

Articles

MOTIVATING EXECUTIVES: DOES PERFORMANCE-BASED COMPENSATION POSITIVELY AFFECT MANAGERIAL PERFORMANCE?

Susan J. Stabile†

There is a time to admire the grace and persuasive power of an influential idea, and there is a time to fear its hold over us. The time to worry is when the idea is so widely shared that we no longer even notice it, when it is so deeply rooted that it feels to us like plain common sense. At the point when objections are not answered anymore because they are no longer even raised, we are not in control: we do not have the idea; it has us.¹

The outcry over high levels of executive compensation, especially in companies whose shareholders are not faring well, has led to a movement towards increased use of various types of performance-based compensation. Corporate boards of directors² increasingly provide compensation packages under which a greater portion of an executive's pay takes the form of contingent compensation arrangements, rather than a

† Associate Dean and Professor of Law, St. John's University School of Law. J.D. 1982, New York University School of Law; B.A. 1979, Georgetown University.

1. ALFIE KOHN, PUNISHED BY REWARDS: THE TROUBLE WITH GOLD STARS, INCENTIVE PLANS, A'S, PRAISE, AND OTHER BRIBES 3 (1993). Kohn observes that "the use of rewards has come to seem so natural and inevitable that merely to pose the question, Why are we doing this? can strike us as perplexing - and also, perhaps, a little unsettling." *Id.* at 13-14.

2. Boards of directors have the responsibility of setting executive compensation. This power comes by virtue of the board's authority to manage the business affairs of the corporation. *See, e.g.*, CAL. GEN. CORP. L. § 300 (West 1990); DEL. GEN. CORP. L. § 141(a) (West 1991). Directors also have the authority to fix their own compensation as directors. *See, e.g.*, CAL. GEN. CORP. L. § 310 (a)(3) (West 1990); DEL. GEN. CORP. L. § 141(h) (West 1991). Although director compensation is also a topic of current discussion, it is beyond the scope of this article.

guaranteed base salary.³ Contingent compensation, at least theoretically, introduces an element of risk for the executive. Where an executive receives all or almost all of her salary in the form of a fixed-base salary, she gets that pay regardless of how she or the company performs. Where a significant portion of pay takes the form of performance-based compensation, such as annual bonus plans, stock options, or stock bonus arrangements, that portion of the executive's compensation is at risk—dependent upon company and/or individual performance.⁴

The movement toward contingent compensation is not difficult to understand. Obviously, it raises eyebrows if corporate executives are paid

3. See MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 89 (1995) ("In a widespread effort to tie executive pay more strongly to long-term stock price performance, corporations in the 1980s increased their use of compensation schemes that include 'stock options.'"); Adam Bryant, *Flying High on the Option Express*, N.Y. TIMES, Apr. 5, 1998, § 3, at 8 (suggesting that large option grants became common as a result of demands from activist shareholders that compensation be linked to performance); see also Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 80 (1992) (quoting the executive director of United Shareholders Association stating that performance-based compensation is the only acceptable solution to excessive executive compensation and other remedies are "wrong-headed"); Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28, 31 (citing a report that more than 80% of the largest U.S. companies now use stock compensation to link long-term performance of a company to executive salaries).

Although having a significant portion of an executive's pay take the form of contingent compensation is a relatively recent phenomenon, pay for performance is not a new idea. Some say that the philosophy of linking pay to performance dates back to the Protestant Reformation of the sixteenth and seventeenth centuries. See ROBERT L. HENEMAN, MERIT PAY: LINKING PAY INCREASES TO PERFORMANCE RATINGS 7 (1992). Others date the philosophy back even further. "The practice of rewarding those who perform well dates back to the very early times when kings allowed their nobles and chiefs to keep the spoils of the battles they won. Shortly before the birth of Christ, Julius Caesar is said to have instituted a more elaborate system to supply bonuses to loyal soldiers participating in successful campaigns - 50 dinari for every legionnaire and 500 for each centurion." DEREK BOK, THE COST OF TALENT 39 (1993); see also Christopher Lowery et al., *Assessing the Merit of Merit Pay*, HUM. RESOURCES PLAN., Mar. 1, 1996, at 26 (citing Locke, "the use of money as a means of motivation probably traces back to the origins of money itself"). The use of performance-based compensation for American executives dates back to the World War I era, when executives began to receive bonuses as a significant part of their compensation. See Bok, *supra*, at 39-40.

Various terms are used to describe these forms of compensation, including contingent compensation, performance-based compensation and incentive compensation. Those terms are used interchangeably in this article.

4. Some would argue that despite the increased use of performance-based compensation, there is no real risk. See, e.g., John W. Hung, *Profits, Pay and Team Work*, FIN. TIMES, July 15, 1998, at 16 ("Study after study has failed to identify a strong relationship between top management compensation and company performance."); Joann S. Lublin, *Pay For No Performance*, WALL ST. J., Apr. 9, 1998, at R1 (reporting that in 1997 CEOs had an 11.7% increase in salaries and bonuses, but corporate profits rose only 8.9%).

enormous amounts at a time when the corporation that employs them is not perceived as earning the shareholders an adequate return on their investment. One would expect a negative reaction to the receipt by ousted Apple Computer CEO, Gilbert F. Amelio, of \$6.7 million in severance pay in 1997, in addition to \$2 million in salary and bonuses for that year, given that Apple suffered losses of almost \$2 billion during Amelio's brief seventeen-month tenure as the company's CEO.⁵ Although it is possible that Apple's shareholders would have lost even more during that period had Amelio not been at the helm, the disparity in how he fared compared to shareholders is not viewed positively by shareholders or the general public.⁶

Those who support the use of performance-based compensation believe that such contingent compensation motivates executives and/or rewards them.⁷ Performance-based compensation is seen as a means of providing incentive for executives to perform in ways that maximize corporate/shareholder wealth⁸ and/or as a way of paying executives

5. See Lublin, *supra* note 4, at R1. In 1996, a year in which Apple shareholders lost 40% of their investment, Amelio received compensation of \$23 million. See Daniel Kadlec, *How CEO Pay Got Away*, TIME, Apr. 28, 1997, at 59. Similarly, several years ago criticism focused on United Airline's compensation for CEO Stephen M. Wolf who was paid \$17 million from 1990 to 1992, while shareholders lost an average of 26% a year on their United Airlines shares. See BLAIR, *supra* note 3, at 9.

6. Seemingly excessive pay is not an issue that is limited to CEOs; other senior executives of large public corporations are also compensated generously. See Joann S. Lublin, *Golden Heirs*, WALL ST. J., Apr. 9, 1998, at R5 (concluding from an analysis of 1997 proxies that the gap in pay between CEOs and executives second-in-command at major public corporations is narrowing). A few examples of non-CEO executive officers who were quite generously compensated in 1997 are Pfizer Executive Vice President Henry McKinnell, who received \$787,000 in 1997, General Electric Senior Vice President Dennis Dammerman, who received \$1,025,000 in 1997, and Exxon Senior Vice President Robert Wilhelm, who received \$807,001 in 1997. See EXXON CORP., PROXY STATEMENT 14 (Mar. 18, 1998); GENERAL ELECTRIC CORP., PROXY STATEMENT 20 (Mar. 13, 1998); PFIZER CORP., PROXY STATEMENT 21 (Mar. 19, 1998).

7. See, e.g., Bruce Overton, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 325 (Fred K. Foulkes ed., 1991) (stating that incentive compensation has the "potential to motivate executives and focus their energies on behavior that directly supports or fulfills organizational goals"); Detlev Vagts, *Challenges to Executive Compensation: For The Markets or the Courts?*, 8 J. CORP. LAW. 231, 240 (1983) (stating that contingent compensation may either measure the contribution of managers or motivate managers).

8. See Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 306 (1995) (citing statement of Kevin Murphy that compensation is not a zero-sum game and that providing better incentives to managers simultaneously makes the manager and the shareholders better off); Kevin J. Murphy, *Politics, Economics and Executive Compensation*, 63 U. CIN. L. REV. 713, 724 (1995) (proposing that companies that offer their CEOs lower base salaries in exchange for potentially higher performance-related pay-offs provide incentives to create wealth); Dana Wechsler, *Would Adam Smith Pay Them So Much?*, FORBES, May 28, 1990, at 210 (quoting Warren Buffett to the effect that a really top executive is worth every penny he is paid. "A

commensurately with their contribution to a corporation's growth and performance.⁹ Boards of directors assure their shareholders that contingent compensation will motivate executives and align their interests with the interests of shareholders.¹⁰ Market reaction to the adoption of contingent compensation plans suggests that shareholders (and prospective shareholders) take those assurances at face value.¹¹

million, \$3 million or \$10 million, [if they perform well], it's still peanuts."). *But see Executive Compensation: Hearings on S.1198 Before the Subcomm. on Taxation of the Senate Comm. on Finance*, 102d Cong. 2d Session (1992) [hereinafter *Hearings on S.1198*] (statement of Sen. Boren) ("We would be less concerned about the amount of compensation paid to executives if we believed that pay tracked performance.").

9. "More aggressive pay-for-performance systems (and a higher probability of dismissal for poor performance) would produce sharply lower compensation for less talented managers. Over time, these managers would be replaced by more able and more highly motivated executives who would, on average, perform better and earn higher levels of pay. Existing managers would have greater incentives to find creative ways to enhance corporate performance and their pay would rise as well." Michael C. Jensen & Kevin J. Murphy, *CEO Incentives - It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 139. The authors go on to explain that the increase in compensation would not represent a transfer of wealth from shareholders to executives, but a reward to managers for improving business performance and increasing the company success. *See id.* That is, rather than taking a bigger piece of the existing pie, the executive is given a generous slice of the bigger pie.

10. *See, e.g.*, APPLE COMPUTER, PROXY STATEMENT 6 (Mar. 16, 1998) (explaining that the principles of the company's executive compensation program are intended to motivate executive officers to improve the financial position of the company); COSTCO, PROXY STATEMENT 9 (Dec. 18, 1997) (stating that the board seeks to align total compensation for senior management with corporate performance and the interests of shareholders); CROWN CORK & SEAL, PROXY STATEMENT 12 (Mar. 23, 1998) (explaining that stock options are an ideal way to link shareholder and executive interests); EXXON, PROXY STATEMENT 10 (Mar. 18, 1998) (informing shareholders that the company's executive compensation program is designed to motivate executives by making significant portion of senior executive's potential compensation dependent upon increased shareholder value); UAL, PROXY STATEMENT 13 (Mar. 12, 1998) (describing the company's executive compensation program as one which supports a pay-for-performance culture and emphasizes pay-at-risk).

The assumption that money motivates behavior is not limited to the use of money to compensate workers. It is not uncommon to see money being used to attempt to motivate students to perform better in school or to motivate people to lose weight or to quit smoking. *See* Laura Koss-Feder, *Take Out Employee Benefits: Incentives That Motivate Workers*, CRAI'S N.Y. BUS., June 9, 1997, at 32 (giving employees incentives to participate in wellness programs); Joan Verdon, *Schools Give Students Incentives to Improve*, THE RECORD, Mar. 7, 1988, at A01 (discussing experiments involving paying students for school attendance or performance); Jack Williams, *He Pushes Good 'Addiction'*, SAN DIEGO UNION TRIB., May 30, 1986, at D1 (reporting on the use of monetary incentives to promote fitness).

11. *See* Sanjai Bhagat et al., *Incentive Effects of Stock Purchase Plans*, 14 J. FIN. ECON. 195 (1985) (believing market effect of adoption of stock plans to be proof of their incentive effect); Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCT. & ECON. 179 (1985) (finding adoption of golden parachutes to be associated with positive security market reaction); David F. Larcker, *The Association Between Performance Plan Adoption and Corporate Capital Investment*, 5 J. ACCT. & ECON. 3 (1983) (finding announcement of adoption of long-term

Although the concepts of “pay as motivator” and “pay as reward” are related,¹² the primary focus of this article is on the use of contingent compensation as a means of motivating superior executive performance.¹³ There may be no question that an executive’s performance is a function of ability, skill, and motivation.¹⁴ There also is no question that things other than money motivate people. My focus, however, is on the role of money and whether the assumption underlying contingent compensation—that “a person will be motivated to work if rewards and penalties are tied directly to his performance”¹⁵—is a valid one.¹⁶ This is an important question for

incentive compensation plan to be associated with positive securities market reaction; suggesting that results may be attributable to tax or other effects rather than incentive reasons); Hassan Tehrani & James F. Waeglein, *Market Reaction to Short-Term Executive Compensation Plan Adoption*, 7 J. ACCT. & ECON. 131, 141 (1985) (finding announcement of adoption of short-term incentive compensation plan to be associated with positive abnormal returns, but suggesting that it is difficult to say whether the positive returns are attributable to the adoption of the plan or other factors); see also Shelley Taylor, *Don’t Wag That Dog!*, INVESTOR REL. Q., Winter 1998, at 4, 5-6 (noting that “[i]n the governance arena, what American (and European) investors care about most is linking management’s pay to share price performance,” based on their belief that rewarding management in the same way as shareholders creates accountability).

