, and the public at large.

**Newly robust corporate governance mechanisms**

Lund notes that robust corporate mechanisms “discipline executives for poor stock performance.” This makes incentive pay largely redundant, such that the benefits are even lower than boards might think. These corporate mechanisms—none of which are new, but have evolved and gained strength in recent years, and will continue to do so—are the activism of institutional investors, oversight by more demanding boards, and a corresponding reduction in CEO job security.

**Shareholder activism:** The vast majority of shares of New York Stock Exchange firms are held not by individuals but by institutions such as public pension funds and, to an even greater degree, by mutual funds and hedge funds. Today these institutions, particularly hedge funds, are apt to act more aggressively than in the past. In addition, proxy advisory firms are on the rise, making the job of monitoring firms easier and less costly.

Investors now discipline boards via “withhold-the-vote campaigns,” and shareholders—who are no longer content to make investment decisions, but are now delving into corporate finance—are voting to change company policy. In effect, shareholders are exercising more power and becoming increasingly active in controlling a firm’s direction. Lund notes that observers have counted as many as 137 investor campaigns in a single fiscal quarter.

CEOs know these campaigns can disempower them. Fending off activists can put a burdensome toll on management’s ability to lead, and force CEOs to exert greater effort in investor relations and corporate communications strategies. Among the leading investor
activists is business magnate Carl Icahn, with a net worth of $12.5 billion. Over his career, he has taken substantial or controlling positions in numerous companies, including RJR Nabisco, Time Warner, Viacom, Gulf & Western, Texaco, and Revlon.

Engaged boards: Today, boards are more likely to have corporate governance committees, and they meet more often than those in past years. Also, many boards have formalized their CEO evaluation process, and are increasingly engaged in scrutinizing senior management and planning management changes, some driven by shareholder activism.

Threat of termination: As a result of these changes, CEO job security is more precarious than ever. Since 1998, CEOs have had a 17.4% annual turnover rate. At S&P 500 firms, as of 2010, CEOs had an average tenure of only 6.6 years. More and more CEOs are getting fired due to floundering share prices and poor performance, as judged by their boards. Lund also points out that only three long-serving CEOs had failed to beat the S&P index, which, he notes, suggests that “the only way to have a long tenure as CEO is to maintain your company’s stock price as it relates to the broader market.” Being terminated for failing to meet targets can be a powerful motivator of CEO performance, often as powerful, Lund says, as incentive pay structures.

High cost of incentive pay

Touching on the high cost of incentive pay, which is the second major point of his paper with Polsky, Lund says costs mount in myriad ways when a firm chooses the incentive pay method of compensation. Among the cost factors is the “risk premium” – the premium charged by a CEO-to-be for receiving riskier pay. He points out that if a company does poorly, the executive not only loses a job and status, but future earnings can be impaired. Also, incentive pay piles more risk onto a CEO’s shoulders by tying pay outcomes to company performance over which the executive has limited control. To attract risk-averse CEOs, incentive pay packages must be made more attractive than high-fixed pay packages – they’re sweetened with a risk premium that can add significantly to a CEO’s pay.

It is very clear that firms are paying high premiums. But how high is high? A 2000 study that Lund cites – “Stock Options for Underserved Executives,” by Brian Hall and Kevin Murphy – notes that executives may apply anywhere from a 37% to a 79% discount to the Black-Scholes value of an option grant. Boards offer what they deem necessary to lure a candidate. Some academics have gone so far as to say that boards are constrained only by the degree to which outsiders would be outraged if they were privy to compensation negotiations.

Still, boards struggle to negotiate an “optimal contract” and arrive at a kind of “Goldilocks pay package” – one that’s not too high, not too low, but balanced just right, theoretically, with ideal incentive pay amounts and optimal structures. They do so in secrecy to reduce the risk that outsiders – including shareholders, the business press, and government – will be able to “identify and appreciate the full extent of overly generous pay packages,” Lund notes. So while cash compensation – salaries and discretionary bonuses – is relatively transparent, incentive pay components are not.