12. Even if one does not believe that pay affects how people behave, and that therefore pay ought not be used as a motivator, one might still think that executive pay should reflect how well executives have performed—i.e., that pay should be used as a reward. To some extent, the effectiveness of using pay as a motivator is dependent on the extent to which executives perceive that pay works as a reward. They must believe that pay will sufficiently reward their effort in order to be willing to expend the effort. Therefore, for contingent compensation to motivate future performance, pay must be sufficiently related to past performance. In addition, when pay is examined after the fact, it will be hard not to be critical of executives who receive high pay when company (and therefore, presumably individual) performance has not been stellar.

13. This is not to deny that companies may use compensation to achieve other aims. See *infra* note 135. Those other aims are not my focus, since my goal here is to consider whether the oft-cited aim of motivating executives is attainable.

14. See VICTOR H. VROOM & EDWARD L. DECI, *MANAGEMENT AND MOTIVATION* 10 (1970); see also PAUL J. CHAMPAGNE & R. BRUCE MCAFEE, *MOTIVATING STRATEGIES FOR PERFORMANCE AND PRODUCTIVITY* 2-5 (1989) (stating that performance is a function of ability and motivation); BRUCE R. ELLIG, *EXECUTIVE COMPENSATION—A TOTAL PAY PERSPECTIVE* 24 (1982).

15. VROOM & DECI, *supra* note 14, at 13. How one measures that performance, via measures of individual performance, company performance, or a combination thereof, is another question. Although defining what constitutes performance is not the focus of this article, the question of individual versus company performance is addressed in section III.B.2.

16. This article focuses on the relationship between compensation and motivation. It does not address the issue of the relationship between job satisfaction and job performance or of the effect of contingent compensation on job satisfaction. Some authors have suggested that the relationship between satisfaction and performance is affected by contingent compensation. See H. Joseph Reitz & William E. Scott, Jr., *Effects of Contingent and Noncontingent Reward on the Relationship Between Satisfaction and Task Performance*, 55 J. APPLIED PSYCHOL. 531, 535 (1971).

two reasons. First, it has implications for compensation decisions and for the laws that provide the framework in which such decisions are made. Not only are boards making decisions without questioning assumptions that may simply be inaccurate, but Congress and the Securities and Exchange Commission ("SEC") rely on the same unquestioned assumptions when acting in ways that encourage contingent compensation.¹⁷ Second, the use of compensation as a motivator is viewed, among other things, as a vehicle for addressing the agency problems inherent in the separation of ownership and management of the corporate form.¹⁸ If, in fact, the assumptions underlying this approach are faulty, corporations relying on performance-based compensation as a means of addressing agency problems need to find a different approach.¹⁹ Finally, even if the assumptions underlying contingent compensation are valid, it is still important to address whether performance-based compensation is currently structured and used in a way that maximally motivates executives.

A fundamental problem with the drive toward using contingent compensation as a means of motivating executives is that neither the boards of directors, who design compensation packages, nor the government agencies, who have adopted rules to encourage the use of performance-

Vroom and Deci regard a focus on satisfaction as an alternative approach to the use of pay as a means of dealing with questions of what motivates workers to perform effectively. They describe as paternalistic the assumption "that people will be motivated to perform their jobs effectively to the extent to which they are satisfied with these jobs." VROOM & DECI, *supra* note 14, at 11. This satisfaction approach utilizes unconditional rewards "in the sense that the amount of reward that any individual receives is not dependent in any clear-cut way on how he behaves within the organization, but rather on the fact that he is a member in that organization." *Id.*

17. See *infra* text accompanying notes 33-38.

18. See *infra* text accompanying notes 31-32. See generally John M. Abowd, *Does Performance-Based Managerial Compensation Affect Corporate Performance?*, 43 INDUS. & LAB. REL. REV. 52-S (1990) (stating that interest in performance-based compensation is based on a belief that it provides a viable solution to the problem of aligning the interests of managers and owners); Bhagat et al., *supra* note 11, at 195 (citing commentators suggesting that equity-based compensation schemes address agency problems by aligning management and shareholder interests); R. Haugen & L. Senbet, *New Perspectives on Informational Asymmetry and Agency Relationships*, 14 J. FIN. & QUANTITATIVE ANALYSIS 671 (1979) (proposing use of stock options as an incentive device to eliminate agency problems).

19. This will not necessarily be easy. Other alternatives for addressing managerial discretion have their own problems. See generally MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 6 (1994) (describing the collective action problem that makes shareholders' effective monitoring of managers difficult); Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1425 (1985) (rejecting the idea that markets are effective in constraining managerial discretion); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282-83 (1982) (suggesting that independent directors do not serve as an effective curb on managerial discretion because they may merely rubber stamp decisions due to a lack of expertise or familiarity).

based compensation, have considered the social science literature²⁰ discussing motivation and the extent to which external incentives, such as money, affect managerial behavior.²¹ The social science literature suggests that determining whether performance-based compensation acts as a successful motivator is more complicated than it may appear from a lay discussion. This article considers the literature as a means of evaluating the existing emphasis on performance-based compensation and suggests modifications in the compensation structure and in the laws affecting the compensation structure of corporate executives.

Part I of this article describes the increased use of contingent compensation to motivate executives and the rationales supporting this trend. Part II critiques the polar opposite of the assumption of the effectiveness of the contingent compensation—the argument that any attempt to motivate executives through contingent compensation is inherently flawed. Part III concludes that there is insufficient evidence to support a complete abandonment of the notion of trying to motivate through compensation. Part IV surveys several psychological theories of motivation and their application to existing compensation practices, concluding that the potential motivational impact of contingent compensation techniques is not being maximized. Part V offers some suggestions for improvement.

I. THE FACE OF EXECUTIVE COMPENSATION

The term “contingent compensation” or “performance-based compensation” can refer to several different methods of compensation, ranging from the basic concept of merit pay²² to more sophisticated forms

20. Theories about contingent pay come from both psychology and economics fields. “A theme common to both sets of theories is that linking pay to performance should increase performance. A major difference between these sets of theories is the view on *why* pay based on performance is likely to lead to better performance.” HENEMAN, *supra* note 3, at 24. Heneman further explains that, in contrast to psychological theories, economic theories are directed toward the operation of the firm or market rather than the motivation of individuals within the firm or market. *See id.* at 35. This article primarily considers theories that are rooted in psychology.

21. There is no dearth of research on motivation. “More papers, chapters, and books have been written about motivation and it has been the subject of more theories—and theoretical controversy—than any other single topic [of organizational research]. Thus, a strong case can be made for the view that motivation—the internal processes that activate, guide, and maintain behavior (especially goal directed behavior) is one of the most pivotal concerns of modern organizational research.” Robert A. Baron, *Motivation in Work Settings: Reflections on the Core of Organizational Research*, 15 MOTIVATION & EMOTION 1 (1991). However, very little of the discussion has gone on in business circles where the use and value of performance based compensation is accepted without question. *See* BOK, *supra* note 3, at 106.

22. The term “merit pay” is generally used to refer to “individual pay increases based

of short or long-term incentive compensation. A typical executive compensation package includes several types of contingent compensation, most typically short-term bonus plan payments, and one or more forms of long-term compensation,²³ such as stock options and/or stock bonuses.

Short-term incentive compensation plans generally provide for an annual payment to executives based upon certain measures of company performance.²⁴ Generally, a board's compensation committee, in consultation with outside compensation consultants, will design a plan establishing benchmarks for corporate performance in certain categories, such as earnings per share, return on assets, or return on equity.²⁵ If the company achieves those benchmarks in a given year, a bonus is paid for that year. If the benchmark is exceeded, a larger amount is paid. If the goal is not met, either a smaller amount or no bonus is paid. Pay according

on the rated performance of individual employees in a previous time period . . . While [merit pay] is based on previous performance, it is intended to motivate increased performance in future periods." HENEMAN, *supra* note 3, at 6. One way in which merit pay differs from other forms of contingent compensation is that merit pay is generally based on subjective ratings rather than on objective ones or on measurable indicators of performance. *See id.* at 12. Also, once obtained, merit pay loses its contingent aspect, typically taking the form of a permanent salary increase that is based on performance. *See id.* at 15.

This article does not address merit pay in its basic function of merit salary increases. Executive salary increases are generally based on a combination of merit and market. *See, e.g.,* CATERPILLAR, PROXY STATEMENT 9 (Feb. 27, 1998); LOCKHEED MARTIN, PROXY STATEMENT 14 (Mar. 19, 1998); OMNICOM, PROXY STATEMENT 9 (May 18, 1998); PFIZER, PROXY STATEMENT 24 (Mar. 19, 1998); SNAP-ON, PROXY STATEMENT 12 (Mar. 13, 1998) (each describing factors considered by board compensation committees in determining compensation).

23. *See* Larcker, *supra* note 11, at 5-6 (describing various types of long-term compensation plans).

24. *See* Tehranian & Waegelein, *supra* note 11, at 132 (describing general characteristics of short-term incentive plans). Sometimes such plans may also take into account individual performance for a portion of the payout. However, this is generally not done with the CEO, since often the only way to judge a CEO's performance is by company performance. *See infra* notes 142-43 and accompanying text.

25. There is no consensus over what measures should be used. *Compare* IRA T. KAY, VALUE AT THE TOP: SOLUTIONS TO THE EXECUTIVE COMPENSATION CRISIS 189 (1992) (criticizing the use of accounting measures), with Michael E. Ragsdale, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 564 (1993) (citing research supporting accounting measures).

A company's industry and its own particular goals may affect what measures are chosen. For example, a manufacturer with sluggish sales might wish to use sales income as a measure whereas a financial institution concerned with its level of non-interest expense might use net non-interest income as a measure. Despite some individual variation, there are some measures that crop up over and over again. According to one study using data from the Fortune 100, to determine bonuses under short-term incentive plans, 37% of the companies used return on equity as a measure, 32% used net income, 29% used earnings per share, 27% used stock price appreciation, and 23% used pre-tax profit. *See* William E. Lissy & Marlene L. Morgenstern, *Currents in Compensation & Benefits*, 27 COMPENSATION & BENEFIT REV., Sept. 19, 1995, at 10.

to such plans is thus contingent on corporate achievement of certain predetermined objectives.

The most prevalent form of long-term compensation is the stock option.²⁶ A stock option grants the holder of the option the right (but not the obligation) to purchase a specified number of shares of company stock at a price that is fixed at the date of grant.²⁷ The option exercise price is typically the fair market value on the date of grant of the shares subject to the option.²⁸ Generally, options become exercisable over time and remain exercisable for a period of ten years. Since the expectation is that the price of the company's stock will rise between the grant date and the exercise date of the option, the exercise of an option is the functional equivalent of the purchase of stock at a discount from the price at which the stock is trading on the date of purchase/exercise.

Another form of stock compensation often used is the granting of bonus stock. Bonus stock is "free" stock; awarding bonus stock is like granting an option with an exercise price of zero dollars. Generally, bonus shares vest over time, and thus cannot be sold for some period after the grant.²⁹ The primary difference between options and bonus stock is that an

26. See GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 175 (1991) (stating that stock options are the favorite form of long-term incentive compensation); Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J.L. BUS. & FIN. 31, 42 (1997) (describing stock options as an almost universal compensation method and noting that 94% of the country's largest 250 companies compensate their executives with stock options).

Traditionally, options were granted only to top executives. However, according to one recent commentator, "they are now handed out to roughly 50 percent of midlevel professionals at major companies, and many surveys show that at least 1 in 10 of the companies offer them to most of their employees." Adam Bryant, *Feeding the New Work Ethic*, N.Y. TIMES, Apr. 19, 1998, § 4, at 1; see also Liz Moyer, *Dime Offers Stock Option Plan*, AM. BANKER, May 21, 1997, at 9 (reporting on expansion of stock option programs by Dime, Chase Manhattan, and BankAmerica to cover non-executive employees).

27. See generally Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1750 (1994) (discussing the perceived importance of rewarding key employees with stock options); Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 492-93 (1983) (discussing issues related to recognizing the stock option as income at the time of grant). In order to avoid recognizing an expense for accounting purposes, the number of shares and the option price have to be fixed at grant. See APB OPINION NO. 25, Accounting for Stock Issued to Employees, ¶ 5 (Accounting Principles Board 1972).

28. While options need not be granted with an exercise price equal to fair market value at the date of grant, doing so is common and reasonable. First, if a corporation wants to grant incentive stock options, thus obtaining favorable tax treatment, the options must be granted with an exercise price no less than fair market value. See 26 U.S.C. § 422(b)(4)(1994). Second, it is necessary to grant options with an exercise price at least equal to fair market value in order to avoid having to recognize an accounting expense for the option. See APB OPINION NO. 25, *supra* note 27, ¶ 5.

29. See Richard Dieter et al., *Accounting for Pensions and Deferred Compensation*, 393

option provides no value (and hence no compensation) unless the company's stock rises after the date of grant, whereas bonus stock guarantees that the executive receives something even if the company's stock falls (so long as it doesn't fall to zero dollars). Another difference is that generally an executive who is granted bonus stock gets full dividend payments from the date of grant, whereas with options, no dividends are paid on the underlying shares until exercise of the option.³⁰

The focus on the use of these various forms of contingent compensation as a means of motivating executives reflects a concern with addressing the agency costs created by the separation of ownership and management inherent in the corporate form of organization.³¹ Some mechanism is necessary to address the fact that the interests of owners and managers sometimes diverge. Since it is not practical for owners to monitor managers directly on a day-to-day basis, something else is needed to ensure that managers work in the best interest of shareholders. Contingent compensation is one alternative to direct monitoring. It attempts to minimize agency costs by making it financially advantageous for executives to behave in a way that serves the interests of owners.³²

TAX MGMT. PORTFOLIO A40 (1993); Michael R. Flyer, *Employee Benefits and Executive Compensation*, in C 803 ALI-ABA COURSE OF STUDY: TAX AND BUSINESS PLANNING AND RESTRUCTURING FOR THE '90s 233, 264 (1993).

Generally, once stock vests, it is nonforfeitable. However, it is possible to structure a bonus stock program which retains forfeitability of shares. See, e.g., COCA-COLA, PROXY STATEMENT 18 (Mar. 12, 1998) (stating that although shares are earned in 20% increments, once shares are earned the executive must remain with the company for five years and may not compete for two years following termination to receive shares).

30. This is because when an executive is awarded bonus stock, ownership occurs immediately, entitling the executive to both voting and dividend rights upon the grant of the stock. See David S. Foster & Walter M. Kolligs, *Promoting a Sense of Ownership*, in COMPENSATION PLANNING FOR EXECUTIVES IN A NEW ENVIRONMENT 1992, at 339, 347 (PLI Tax L. & Estate Planning Course Handbook Series No. 329, 1992).

Although these are the most popular forms of long-term compensation, other forms of long-term compensation include a combination of restricted stock and cash payouts based on corporate performance targets being met at the end of a three or five-year performance cycle. See, e.g., CATERPILLAR, PROXY STATEMENT 13 (Feb. 24, 1998); CONAGRA, PROXY STATEMENT 14 (Aug. 21, 1998), and deferred compensation, payable only at the end of an executive's career, based on a formula which measures the company's asset value and earning power value. See, e.g., JOHNSON & JOHNSON, PROXY STATEMENT 9 (Mar. 11, 1998).

31. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATIONS AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 171-72 (6th ed. 1996); LARRY E. RIBSTEIN, *BUSINESS ASSOCIATIONS* 305, 308-10 (2d ed. 1990); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

32. "An effective pay package will minimize the costs of the agency relationship between owners and managers." Wilbur Lewellen et al., *Executive Compensation and Executive Incentive Problems: An Empirical Analysis*, 9 J. ACCT. & ECON. 287, 287 (1987); see also Abowd, *supra* note 18, at 53-S to 55-S (discussing literature regarding use of pay to reduce agency costs).

Thus, boards structure compensation packages so as to motivate executives to behave in a manner consistent with shareholders' interests. Short-term incentive plans, with receipt of bonus amounts dependent on achievement of certain targets, send a signal to executives that those targets are valuable. Long-term incentive plans, particularly those that give executives an equity interest in the corporation, aim to give the executives a longer-term view than they might otherwise possess if they were only compensated with current cash by putting the executives in a position similar to that of the shareholders.

The movement toward performance-based compensation has been fueled, or at least supported, by the federal government. The Securities and Exchange Commission's 1992 amendments to the proxy rules require that a company's proxy statement include a performance graph that compares the shareholders' return with the market as a whole or with a peer group of companies.³³ This graph must accompany a report of the board's compensation committee³⁴ explaining both the board's general compensation philosophy and its specific compensation decisions with respect to the company's most highly paid executive officers.³⁵ These

Agency costs cannot be completely eliminated by the use of contingent compensation because the board would remain dependent on management for information. *See* Anne T. Coughlan & Ronald M. Schmidt, *Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation*, 7 J. ACCT. & ECON. 43, 45 (1985) (reporting that agency problems are not solved because boards are making compensation decisions based only on information supplied to them by management).

33. The required graph compares the company's total shareholder return against those of a broad market index and a peer group. If a company is in the Standard and Poor's 500 ("S&P 500"), it must use that index. If a company is not in the S&P 500, it can use an index that includes companies on an exchange, traded on the NASDAQ, or that are of similar market capitalizations. The peer comparison can be made on the basis of a published industry or line-of-business or on the basis of a peer group selected by the company, so long as the basis for selection is closed. *See* 17 C.F.R. § 229.402(l)(i), (ii) (1998).

34. Although the board of directors has the power to set the compensation of executives, *see supra* note 2, the vast majority of boards delegate that authority to compensation committees. *See* ANDREW HACKER, *MONEY: WHO HAS HOW MUCH AND WHY* 112 (1997) (noting that virtually all boards have compensation committees); James W. Fisher, Jr., *The Role of the Compensation Committee*, in *EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990S*, 366, 366 (Fred K. Foulkes ed., 1991) (according to recent surveys 84-99% of large companies have compensation committees establishing executive compensation).

35. *See* 17 C.F.R. § 229.402 (1996). The report that must be submitted by the board compensation committee must describe the bases for executive compensation decisions, including the relationship to company performance. The factors and criteria on which the CEO's salary was based must be specified as well. *See id.* § 229.402(k)(2).

The 1992 amendments made significant changes in how compensation of executives is reported to shareholders. The aim of the amendments was to provide shareholders with clearer and more understandable information. *See id.* § 229.402(a)(2) (describing desire to provide "clear, concise, and understandable disclosure" of compensation awarded to senior executive officers). The four main tables required by the rules include a summary

amendments encourage board committees to think in terms of performance-based compensation, since such pay will be more easily justified to shareholders whose focus has been drawn to company performance by the graph. In addition, when Congress amended section 162 of the Internal Revenue Code ("Code") to disallow a deduction for compensation in excess of \$1 million paid to senior executive officers,³⁶ it allowed an exception for compensation that hinges on the "attainment of one or more performance goals."³⁷ Thus, to the extent that a company wants to provide deductible compensation in excess of \$1 million, it must be in the form of performance-based compensation, which is exactly the result Congress was seeking to achieve.³⁸

compensation table, two option and stock appreciation right tables, and a table dealing with long-term incentive plan awards. *See id.* § 402(a)(1)(i). The essential table is the summary compensation table, which contains all compensation paid during the previous three years to the CEO and to the four most highly paid executive officers with salaries and bonuses in excess of \$100,000 for the last completed fiscal year. *See id.* §§ 229.402(b)(1), 229.402(a)(3)(i)-(iii) and Instruction 1 to Item 402(a)(3). *See generally* Susan Cooper Philpot, *Proxy Statements and Proxies Under the Securities Exchange Act of 1934*, in SECURITIES FILINGS 1998, at 229 (PLI Corp L. & Practice Course Handbook Series No. 1081, 1998); Patrick J. Straka, *Executive Compensation Disclosure: The SEC's Attempt to Facilitate Market Forces*, 72 NEB. L. REV. 803, 811 (1993) (describing the rule changes).

36. *See* 26 U.S.C. § 162(m) (1994). Under prior law, executive compensation was tax deductible as long as it was "reasonable." Section 162(m), enacted in 1993, provides that a public corporation will not receive a tax deduction for covered employees whose compensation is over \$1 million unless the excess amounts are based on "the attainment of one or more performance goals." 26 U.S.C. § 162(m)(4)(C). The term "covered employees" includes the CEO and the four highest paid executives who are in office on the last day of the fiscal year. However, two bills, which did not pass, were introduced that would have extended the section to all employees. *See* Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J.L. BUS. & FIN. 5, 14 (1997).

37. 26 U.S.C. § 162(m)(4)(C). To qualify for the exception, a compensation committee, composed solely of two or more outside directors, must certify in writing that the covered employee has satisfied "one or more preestablished, objective performance goals." Treas. Reg. § 1.162-27(e)(2)(i)(1995). Measures such as stock prices, market share, sales volume, earnings per share, return on equity, or cost can be used to establish the goals. The material terms of the performance goals must also be approved by a majority shareholder vote. "Material" terms include (1) the individuals eligible to receive the compensation, (2) the criteria used, and (3) either a formula which can be used to calculate compensation or a maximum amount which can be paid. *See* Treas. Reg. § 1.162-27(e)(4)(i). If the compensation involves stock options, shareholder approval must include approval of the option price or formula used to set the price and the maximum number of shares that can be awarded. *See* Treas. Reg. § 1.162-27(e)(4)(iv); *see also* FED. TAX GUIDE REP. PG-2360 (CCH) (Aug. 20, 1993).

38. Section 162(m) "was not intended to be a revenue-raising provision, but a behavior-shaping provision. The exception for performance-based compensation 'is not a loophole.'" Meegan M. Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747, 747 (1994) (quoting Catherine Creech, former Treasury benefits tax counsel, Address at Meeting of the District of Columbia Bar (Feb. 2, 1994)). Thus, Congress' aim in enacting § 162(m) and the exception for performance-based pay was to

A number of studies have attempted to assess the effectiveness of contingent compensation, and several studies have concluded that such plans positively influence company and/or individual performance.³⁹ However, it is difficult to assess those conclusions for several reasons. First, a number of the studies involve lower level managers or non-managerial employees,⁴⁰ and their results may or may not be translatable to plans involving executives. One can posit reasons why lower-level employees would be more or less likely to be motivated by performance-based compensation. On the one hand, the fact that rank and file employees have a lower base salary than executives may mean that contingent compensation will be more likely to positively affect their performance, since the potential to receive additional dollars may be more meaningful.⁴¹ On the other hand, it is less clear that compensation in the form of stock grants or stock option grants will motivate rank and file employees because the link between their actions and a company's stock price is less direct than with executives.⁴² These factors make it difficult to

encourage performance-based compensation. See *Hearings on S.1198*, *supra* note 8, at 2. "[W]e would be less concerned about the amount of compensation paid to executives if we believed that pay tracked performance." *Id.*

39. See *infra* notes 40-43. Some of the studies address contingent compensation based on individual performance. Others address contingent compensation based on company performance, assuming that if a company performs well after adopting a plan, individual performance must have been positively affected by the plan. The discussion in later sections of this article addresses studies concluding generically that contingent compensation yields certain results. Studies attempting to address specific motivational hypotheses are discussed as relevant in section III.

40. See Diana L. Deadrick & K. Dow Scott, *Employee Incentives in the Public Sector: A National Survey of Urban Mass Transit Authorities*, 16 PUB. PERSONNEL MGMT. 135, 141 (1987) (finding from questionnaire survey of 850 transit directors that merit pay programs are effective); Robert L. Opsahl & Marvin D. Dunnette, *The Role of Financial Compensation in Industrial Motivation*, in VROOM & DECI, *supra* note 14, at 133 (citing evidence suggesting that incentive pay systems result in greater output per man hour and lower unit costs than straight pay systems).

41. See *infra* text accompanying notes 132-141 (discussing why the typically high base salary of executives minimizes the motivating potential of performance-based compensation).