In addition, under formulaic bonus arrangements – which are evaluated ex ante, or at
the time they are created, rather than ex post, at the time they pay out – predictions of likely amounts at creation can fall short of what is actually paid out later. Also, tying payouts to hitting a mark, or target, can obscure the fact that marks may have been insufficiently ambitious to justify such payouts, Lund says.

There are serious concerns regarding stock option grants, also. For example, companies can “game the valuation of options through techniques such as springloading, backdating, repricing, or refreshing,” he notes. More importantly, attention to upward stock movements can divert attention from these large payouts, and sometimes shareholders’ criticisms are blunted, Lund notes, given a failure to object at earlier stages.

Some academics call for more transparency, though there’s question as to how transparent pay components can be. However “transparent” they might become, incentive pay components will always be subject to more manipulation than commensurate amounts of cash compensation. In addition, it will still be difficult if not impossible to compare the pay of executives at different companies because the value of stock options “depend on a number of firm-specific factors,” Lund points out. So even if stock prices are similar, comparisons are not really possible.

Another cost-raising factor of incentive pay is the bargaining process itself. The mere act inflates compensation costs. The board operates from a weakened position at the bargaining table because it has already agreed in principle that the CEO-to-be’s performance is determinative of firm performance. Thus, incentive pay by the nature of premium-paying, makes it easier for boards to overpay executives.

In addition, and somewhat irrationally, boards tend to view equity grants as costing the firm less than commensurate cash awards, simply because these grants do not require cash outlays. This misperception works in favor of the CEO and raises agency costs.

Furthermore, boards believe generally that extraordinary incentive pay packages are warranted simply because they are performance-based. Using this logic, Viacom recently doubled the value of its CEO’s annual pay package to $84.5 million. The justification was rather simple: the board said that “about 90% of the compensation … was in long-term options, which aligned the [CEO’s] interest with those of the company.”

All of this points to “incredible leverage for the CEO-to-be at the time” pay packages are negotiated, Lund says. He or she already knows, also, that it is in the best interest of the board, after having undergone a wide-ranging and potentially costly search process, to succeed in pay-setting negotiations. Firms simply don’t want to appear unable to afford a talented CEO’s demands. This lends power to the CEO at the negotiating table.

For these reasons and others, incentive pay’s marginal cost – relative to a straight salary alternative – is high.

Despite mounting evidence that incentive pay has its problems, it will continue to be the status quo in executive compensation for the foreseeable future, Lund says. “As the status quo, it now enjoys positional advantages.” Boards, in fact, are subject to “herding behavior,” making changes to their conventions more difficult and less likely, particularly in the wake of a financial crisis that has spooked even the most cynical boards.

With respect to incentive pay, Lund’s main thesis – that its influence on firm performance is vastly overestimated – flies against prevailing opinion in academia and in boardrooms. Yet it is largely this orthodoxy that has driven pay upwards in recent years, creating public criticism. The irony then is this: Lund’s critique of the academic orthodoxy might result in lower overall pay packages, thereby quelling some of the more popular criticism of executive pay.

### Corporate Law Colloquium

**Speakers – 2011-2012**

Professor Lund’s Advanced Corporations Seminar welcomed these key national scholars in the corporate law arena.

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  Seton Hall University School of Law
- **Minor Myers**  
  Brooklyn Law School
- **David Zaring**  
  The Wharton School of the University of Pennsylvania
- **Jeff Gordon**  
  Columbia Law School
- **Judd Sneirson**  
  Hofstra University School of Law
- **Gregg Polsky**  
  UNC School of Law
- **Frederick Tung**  
  Boston University School of Law
- **William Bratton**  
  University of Pennsylvania Law School
- **Robert Jackson, Jr.**  
  Columbia Law School
- **Steven Davidoff**  
  Moritz College of Law (Ohio State University)
- **Kimberly Krawiec**  
  Duke University School of Law
- **Jayne Barnard**  
  William & Mary Law School