42. See Bhagat et al., *supra* note 11, at 208 (stating that among lower level employees, there is a "free rider problem"; each employee hopes the group collectively will produce so that he or she can benefit, but each individual has limited incentive to participate personally because his or her effort will not have a big effect on share value); George Milkovich & Carolyn Milkovich, *Strengthening the Pay-Performance Relationship: The Research*, COMPENSATION & BENEFITS REV., Nov. 1, 1992, at 53, available in 1992 WL 3079143 (commenting that profit sharing and bonus plans create a "line of sight" problem among lower-level employees because only a few employees can see a direct connection between their performance and the company's profits); Bryant, *supra* note 26, §4, at 4 (stating that lower level employees "don't quite know what they can do differently to help lift the stock price - except, at consumer-goods companies, maybe buying more of their company's own products").

draw conclusions about the effectiveness of contingent compensation on executive performance from studies of nonexecutive employees.

Second, and more importantly, a number of the studies that show improved performance after the plans are introduced are explicitly inconclusive regarding causation.⁴³ This may be because the studies do not control for the level of pay, tax consequences, or for other changes in the workplace that may accompany the adoption of a contingent compensation plan.⁴⁴ For example, many companies that reported improved results following adoption of incentive plans also made significant changes in corporate culture at the same time, making it difficult to assess the extent to which adoption of the contingent pay arrangement affected performance.⁴⁵

43. See, e.g., Bhagat et al., *supra* note 11, at 195 (suggesting that stock purchase plans have positive incentive effect, but basing that conclusion merely on market reaction to adoption of the plans); Larcker, *supra* note 11, at 27-28 (finding evidence that firms adopting performance plans experience a statistically significant growth in capital investment, but that it is problematic to directly attribute these results to the 'incentive effect' of performance plans); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 169, 176-78 (1995) (finding a positive linear correlation between firm performance and the portion of the CEO's compensation that is equity-based, but unable to demonstrate causation); Tehranian & Waagelein, *supra* note 11, at 140-41 (finding that firms adopting short-term compensation plans experience positive abnormal returns two months after the adoption announcement and that these returns are associated with positive unexpected earnings, but noting that these results could either be because the plan provided executives with incentive to increase earnings or that managers knew that earnings were likely to be unexpectedly high and were instrumental in getting the board to adopt a plan that would reward that result); Rajesh Aggarwal & Andrew A. Samwick, *Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence* (Mar. 1997) (suggesting the need to take into account other factors such as manager risk-aversion and product market characteristics in evaluating performance-based incentives) (working draft on file with author).

44. See Abowd, *supra* note 18, at 552 (stating that studies on effect of contingent compensation do not control for tax consequences, making it difficult to determine incentive effect); Lawrence M. Kahn & Peter D. Sherer, *Contingent Pay and Managerial Performance*, 43 INDUS. & LAB. REL. REV. 107-S, 108-S to 109-S (1990) (discussing failure to control for level of pay).

45. See Douglas B. Myers, *How a Shift in Corporate Culture Has Increased Plano Bank & Trust's Shareholder Value*, 19 J. RETAIL BANKING SERVICES 7 (1997) (describing changes in corporate culture at a Dallas bank and trust company, accompanying the adoption of contingent compensation plans).

There is also a more cynical explanation for why performance in certain areas may increase following adoption of a performance-based plan: corporate managers adopt those forms of compensation that are consistent with their expectations. Under that theory, employers adopt performance-based compensation only when they expect the company to do well. If such plans are only adopted during periods when expectations are high (such as during a period when the stock market is generally doing well) it is no surprise that the company will seem to perform well following adoption of the plan. More specifically, if managers think certain aspects of a company's performance, for example, sales, may do well in a subsequent period, they may adopt a short-term incentive plan that rewards employees if certain sales levels are met. Then, when the targets are met, they can say the

Finally, not surprisingly, other studies conclude that there is no statistical relationship between contingent compensation decisions and performance.⁴⁶ In light of the difficulty in forming conclusions about contingent compensation based on these types of empirical studies, the following sections of this article will explore the social science literature about the nature of motivation as a means of evaluating the attempt to motivate managerial performance through compensation.

II. AT THE EXTREME: THE COMPLETE REJECTION OF MONEY AS A MOTIVATOR

The polar opposite of the assumption of the effectiveness of contingent compensation is the position that completely rejects the notion that monetary rewards improve performance. The rejection is based on several factors, most notably the beliefs that (1) pay is not a motivator; (2) rewards undermine intrinsic interest; and (3) rewards punish.⁴⁷

A. *Money As a Motivator*

The argument that the potential for additional pay is not a motivator is crucial, since money must be important to a person before a promise of more money could possibly motivate that person. Although it may seem

plan worked to motivate increased sales, when, in fact, the same results would have been achieved absent adoption of the plan.

46. See, e.g., Atul Mitra et al., *The Case of the Invisible Merit Raise: How People See Their Pay Raises*, COMPENSATION & BENEFITS REV., May 15, 1995, available in 1995 WL 8473991 (concluding that employers should be concerned that huge raises have no motivational effect and, therefore, do not increase performance, even if they do increase morale and satisfaction).

47. Those who completely reject the use of monetary rewards do so on the grounds that rewards rupture relationships both horizontally and vertically. Horizontal relationships suffer because incentive programs are often structured in a way that reduces the likelihood that workers will cooperate with each other, and vertical relationships suffer because when the person to whom a worker reports has control over how much the worker makes, the worker is more likely to conceal problems and less likely to ask for help. See, e.g., KOHN, *supra* note 1, at 54, 55; see also Dana Wechsler Linden & Vicki Contavespi, *Incentivize Me, Please*, FORBES, May 27, 1991, at 208, 211 (citing W. Edwards Deming's conclusion that the incentive system destroys teamwork, making coworkers overly competitive); *Tie Incentives to Goals for Results*, S.F. BUS. TIMES, Feb. 7, 1997, available in 1997 WL 7731822 (citing compensation consultant Wayne Dunlap to the effect that individual performance incentives discourage teamwork).

This is not likely to be a concern in the case of a CEO, who has no peers and is usually judged by the board of directors. There is no evidence on the extent to which rewards may harm relationships among senior executives or between senior executives and the CEO, who evaluates their performance. I think there would be no such harm because senior management generally works closely together and the rewards given to one generally do not diminish or limit the rewards available to others.

counter-intuitive to suggest that money does not motivate, critics of contingent compensation argue that money is not as significant a factor in how people live and work as many people believe.⁴⁸ Rather, they propose that workers who have enough money to afford basic necessities—a category that obviously includes executives—care much more about the non-monetary aspects of their employment situation. Those making this argument take the position that reputation, job satisfaction, security, and other factors are stronger motivators than money.⁴⁹ Even those who

48. See, e.g., KOHN, *supra* note 1, at 36, 42-43; Nancy C. Morse & Robert S. Weiss, *The Function and Meaning of Work and the Job*, in VROOM & DECI, *supra* note 14, at 42, 43 (arguing that working is more than a means of economic support; evidence supports the argument that most people would work even if they did not need to for financial reasons); Herbert H. Meyer, *The Pay-for-Performance Dilemma*, ORGANIZATIONAL DYNAMICS, Winter 1975, at 39, 40 (arguing that people do not work just for money and if the interest and challenge of the work are held constant, it would be difficult to demonstrate that highly paid persons would put out more effort than those less well paid).

49. See, e.g., BOK, *supra* note 3, at 22-23 (citing Chester I. Barnard, the author of THE FUNCTIONS OF THE EXECUTIVE (1940) and W. Edwards Deming, “the father of ‘total quality management,’” as well as several psychologists, questioning the effectiveness of monetary incentives as the incentive for action); Yungsan Kim, *Long-Term Firm Performance and Chief Executive Turnover: An Empirical Study of the Dynamics*, 12 J.L. ECON. & ORG. 480, 480 (1996) (citing the 1980 study by FAMA, suggesting that a manager’s concern about his reputation and career can provide such a strong motivation that it can resolve the managerial incentive problem without the use of explicit incentive compensation, and the 1982 study of Holmstrom, arguing that once reputation is established, the marginal effect of current performance on the executive’s reputation becomes small); Bernadette M. Ruf & Leonard H. Chusmir, *Dimensions of Success and Motivation Needs Among Managers*, 125 J. PSYCHOL. 631 (1992) (stating that power and achievement correlate with personal fulfillment and other factors rather than merely with wealth); Linden & Contavespi, *supra* note 47, at 211 (citing W. Edwards Deming, who argues that people are primarily motivated by self-esteem, dignity and love of learning, rather than money).

This is even true for lower-paid workers. See Jeff O’Heir, *Motivation is Topic at CFO Conference*, COMPUTER RESELLER NEWS, Mar. 10, 1997, at 135 (stating that challenging work and recognition are more important to non-executive high-tech employees than is competitive pay); Edward D. Sargent, *D.C. Teachers in Study Reject Merit-Pay Plan*, WASH. POST, May 30, 1984 (reporting that career development and recognition were more important to teachers than money).

“Need theorists” also reject money, in and of itself, as a motivator. Rather, they believe that human motivation stems from basic sets of needs. Money may be an end to lower level needs, but for high achievers, the higher level needs must be met before there can be positive effects on performance, job endurance, and satisfaction. See generally A.H. MASLOW, MOTIVATION AND PERSONALITY 80-92 (1954) (proposing a hierarchical arrangement of five basic needs); Clayton P. Alderfer, *An Empirical Test of a New Theory of Human Needs*, 4 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 142, 145-47 (1969) (proposing three basic needs, money falling under “existence needs”). “Needs theorists” do have their critics. See, e.g., Mahmoud A. Wahba & Lawrence B. Bridwell, *Maslow Reconsidered: A Review of Research on the Need Hierarchy Theory*, 15 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 212, 233-36 (1976) (criticizing Maslow’s theory on the ground that it suffers from conceptual and operational shortcomings); John P. Wanous & Abram Zwany, *A Cross-Sectional Test of Need Hierarchy Theory*, 18 ORGANIZATIONAL

acknowledge that money may be a motivator in certain circumstances question whether pay has more than a marginal impact on executives who already possess substantial wealth.⁵⁰ Others suggest that money is a greater or lesser motivator depending on where the recipient is in his or her career.⁵¹

The difficulty with claims that money does or does not motivate is that money is frequently associated with factors that those rejecting its use as a motivator generally accept as important in motivating people. These factors include achievement, status, reputation, and security. This association may have one of several results. First, it may result in money becoming a conditioned incentive. That is, "repeated pairings of money with primary incentives establish a new learned drive for money."⁵² Thus,

BEHAV. & HUM. PERFORMANCE 78, 94 (1977) (discussing both Maslow and Alderfer).

50. See BOK, *supra* note 3, at 244; KOHN, *supra* note 1, at 36 (arguing that for reward to cause someone to act in a certain way, the recipient of the reward must be needy enough for the reward to reinforce the desired behavior).

There is no question that money acts as an anxiety reducer, in the sense that absence of money, and therefore the absence of an ability to satisfy physical needs, is anxiety-provoking. However, even for average workers, "[o]nce a certain minimum level of living has been achieved, human behavior is directed largely towards some social goal or goals." Arthur H. Brayfield & Walter H. Crockett, *Employee Attitudes and Employee Performance*, in MANAGEMENT AND MOTIVATION 72, 74 (Victor H. Vroom & Edward L. Deci eds., 1970) (suggesting that goals such as achievement and acceptance by others are as significant for average workers as is satisfying basic physical needs). Executives are even less likely than average workers to be driven by a concern for money merely for its ability to satisfy basic physical needs.

51. See, e.g., GRAEF S. CRYSTAL, EXECUTIVE COMPENSATION: MONEY, MOTIVATION, AND IMAGINATION 21 (1978) (citing research that has "shown that the value an individual places on various types of compensation changes over a period of time in accordance with his current needs"); G.H. Foote, *Compensation and the Executive Career Cycle*, in THE ARTS OF TOP MANAGEMENT, A MCKINSEY ANTHOLOGY (Roland Mann ed., 1971); Kim, *supra* note 49, at 496 (suggesting that as the tenure of a chief executive officer increases, the value of incentive compensation to maintain the CEO's incentive to perform increases). But see Neil M. Ford et al., *Differences in the Attractiveness of Alternate Rewards Among Industrial Salespeople: Additional Evidence*, 13 J. BUS. RES. 123, 135-37 (1985) (finding that money does not lose its attractiveness over time and also finding an across the board low valence attached to recognition as reward).

Some argue that executives, particularly CEOs, are likely to already be working as hard as they can, meaning that money cannot motivate them to work any harder. See, e.g., K.R. SRINIVASA MURTHY, CORPORATE STRATEGY AND TOP EXECUTIVE COMPENSATION 79-80 (1977) ("Top executives work hard for their firms, anyway, and a change in their compensation would not result either in increased effort or in a better corporate performance."); Graef Crystal, *Incentives Fail to Improve Kodak's Picture*, PENSIONS & INVESTMENTS, Feb. 8, 1993, at 14. However, the use of contingent compensation for executives is not so much aimed at getting more work out of executives, but rather, at getting better decisions. The idea is to provide incentives for executives to make decisions that will benefit the company and its shareholders in the long and short term. See *supra* text accompanying notes 31-32.

52. Opsahl & Dunnette, *supra* note 40, at 129.

money may not have been a primary motivator of human behavior at one time, but it has become a learned motivator. Second, the association means that money is viewed as an instrument for gaining desired outcomes. This is simply the notion that money may not be an important motivator for its own sake, but rather for the security it affords.⁵³ Third is the related notion that money acquires importance as a symbol of achievement, in the sense that it provides visible external evidence of one's achievement, not otherwise knowable by others.⁵⁴ Again, the notion is that money for its own sake is not a motivator, but that money, because of what its acquisition symbolizes to others about the acquirer, is important.

Researchers who have identified distinct components of achievement motivation,⁵⁵ such as concern for excellence, competitiveness, acquisitiveness, status with experts, or status with peers,⁵⁶ have concluded that the motive to achieve is distinct from acquisitiveness for money.⁵⁷ Jackson, Ahmed and Heapy, for example, postulate that there are "distinct types of individuals in which motives to excel, to acquire money, to seek status, and to compete are present in different proportions."⁵⁸ They posit, for example, that two individuals might be in the same percentile in achievement motivation and may have equivalent positions on the excellence dimension, but the first might be low and the second high on competitiveness and acquisitiveness.⁵⁹ They suggest the first type of

53. See MURTHY, *supra* note 51, at 26 (stating that through conditioning, individuals associate money with a cessation of anxiety); Opsahl & Dunnette, *supra* note 40, at 131-32 (citing Gellerman as suggesting that money in itself has no intrinsic meaning except that it acquires motivating force when it comes to symbolize intangible goals).

54. See CHAMPAGNE & MCAFEE, *supra* note 14, at 73 (stating that "[t]he financial payoff for working is an important way of stating the value of a person's work"); MURTHY, *supra* note 51, at 26 ("For persons with a high need for achievement, money has a special significance; it is a measure of their accomplishment."); MICHAEL NASH, MAKING PEOPLE PRODUCTIVE: WHAT REALLY WORKS IN RAISING MANAGERIAL AND EMPLOYEE PERFORMANCE 114 (1985) ("High achievers do not work just for money, but money is important to them as a symbol of higher achievement."); Douglas N. Jackson et al., *Is Achievement a Unitary Concept?*, 10 J. RES. PERSONALITY 1, 3 (1976). The importance of pay for this purpose obviously varies by individual. See Henk Thierry, *Payment: Which Meanings Are Rewarding?*, 35 AM. BEHAV. SCI. 694, 701 (1992) (stating that the significance of pay to an employee is controlled by the degree to which pay relates to cognitions of self).

55. See David C. McClelland, *The Role of Money in Managing Motivation*, in MANAGERIAL MOTIVATION AND COMPENSATION (H.L. Tosi et al. eds., 1972); see also EDWARD E. LAWLER III, MOTIVATION IN WORK ORGANIZATIONS 21-22 (1973) (discussing McClelland's research).

56. See Richard E. Snow & Douglas N. Jackson III, *Individual Differences in Conation: Selected Constructs and Measures*, in MOTIVATION: THEORY AND RESEARCH 71, 81 (Harold F. O'Neil, Jr. & Michael Drillings eds., 1994); Jackson et al., *supra* note 54, at 17.

57. See Jackson et al., *supra* note 54, at 18.

58. *Id.*

59. See *id.* at 17.

individual would most likely be found engaging in scientific activity and the second in business,⁶⁰ suggesting that executives are more likely to score high on the acquisitiveness scale.

Thus, at least for some people (particularly those engaged in business), money, for its own sake, may be a significant motivator. For others, it may not motivate on its own, but motivate because of its instrumental or symbolic importance. That means that for many people, money will, directly or indirectly, be a motivating force.

The remainder of this section briefly addresses the other two aspects of the position that completely rejects the use of money as a motivator.

B. *Effect of Rewards on Intrinsic Interest*

Those who completely reject the notion that contingent compensation can positively affect performance also argue that extrinsic motivators are both less effective than intrinsic motivation and, more importantly, have an adverse impact upon intrinsic motivation.⁶¹ The mere existence of research suggesting that the best workers are intrinsically motivated⁶²—that is, motivated by internal or assimilated norms⁶³—and that interest in a task is higher when the employee is not being rewarded for doing so,⁶⁴ is not cause

60. *See id.* Similarly, it has been suggested that “[m]ore often than not, theorists who believe that people do not work for money are academicians whose own value systems or whose organizations’ mores say that money is not that important.” NASH, *supra* note 54, at 164-65.

61. *See* KOHN, *supra* note 1, at 40. Concern for the possible harmful effects of extrinsic rewards originally arose from research involving token rewards in educational settings, where results indicated that a child’s “love of learning” could be permanently destroyed if rewards were given for the performance of tasks. Kelli J. Skaggs et al., *The Use of Concurrent Schedules to Evaluate the Effects of Extrinsic Rewards on “Intrinsic Motivation”: A Replication*, 12 J. ORGANIZATIONAL BEHAV. MGMT. 45, 46 (1992). With the increased use of performance-contingent reward systems in business, researchers became concerned that extrinsic motivation may decrease intrinsic motivation in the workplace. *See id.* at 47.

62. *See* KOHN, *supra* note 1, at 133 (stating that individuals who are committed to excellence and likely to do the best work are particularly unlikely to respond to financial incentives); MARTIN MORF, *OPTIMIZING WORK PERFORMANCE: A LOOK BEYOND THE BOTTOM LINE* 51 (1986). Intrinsically-motivated behavior is believed to be more creative, spontaneous and flexible than extrinsically-motivated behavior. *See* EDWARD L. DECI & R.M. RYAN, *INTRINSIC MOTIVATION AND SELF-DETERMINATION IN HUMAN BEHAVIOR* 35 (1985); John Condry, *Enemies of Exploration: Self-Initiated Versus Other-Initiated Learning*, 35 J. PERSONALITY & SOC. PSYCHOL. 459, 462 (1977).

63. The intrinsic motivation may, for example, be task involvement motivation, where the activity is perceived as inherently satisfying and the individual is mainly concerned with assessing and developing individual mastery, or ego involvement motivation, where the attention is focused on assessing ability in relation to others.

64. *See* KOHN, *supra* note 1, at 68 (stating that if the goal is quality or lasting commitment, external incentives are less effective than intrinsic motivation).

for concern. However, these would be cause for concern if the use of rewards to motivate does actually undermine the intrinsic motivation that promotes optimal performance.⁶⁵

Two reasons have been offered to explain why rewards might decrease intrinsic motivation: (1) anything presented as a prerequisite for something else, as a means toward some other end, comes to be seen as less desirable,⁶⁶ and (2) rewards are often perceived as a threat to autonomy, resulting in rebellion as a response to the threat.⁶⁷ The result is a decline in intrinsic motivation.⁶⁸

However, the evidence on this point is far from consistent. Many argue that the concept of intrinsic motivation is difficult to define or measure, making it difficult to judge whether pay affects it.⁶⁹ Others find that performance-based compensation may actually increase intrinsic

65. See DECI & RYAN, *supra* note 62, at 298 (“[T]he research has consistently shown that any contingent pay system tends to undermine intrinsic motivation. The use of rewards to motivate behavior can, in general, be said to be deleterious to intrinsic motivation.”); KOHN, *supra* note 1, at 69-70 (citing studies by Deci and Lepper); MORF, *supra* note 62, at 56; PHILIP SLATER, WEALTH ADDICTION 127 (1980) (“Using money as a motivator leads to a progressive degradation in the quality of everything produced.”); Edward L. Deci, *The Effects of Contingent and Noncontingent Rewards and Controls on Intrinsic Motivation*, 8 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 217 (1972); Herbert H. Meyer, *The Pay-for-Performance Dilemma*, 3 ORGANIZATIONAL DYNAMICS 39, 41 (1974) (citing research of Edward Deci demonstrating that if pay is directly attached to performance of a task, intrinsic interest in the task declines).

66. See Jonathan L. Freedman et al., *Inferred Values and the Reverse-Incentive Effect in Induced Compliance*, 62 J. PERSONALITY & SOC. PSYCHOL. 357, 367 (1992) (suggesting that when larger amounts of money are offered, people will infer that the activity is less enjoyable, more difficult, or more dangerous).

67. See KOHN, *supra* note 1, at 76, 78; HARRY LEVINSON, THE GREAT JACKASS FALLACY 10-11 (1973) (arguing that reward-punishment psychology assumes that the leader has control and others are in a jackass position with respect to him, leading to decreased productivity and other negative results); Skaggs et al., *supra* note 61, at 46 (suggesting that when extrinsic rewards are provided for intrinsically motivating work, creativity, spontaneity, and flexibility are decreased, and the employee may experience a loss of self-determination and autonomy); Monique Jerome-Forget, *Taking a Closer Look at Personal Motivation*, FIN. POST, Aug. 16, 1997, at 23 (describing psychological research finding that “individuals perceive certain external interventions as controlling their behavior and react by reducing their intrinsic motivation”).

68. Commenting on the use of stock options among technology companies, a former clinical and industrial psychologist recently bemoaned the change from doing something for the love of it to just seeking to make a buck. See Bryant, *supra* note 26, § 4, at 1, 4.

69. See HENEMAN, *supra* note 3, at 49-50 (citing Dyer & Parker and criticizing Deci’s work on the grounds that intrinsic motivation is difficult to define or measure); FRANK J. LANDY & DON A. TRUMBO, PSYCHOLOGY OF WORK BEHAVIOR 379 (1980) (noting that the categorization of rewards as intrinsic or extrinsic does not add to investigations of effect of rewards on behavior); Lee Dyer & Donald F. Parker, *Classifying Outcomes in Work Motivation Research: An Examination of the Intrinsic-Extrinsic Dichotomy*, 60 J. APPLIED PSYCHOL. 455-58 (1975) (finding that it seems impossible to distinguish between intrinsic and extrinsic rewards conceptually).

motivation by reinforcing the internal drive.⁷⁰

One concern expressed by those who believe that extrinsic rewards negatively affect intrinsic motivation is that employees respond to reward situations by doing only what it takes to receive the reward—they will not take risks, they will not seek creative solutions to problems, and they will simply work to achieve the award.⁷¹ As applied to executives, there has been concern expressed that short-term incentive plans cause executives to become too focused on only those measurements that serve as targets for bonus awards.⁷² This argument does not say that rewards do not motivate; rather, it says that they provide a distorted motivation.

It is hard to assess the concern about loss of intrinsic motivation in the context of executive performance. Many of the studies discussing intrinsic motivation and the loss occasioned by adding external reward use activities

70. See HENEMAN, *supra* note 3, at 49-50 (citing Scott, Farr & Podsakoff for the idea that pay for performance does not always reduce intrinsic motivation); James L. Farr et al., *Further Examinations of the Relationship Between Reward Contingency and Intrinsic Motivation*, 20 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 31-32 (1977) (demonstrating that external rewards have either no effect on or increase intrinsic motivation); Judith M. Harackiewicz & George Manderlink, *A Process Analysis of the Effects of Performance-Contingent Rewards on Intrinsic Motivation*, 20 J. EXPERIMENTAL SOC. PSYCHOL. 531 (1984) (concluding that if an individual cares about doing well, intrinsic motivation is increased by performance-contingent rewards); see also EDWIN A. LOCKE & GARY P. LATHAM, A THEORY OF GOAL SETTING AND TASK PERFORMANCE 58 (1990) (concluding that intrinsic motivation rarely operates in isolation from other types of motivation in work settings, and that work life tends to be governed more by achievement motivation and extrinsic motivation than by intrinsic motivation); Jim Braham, *A Rewarding Place to Work*, INDUSTRY WK., Sept. 18, 1989, at 15 (stating that money must be present and in sufficient quantity in order for intrinsic rewards to motivate).

71. See CHAMPAGNE & MCAFEE, *supra* note 14, at 74 (linking objective measures to rewards causes those measurable aspects to receive all the employee's attention, to the neglect of other less measurable behaviors); MORF, *supra* note 62, at 56 (proposing that extrinsic rewards contingent on performance can reduce intrinsic motivation and direct the attention of employees exclusively to those things that clearly pay off); Gail D. Heyman & Carol S. Dweck, *Achievement Goals and Intrinsic Motivation: Their Relation and Their Role in Adaptive Motivation*, 16 MOTIVATION & EMOTION 231, 232 (1992) (stating that individuals may avoid challenges, and make task choices that emphasize short-term success at the expense of opportunities for future development); Robert H. Meehan, *Why Merit Increase Programs Fail*, 8 COMPENSATION & BENEFITS MGMT. 46, 47 (1992) (citing evidence that monetary rewards results in intrinsic rewards being "lost in the quest for performance-rating scores and the dollar increase"); Meyer, *supra* note 48, at 41 (citing research of Edward Deci that when pay becomes the important goal, the individual's interest tends to focus on the goal rather than performance of the task).

72. See, e.g., Sumer C. Aggarwal & Sudhir Aggarwal, *Compensation: A Management Rewards System for the Long and Short Terms*, 65 PERSONNEL J. 115, 116 (1986) ("[T]he rewards must not only motivate managers towards desirable and company-oriented behavior, but also promote a sense of responsibility towards sharing risks for the future."); Alfie Kohn, *Incentives Can Be Bad for Business*, INC., Jan. 1988, at 93 (stating that rewards discourage managers from taking risks and encourage narrow focus on accomplishing the stated goal).

such as game playing and reading that may be inherently pleasurable, so that the intrusion of money into the activity may adversely impact the pure pleasure. There is little, if anything, however, to suggest that corporate management is so inherently pleasurable that people would engage in the activity even if no paycheck were attached to it. Additionally, if executives are, in fact, high on the acquisitiveness scale and start out looking for money and the perquisites that money brings them (rather than being interested in corporate management for its own sake), it is less likely that closely associating pay and performance will have a significant adverse effect on their intrinsic motivation to perform.

C. *Reward As Punishment*

Some researchers argue that reward functions as a form of psychological punishment because of the added level of control it gives the employer. This form of punishment can lead to defiance, defensiveness, and rage.⁷³ Rewards are said to punish in two respects. First, they control, although by seduction, and thus feel punitive.⁷⁴ Second, to many, a reward withheld is the same as punishment. Thus, where people do not receive the rewards they expect, the effect is indistinguishable from punishment.⁷⁵ The result is loss of self-esteem and a tendency to reevaluate the importance of the activity for which the employee was insufficiently rewarded.⁷⁶

However, one should be hesitant about applying this notion to the executive workforce. As one commentator has noted, “[t]he fair exchange of money for goods and services is not the same as controlling through rewards.”⁷⁷ If the pay given to an executive represents a “fair and equitable

73. Kohn finds it interesting that many of the same people who reject punishment as a form of behavior control embrace reward. For him, reward and punishment are two sides of the same coin rather than opposites, in that both proceed from the same psychological model, “one that conceives of motivation as nothing more than the manipulation of behavior.” KOHN, *supra* note 1, at 51.

74. *See id.* But see CHAMPAGNE & MCAFEE, *supra* note 14, at 34 (stating the behaviorist counter to this argument that all management programs are manipulative in some way and that making individuals “aware of the consequences provides them with an opportunity to make explicit choices between well-defined alternatives”).

75. *See generally* KOHN, *supra* note 1, at 50-52; CHAMPAGNE & MCAFEE, *supra* note 14, at 22-23 (stating that punishment involves either taking direct punitive action or withholding a reward); Meyer, *supra* note 48, at 42 (describing how merit pay plans have the effect of threatening the self-esteem of a majority of workers because they may not receive the reward they feel their performance justifies).

76. *See* Meyer, *supra* note 48, at 44; David J. McLaughlin, *Does Compensation Motivate Executives?*, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990S 59, 76 (Fred K. Foulkes ed., 1991) (stating that executive overcompensation can demoralize the individual as well as the entire work force).

77. Richard B. Polley, *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise and Other Bribes* (Book Review), SOC., July, 1995, at 92, 93 (reviewing

exchange for the service,"⁷⁸ there is no control or manipulation in the payment. Thus, to the extent that this notion has any applicability to the issue of the use of pay to motivate executives, it is merely to suggest that it is important to ensure that executives understand the link between performance and pay and that the link is not manipulated in such a manner that executives believe they are being deprived of their due compensation, especially by factors beyond their control. It thus has the same implications as the equity theory, described below.⁷⁹

The foregoing arguments are certainly not enough to cause us to jettison the notion of trying to tie pay to performance. At a minimum, companies must have some way of allocating compensation and pay increases. Attempting to make compensation decisions that will positively affect performance is preferable to other alternatives,⁸⁰ assuming, of course, that performance can be defined and accurately measured.⁸¹ In addition, it would appear from the evidence that money has the capacity to act as an effective motivator at least in some circumstances. The question is what do theories of motivation teach us about how to best structure contingent compensation arrangements.

III. A MIDDLE GROUND: THEORIES OF MOTIVATION AND THEIR IMPLICATIONS FOR EXECUTIVE COMPENSATION PACKAGES

The use of performance-based compensation is premised on the acceptance of the notion that money can be an effective motivator. The question is how to best structure such plans to maximize their motivational impact. This section attempts to answer that question by examining psychological theories of motivation. Section A discusses several

ALFIE KOHN, *THE TROUBLE WITH GOLD STARS, INCENTIVE PLANS, A'S, PRAISE AND OTHER BRIBES* (1993)). Not all commentators agree with Kohn's notion that incentive pay in the workplace is necessarily controlling. *See id.*

78. *Id.*

79. *See infra* text accompanying notes 117-126.

80. One author suggests that there are three approaches to how organizations distribute resources to employees: (1) nepotism and favoritism, (2) across-the-board distributions, and (3) merit allocations. *See* Richard E. Kopelman, *Organizational Control System Responsiveness, Expectancy Theory Constructs, and Work Motivation: Some Interrelations and Causal Connections*, 29 *PERSONNEL PSYCHOL.* 205 (1976). Of course, there may be other aims sought to be achieved by compensation decisions, such as attracting and retaining employees and preventing or solving labor disputes.

81. Most commentators agree that if performance cannot be clearly measured, it is best not to give extrinsic rewards. *See, e.g.,* CHAMPAGNE & MCAFEE, *supra* note 14, at 74 (stating that extrinsic rewards cannot and should not be used to motivate job performance in jobs where there are no objective measures for performance); Linden & Contavespi, *supra* note 47, at 212 (quoting W. Edwards Deming to the effect that performance cannot be measured, meaning that merit pay merely rewards circumstances).

psychological theories of motivation and sketches their general implications for compensation decision making.⁸² These theories all accept, at least to some degree, the notion that money acts as a motivator.⁸³ Section B then discusses the applications of motivation theory to contingent compensation as it is currently structured and practiced.

A. *Theories of Motivation*

1. Reinforcement Theory

Reinforcement theory is based on the work of B.F. Skinner,⁸⁴ although a number of other authors have extended his theory from the laboratory setting to the workplace.⁸⁵ The thrust of the reinforcement theory is that the frequency of a desired behavior "is likely to be increased when a valued reward is made contingent upon that behavior."⁸⁶ The theory also postulates that "the contingency between behavior and rewards is likely to be strengthened the more clearly the behavior is defined, the closer in time the reward is to the behavior, and the closer in magnitude the reward is to the behavior."⁸⁷

The available research applying a generalized money reinforcement theory to the workplace suggests that it may be of limited value in the

82. Since my focus is on the ability of compensation to motivate executives, I am focusing on those psychological theories of motivation that would seem to have implications specifically for the use of pay. Thus, for example, I do not discuss certain psychological theories that may be of general interest in structuring a workplace environment to increase worker motivation but that do not necessarily have implications for compensation. *See, e.g.,* LANDY & TRUMBO, *supra* note 69, at 336-43 (describing Maslow's Need Hierarchy Theory and Alderfer's ERG Theory).

83. This assumption is important for non-psychological theories of behavior as well. If we were speaking about economic theories of rational utility maximization or rational choice, we would still require the assumption that the decision maker valued money in order for certain rational decisions to be made to facilitate attainment of money. *See* LEVINSON, *supra* note 67, at 22-23 (describing economic model of man); DOUGLAS MCGREGOR, *THE HUMAN SIDE OF ENTERPRISE* (1960) (taking the view that most people work for pay); EDGAR H. SCHEIN, *ORGANIZATIONAL PSYCHOLOGY* (1972) (developing the rational-economic model of man, which assumes that economic gain is the greatest motivator of human behavior).

84. B.F. SKINNER, *SCIENCE AND HUMAN BEHAVIOR* (1953).

85. *See* HENEMAN, *supra* note 3, at 28 (citing those authors who have built on the work of Skinner); LANDY & TRUMBO, *supra* note 69, at 352-55 (discussing research showing that individuals rewarded for successful job performance produce more than those not rewarded).

86. HENEMAN, *supra* note 3, at 28.

87. *Id.*; *see also* CHAMPAGNE & MCAFEE, *supra* note 14, at 35 (stating that successful reinforcement programs are set up so that rewards are directly related to specific behaviors and are given without delay after the desired behavior).

context of executive compensation.⁸⁸ Although the evidence suggests that performance improves when the principles of reinforcement theory are followed, for the most part the studies consider short-term rather than long-term effects. Additionally, and perhaps more importantly, they use simple measures of performance, such as quantity of output, rather than measuring activities and decision-making processes more characteristic of executive performance.⁸⁹

Nonetheless, reinforcement theory appears to have some basic implications for designing contingent pay for executives. It suggests that (1) the performance sought must be clearly defined; (2) pay increases must be contingent only upon performance to condition the appropriate behavior; (3) the size of pay increases should correlate to levels of performance; and (4) the contingent reward needs to be close in time to the desired performance.⁹⁰

More valuable than reinforcement theory to the issue of executive compensation are the following three psychological theories.

2. Goal-Setting Theory

Goal-setting theory developed in the mid-1960s as an alternative approach to the studies of motivation that were then dominant, such as reinforcement theory.⁹¹ One of the early formulators of the theory was Edwin A. Locke.⁹² Since his formulation, the theory has become "one of

88. See LANDY & TRUMBO, *supra* note 69, at 355 ("While we accept the basic proposition that contingent rewards affect behavior, we are not convinced that the behaviorist model can be usefully applied in any meaningful sense to a wide range of work behavior."); MURTHY, *supra* note 51, at 25 (noting that experimental evidence for a monetary reinforcement theory is considered limited and inconclusive); Gary W. Heiman, *A Note on Operant Conditioning Principles Extrapolated to the Theory of Management*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 165, 168 (1975).

89. See HENEMAN, *supra* note 3, at 29; see also LANDY & TRUMBO, *supra* note 69, at 362-63 (describing problems of applying behaviorism in the workplace); Edwin A. Locke, *Toward a Theory of Task Motivation and Incentives*, 3 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 157 (1968).

90. Heneman discusses these implications in the context of merit pay generally. See HENEMAN, *supra* note 3, at 29.

91. See Edwin A. Locke & Gary P. Latham, *Goal Setting Theory*, in MOTIVATION: THEORY AND RESEARCH 13, 14 (Harold F. O'Neil, Jr. & Michael Drillings eds., 1994). Goal setting represents a reaction to the fact that "[a]ll-encompassing theories of motivation based on such concepts as instinct, drive, and conditioning have not succeeded in explaining human action." Edwin A. Locke et al., *Goal Setting and Task Performance: 1969-1980*, 90 PSYCHOL. BULL. 125, 125 (1981) (describing goal setting as falling within the broad domain of cognitive psychology and being consistent with trends such as cognitive behavior modification).

92. See HENEMAN, *supra* note 3, at 33; Locke, *supra* note 89, at 157. Locke states that "[o]ther than the core premise, there was no network of theoretical propositions that could formally be called goal theory until my 1990 book with Latham, although most components

the most thoroughly researched areas in the management and organizational behavior literatures."⁹³

Locke's theory of goal setting addresses the relationship between goals, "goal" being defined as what an individual consciously sets out to do, and performance. The theory postulates that an individual's actions are regulated by his or her conscious intentions, or "goals".⁹⁴

According to goal-setting theory, goals motivate individuals when the goals are specific, challenging, and are accepted by the individual.⁹⁵ "[H]ard goals result in a higher level of performance than do easy goals, and specific hard goals result in a higher level of performance than do no goals or a generalized goal of 'do your best.'"⁹⁶ There has been a tremendous volume of research supporting goal-setting theory. Goal specificity, difficulty, and acceptance have all been demonstrated to relate to performance.⁹⁷

The evidence is particularly strong regarding the importance of goal specificity and the level of difficulty. According to Locke and Latham, there have been over 400 studies that have examined the relationship of difficulty and specificity to performance. They have consistently found that the harder the goal the better the performance, and that specific and difficult goals produce higher performance than goals that are vague but challenging.⁹⁸ Other researchers reviewing the literature have reached the same conclusion.⁹⁹ Difficulty appears to be important because people

of the theory had appeared in earlier writings." Edwin A. Locke, *Goal Theory v. Control Theory: Contrasting Approaches to Understanding Work Motivation*, 15 *MOTIVATION & EMOTION* 9, 19 (1991).

93. Anthony J. Mento et al., *A Meta-Analytic Study of the Effects of Goal Setting on Task Performance: 1966-1984*, 39 *ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES* 52, 74 (1987).

94. See Gary P. Latham & Gary A. Yukl, *A Review of Research on the Application of Goal Setting in Organizations*, 18 *ACAD. MGMT. J.* 824, 824 (1975); Locke & Latham, *supra* note 91, at 126.

Locke's early work treated goal and intention as interchangeable concepts. See Locke, *supra* note 89, at 158-59; see also Locke & Latham et al., *supra* note 91, at 125. Later, Locke and Latham distinguished goal from intention; goal representing the object of actions and intention representing planned actions. See Mark E. Tubbs & Steven E. Ekeberg, *The Role of Intentions in Work Motivation: Implications for Goal-Setting Theory and Research*, 16 *ACAD. MGMT. REV.* 180, 181 (1991) (suggesting that one's intentions, defined as "a cognitive representation of both the objective (goal) one is striving to reach and an action plan one intends to use to reach that objective," is separate and distinct from one's goal).

95. See HENEMAN, *supra* note 3, at 33; Latham & Yukl, *supra* note 94, at 824.

96. Latham & Yukl, *supra* note 94, at 840 (finding strong support for Locke's propositions that "specific goals increase performance and that difficult goals, if accepted, result in better performance than do easy goals").

97. See HENEMAN, *supra* note 3, at 34 (citing Mento and Tubbs).

98. See Locke & Latham, *supra* note 91, at 15-16.

99. See, e.g., Latham & Yukl, *supra* note 94, at 829-30 (reporting on studies evaluating

adjust their efforts to the difficulty of the task. Specificity is key because vague goals are compatible with many different outcomes including less than optimal performance,¹⁰⁰ whereas specific goals impose structure and reduce distraction.¹⁰¹ Regardless of the reasons, “[i]f there is ever to be a viable candidate from the organizational sciences for elevation to the lofty status of a scientific law of nature, then the relationship between goal difficulty, specificity/difficulty, and task performance are most worthy of serious consideration.”¹⁰²

The link between goal-setting theory and compensation comes at the level of goal commitment. Commitment refers to the “degree to which an individual is attracted to the goal, considers it important, is determined to

goal specificity and finding virtually all to support the importance of specificity); Locke & Latham, *supra* note 91, at 131 (reviewing literature since 1968 and finding that overall 48 studies partly or wholly support the hypothesis that hard goals lead to better performance and that 51 partly or wholly support hypotheses regarding importance of specific goals); Mento et al., *supra* note 93, at 75 (concluding from their meta-analytic study involving published research conducted from 1966 to 1984 that goal difficulty and specificity are consistently related to performance); Mark E. Tubbs, *Goal Setting: A Meta-Analytic Examination of the Empirical Evidence*, 71 J. APPLIED PSYCHOL. 474, 479 (1986) (reaching a conclusion from his meta-analytic study of the empirical evidence that supported Locke’s goal setting theory).

100. See Locke & Latham, *supra* note 91, at 15-16. See generally Anthony J. Mento et al., *Relationship of Goal Level to Valence and Instrumentality*, 77 J. APPLIED PSYCHOL. 395 (1992) (suggesting that the ambiguity inherent in vague goals allows people to give themselves the benefit of the doubt in evaluating their performance).

101. See CHAMPAGNE & MCAFEE, *supra* note 14, at 92 (“Increasing goal specificity on a task reduces role ambiguity and narrows the search for acceptable behaviors . . . People told to do their best do not really know what to do at all.”); MORF, *supra* note 62, at 53.

102. Mento et al., *supra* note 93, at 74. Tubbs suggests that “there appears to be little need to continue conducting studies solely concerned with testing the effects of goal difficulty and goal specificity on performance. A large number of such studies have already been done, and although there has been variation in the findings, the effects are generally positive across the different types of studies.” Tubbs, *supra* note 99, at 480. *But see* Heyman & Dweck, *supra* note 71, at 241 (suggesting that although learning goals generally enhance intrinsic motivation, performance goals undermine intrinsic motivation).

While there is consensus about goal difficulty and goal specificity, there is less agreement about other aspects of goal setting theory. For example, many researchers disagree about the value of participatively set versus assigned goals. See, e.g., CHAMPAGNE & MCAFEE, *supra* note 14, at 93-95 (suggesting that research is mixed on whether or not employee participation in setting goals has a positive effect and that participation in goal setting might be useful only if it results in more difficult goals being established); Latham & Yukl, *supra* note 94, at 840 (stating that results as to assigned versus participative goals are not consistent); Locke & Latham, *supra* note 91, at 16-17 (suggesting controversy in literature concerning the effectiveness of assigned versus participatively set goals and concluding that assigned goals with rationale are as motivating as participatively set goals). Some have suggested that even if participation is not important in terms of performance, it does affect job satisfaction. See Lowery et al., *supra* note 3, at 26 (suggesting that a frequent employee complaints about performance-based compensation demonstrates lack of control or involvement in the plan and that employee perception of being left out of the process negatively affects job satisfaction).

attain it, and sticks with it in the face of obstacles.”¹⁰³ Several researchers have suggested that money is a factor that plays a role in affecting an individual’s degree of goal commitment. They argue that contingent pay may create greater commitment to a goal.¹⁰⁴ In evaluating this idea, it is important to keep in mind that another factor affecting goal commitment is the belief that achieving the specified goals is possible.¹⁰⁵ Therefore, under goal-setting theory individual motivation suffers if goals are set at too low a level of difficulty, or if they appear so difficult as to be unreachable.¹⁰⁶

Feedback may be a second link between goal-setting theory and compensation. Feedback entails providing knowledge of the results of performance. Goal theorists generally discuss the importance of feedback, and the research seems to indicate that feedback has a positive impact on performance, even independent of goal setting.¹⁰⁷ While goal setting alone

103. Locke & Latham, *supra* note 91, at 16.

104. See HENEMAN, *supra* note 3, at 33-34 (noting that pay incentives contribute to the motivational effect of goal setting by creating greater commitment to the goal); MORF, *supra* note 62, at 53 (proposing that once a goal has been accepted, money can increase the valence of attaining it and therefore increase commitment to the goal); Latham & Yukl, *supra* note 94, at 837 (stating that monetary incentives are more likely to increase goal acceptance and commitment than to induce a person to set a higher goal); Locke & Latham, *supra* note 91, at 136-37 (suggesting that money can affect task performance independently of goal level).

105. See CHAMPAGNE & MCAFEE, *supra* note 14, at 91 (“Goals should cause people to exert themselves, but the outcomes must still be within their grasp.”); Locke & Latham, *supra* note 91, at 17; Edwin A. Locke, *Relation of Goal Level to Performance with a Short Work Period and Multiple Goal Levels*, 67 J. APPLIED PSYCHOL. 512, 513-14 (1982) (finding that performance decreases when success seems impossible); Edwin A. Locke & Gary P. Latham, *Work Motivation and Satisfaction: Light at the End of the Tunnel*, 1 PSYCHOL. SCI. 240, 240 (1990) [hereinafter *Work Motivation and Satisfaction*] (“Monetary incentives strengthen goal commitment providing people value money, the amount of money is sufficiently large and the incentives are not tied to goals perceived as impossible.”).

106. See Locke & Latham, *supra* note 91, at 17 (citing research of Lee, O’Neil, Locke, and Phan).

It has been found consistently that performance is linearly related to goal level. Given sufficient ability and high commitment to the goal, the harder the goal the better the performance . . . Goal theory predicts and finds a performance drop at high goal difficulty levels only if there is a large decrease in goal commitment (or a poor task strategy was used). Performance levels out, of course, when the limits of ability are reached.

Id. at 15.

107. See, e.g., MORF, *supra* note 62, at 52 (discussing how goals facilitate feedback and feedback is reinforcing of performance); John M. Ivancevick & J. Timothy McMahon, *The Effects of Goal Setting, External Feedback, and Self-Generated Feedback on Outcome Variables: A Field Experiment*, 24 ACAD. MGMT. J. 359 (1982) (proposing that goal-setting has greater effect on motivation when accompanied by feedback); Jay S. Kim & W. Clay Hamner, *Effect of Performance Feedback and Goal Setting on Productivity and Satisfaction in an Organizational Setting*, 61 J. APPLIED PSYCHOL. 48, 55 (1976) (reporting own study results that feedback enhances performance beyond what would be achieved by goal setting

enhances performance, performance is enhanced even more when feedback is provided. Contingent compensation provides a form of feedback, since the executive's pay provides a measure of his attainment of the established goals.

Goal-setting theory would thus appear to have three basic implications for designing contingent pay for executives: (1) compensation should be made contingent upon specific and understandable¹⁰⁸ goals; (2) compensation should be made contingent upon goals that are difficult, but not so difficult that they are perceived as unattainable; and (3) compensation should be structured to provide meaningful feedback to executives.

3. Expectancy Theory

Expectancy theory as a formal model was first developed by Vroom¹⁰⁹ in 1964 and has been refined by many others since then.¹¹⁰ The theory postulates that an individual's motivation is a function of three types or sets of perceptions: expectancy, instrumentality, and valence. Expectancy refers to an individual's perception that changes in individual effort will lead to changes in performance. Instrumentality refers to the individual's belief that performance will lead to certain rewards or outcomes. Valence

alone); see also CHAMPAGNE & MCAFEE, *supra* note 14, at 94 (noting that most research suggests that knowledge of results is effective only if it is related to the accomplishment of specific goals, and that general praise has no discernable effect on behavior). Some would go further, arguing that goal setting without feedback has little long term effect on performance. See *Work Motivation and Satisfaction*, *supra* note 105, at 241.

108. Goals fail to motivate if people do not understand the link between goal and reward. See CHAMPAGNE & MCAFEE, *supra* note 14, at 91 (stating that goals lose their motivating potential when the relationship between an individual's performance and the rewards is not understood). But see John C. Mowen et al., *Joint Effects of Assigned Goal Level and Incentive Structure on Task Performance: A Laboratory Study*, 66 J. APPLIED PSYCHOL. 598, 602 (1981) (rejecting the argument that a lack of understanding of the link between performance and compensation under a complex bonus incentive system resulted lower performance for difficult goals).

109. See generally VICTOR H. VROOM, *WORK AND MOTIVATION* (1964). There were, however, precursors to Vroom's model. One was the "path-goal" instrumentality theory of Georgopolous, Mahoney and Jones enunciated in 1967. See LANDY & TRUMBO, *supra* note 69, at 343. Others mentioned as precursors to Vroom are Atkinson and Lewin. See generally John W. Atkinson, *Towards Experimental Analysis of Human Motivation in Terms of Motives, Expectancies, and Incentives*, in JOHN W. ATKINSON, *MOTIVES IN FANTASY, ACTION AND SOCIETY* (David C McClelland ed., 1958); Kurt Lewin, *Psychology of Success and Failure*, in UNDERSTANDING HUMAN MOTIVATION 317 (Chalmers L. Stacey & Manfred F. DeMartino eds., 1958).

110. See HENEMAN, *supra* note 3, at 24-25 (citing Porter and Lawler as among those who have refined Vroom's notions); LANDY & TRUMBO, *supra* note 69, at 344-47 (discussing Porter and Lawler's model as well as later research on expectancy theory). See generally LAWLER, *supra* note 55.

refers to the attractiveness of the rewards or outcomes that will result from the performance.¹¹¹ In lay terms, the theory can be expressed in the form of three questions: (1) Can I do it?; (2) What will I get?; (3) How much do I want what I can get?¹¹² The answers to these questions ultimately determine productivity.

In basic terms, the theory states that the greater the valence of outcomes and the higher the instrumentality and expectancy perceptions, the greater the individual's effort.¹¹³ Like goal-setting theory, there has been a tremendous amount of research done on expectancy theory that supports the major components of the theory.¹¹⁴

When pay is the outcome in question, expectancy theory states that pay will have a high motivational force when compensation has a high valence, is perceived to be dependent on high performance, and increases in the individual's effort level are perceived to lead to greater compensation. As with goal setting, an individual who believes that she can successfully complete a task is more likely to be motivated to try it than one who does not believe the task can be successfully completed.¹¹⁵

Expectancy theory has several implications for structuring contingent compensation arrangements. The theory suggests that (1) for contingent compensation to be an effective motivator, increased pay must be more attractive (i.e., have a greater positive valence) than other outcomes (such as increased leisure time, etc.); (2) executives must perceive performance as being instrumental in attaining the desired outcome, which means that

111. See HENEMAN, *supra* note 3, at 25; MORF, *supra* note 62, at 44; Edward E. Lawler, III, *Job Design and Employee Motivation*, in *MANAGEMENT AND MOTIVATION*, *supra* note 14, at 160, 160-61.

112. See CHAMPAGNE & MCAFEE, *supra* note 14, at 60.

113. See HENEMAN, *supra* note 3, at 25 (noting that the three perceptions combine in a multiplicative manner, such that if any of expectancy, instrumentality or valence has a value of zero, motivational force will be zero); Lawler, *supra* note 111, at 160-61 (noting that the factors combine multiplicatively). Thus, there will be no motivation if (1) people do not believe they will succeed; (2) they do not think that performing well will be adequately rewarded; or (3) they do not want the rewards offered. See CHAMPAGNE & MCAFEE, *supra* note 14, at 63. Expectancy theory might appear to contradict goal setting, since it postulates that "effort-performance expectancy drops as goal difficulty rises." MORF, *supra* note 62, at 53. However, "the lowered effort-performance expectancy is typically more than counterbalanced by the higher valence of more challenging goals." *Id.* (citing Matsui, Okada & Mizuguchi).

114. See HENEMAN, *supra* note 3, at 26-27. See, e.g., Richard E. Kopelman, *Organizational Control System Responsiveness, Expectancy Theory Constructs, and Work Motivation: Some Interrelations and Causal Connections*, 29 *PERSONNEL PSYCHOL.* 205, 205-06 (1976) (describing his own work and citing several other authors and studies supporting expectancy theory).

115. See CHAMPAGNE & MCAFEE, *supra* note 14, at 61; MORF, *supra* note 62, at 44. See generally J. Stacy Adams, *Inequity in Social Exchange*, 2 *ADVANCES EXPERIMENTAL SOC. PSYCHOL.* 267 (1965).

the relationship between pay and performance must be clearly defined,¹¹⁶ and pay should not depend on factors other than performance; (3) executives must believe that performance can be accurately measured; and (4) executives must perceive a relationship between their own actions and the performance measures that result in increased compensation.

4. Equity Theory

Equity theory, articulated by researchers such as J.S. Adams¹¹⁷ and Edward E. Lawler,¹¹⁸ posits that motivation is affected not only by a person's own compensation and the relationship between that person's pay and performance, but also by the pay of others (and by the relationship between their pay and performance).¹¹⁹

Equity theory rests on the fundamental notion that people want to be treated fairly. It posits that individuals establish a relationship between their inputs (what they contribute in their work setting), and their outputs (what they receive for their input). Since individuals' notions of what is equitable derives from comparing their reward with others' rewards, they analyze the relationship between their own inputs and outputs in light of the correlative relationship of a similar group of people whom they believe should be rewarded comparably. If they receive too much in relation to the comparison group they feel uncomfortable, guilty, or embarrassed, and if they receive too little they feel resentful and disgruntled. In either case, their work output and quality are adversely affected.¹²⁰ "Equity theory

116. See Kopelman, *supra* note 114, at 205-06 (suggesting that this is the most widely cited implication of expectancy theory); Opsahl & Dunnette, *supra* note 40, at 138 (suggesting that the effectiveness of incentive plans in general depends on the individual's knowledge of the relation between performance and pay).

117. See Adams, *supra* note 115, at 267.

118. LAWLER, *supra* note 55, at 17-18.

119. See HENEMAN, *supra* note 3, at 30-31 (discussing the theory and citing those who have articulated it); see also MORF, *supra* note 62, at 23 (assuming that in area of work motivation, perceived outcomes and rewards are more important than objective outcome of work performance). Equity theory is a variation of the balance theory which holds that "behavior is initiated, directed, and sustained by the attempts of the individual to maintain some internal balance of psychological tension." LANDY & TRUMBO, *supra* note 69, at 355-56. The theory, as applied to the workplace, as based on Festinger's theory of cognitive dissonance, essentially posits that because tension is unpleasant, individuals act to reduce the tensions created by discrepant cognitions. See *id.*

120. See LAWLER, *supra* note 55, at 17; VROOM & DECI, *supra* note 14, at 96-97; Stuart C. Carr et al., *Effects of Unreasonable Pay Discrepancies for Under- and Overpayment on Double Demotivation*, 122 GENETIC, SOC., & GEN. PSYCHOL. MONOGRAPHS 477 (1996) (finding that pay discrepancies decreased work motivation and job satisfaction, and produced greater readiness to change jobs). But see Richard C. Huseman et al., *A New Perspective on Equity Theory: The Equity Sensitivity Construct*, 12 ACAD. MGMT. REV. 222, 231 (1987) (proposing that individuals are not equally sensitive to equity in that

states that the presence of inequity will motivate an individual to reduce inequity and that the strength of the motivation to reduce inequity varies directly with the perceived magnitude of the imbalance experienced between inputs and outcomes.¹²¹ The likely result of a perception that one is paid less than she deserves is that the employee will achieve balance by reducing her own productivity.¹²² Even for employees for whom money itself is not the most important factor in their employment, fairness in pay does assume importance.¹²³

For purposes of equity theory, individuals may compare themselves to others inside or outside the work organization.¹²⁴ In the case of executives, it is particularly likely that the comparison will be external. This is true not only because a CEO is not really comparable to anyone else within an organization, but also because information about the compensation of senior executives at public companies is so readily available that executives cannot help but compare their own compensation to others in similar

“Benevolents prefer that their outcome/input ratio be less than the comparison other’s; Equity Sensitives, who adhere to a norm of equity, prefer balanced outcome/input ratios; and Entitleds prefer that their outcome/input ratios exceed the comparison other’s.”); David I. Levine, *What do Wages Buy?*, 38 ADMIN. SCI. Q. 462, 463, 481 (1993) (finding that culture makes a difference; noting that Japanese workers experienced lowered morale and commitment about over-payment than their counterparts in the United States; “it is considered bad form in Japan to be an overachiever . . . This ideology is reflected in the classic Japanese proverb: ‘The nail that sticks out gets hammered down.’”) (internal citations omitted).

121. LAWLER, *supra* note 55, at 18; *see also* Bonnie R. Rabin, *Executive Compensation and Firm Performance: An Empirical Analysis* 47-48 (Library of the New York State School of Industrial and Labor Relations at Cornell University) (1987) (discussing Adams equity theory).

122. *See* LAWLER, *supra* note 55, at 18; J. Stacy Adams & William B. Rosenbaum, *The Relationship of Worker Productivity to Cognitive Dissonance About Wage Inequities*, 46 J. APPLIED PSYCHOL. 161, 163 (1962) (finding that lower paid workers decrease productivity to restore equity); Melvin M. Mark & Jerald Greenberg, *Evening the Score*, PSYCHOL. TODAY, Jan. 1987, at 44 (citing sports examples in support of notion that when people do not get rewards they believe they deserve, they try to restore equity by decreasing their performance levels).

Another response to disparity is to withdraw from the situation—either by leaving or absenteeism. *See* D.R. Schmitt & G. Marwell, *Withdrawal and Reward Allocation as Responses to Inequity*, 8 J. EXPERIMENTAL SOC. PSYCHOL. 207, 219 (1972).

123. *See* CRYSTAL, *supra* note 51, at 15 (“[C]ompanies that are able to maintain significant compensation differentials between outstanding and mediocre performers seem to have less trouble in keeping executive talent over the short term—even when their overall compensation posture is below average—than companies whose compensation practices are above average but who consistently fail to provide the proper degree of performance recognition.”); O’Heir, *supra* note 49, at 135 (tying pay to performance and stating that fair performance measures are of greater importance than pay itself for non-executive high tech company employees).

124. *See* HENEMAN, *supra* note 3, at 30. *See also* Aggarwal & Aggarwal, *supra* note 72, at 116 (noting that information from national executive pay surveys have formed the basis of management rewards rather than performance or job contributions).

positions in other organizations.

Although the studies on equity theory have mixed results,¹²⁵ employees asked about their reaction to the adoption of performance-based compensation arrangements frequently express concerns about fairness of the allocation of rewards.¹²⁶ Indeed, it is almost a common sense notion that a participant's perception of the fairness of a performance-based compensation plan is important.

Equity theory has two implications for contingent pay plans. It implies both that: (1) the relationship between pay and performance must be clearly specified and clearly communicated so as to diminish the difference between the perceived relationship between pay and performance and the actual relationship; and (2) attention must be paid to the relationship between the pay of an executive and the pay of similarly situated executives both within the organization and among the organization's industry peer group.

B. Application of Motivation Theories to Executive Compensation Packages

The preceding section suggests that the various theories of motivation have much to say about how contingent compensation arrangements can best be structured. Although there may be some tension between the theories at certain levels—for example, between reinforcement theory's insistence that pay increases be contingent only on performance and equity theory's notion that the pay of other similarly situated individuals must be considered as well—there are some common themes as well.¹²⁷ Once we accept the fundamental notion that money may serve as a motivator, it would appear that in order for contingent compensation plans to maximize their motivating effect, at a minimum, the plans should meet several criteria.

125. See HENEMAN, *supra* note 3, at 32; LANDY & TRUMBO, *supra* note 69, at 356-57.

126. See, e.g., Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 290-91 (1992) (noting that employees do not look favorably upon compensation plans because of managers' inability to evaluate employees and because employees feel that managers do not have the ability to distinguish among the performances rendered by the employees they are evaluating); Lowery et al., *supra* note 3, at 26 (surveying employees at seven companies adopting performance-based plans suggests that employees were concerned with lack of fairness or perception of favoritism in award allocations).

127. I say "may be" a tension because, depending on how one defines performance, it may be possible to make the two theories consistent. However, to the extent tension exists, it is equity theory's conclusion that will win out, since as a matter not only of equity theory, but also of the need to retain executives, boards will always consider the pay of other executives (both within and without) the organization in deciding what to pay their senior officers, particularly the CEO.

First, the goals established for executives to receive certain pay increases must be sufficiently difficult, although not so difficult as to be unattainable (or to be perceived as unattainable). In addition, there should be some specificity to the goals. Goal difficulty is important to both goal-setting theory (which finds performance to be linearly related to goal level)¹²⁸ and expectancy theory (which posits that more challenging goals are more attractive).¹²⁹

Second, there must be some relationship between the individuals' performances and attainment of the goals on which pay is based. For example, if short-term incentive plans provide for bonuses to be paid upon the attainment of certain corporate targets, the individual has to perceive that superior performance on her part will affect whether the corporation achieves those targets.

Third, the relationship between pay and performance should be clearly specified. Under all of the theories, particularly expectancy theory, the individual must understand the relation between performance and pay.¹³⁰

Finally, pay must actually depend on performance. It must be ensured that executives do not sense that the contingent pay arrangements can be manipulated in such a way that the executives are either cheated of compensation they deserve or paid in excess of what their performance warrants. Although this requirement is most important for equity theory, it is clearly implicated in the other theories as well.¹³¹

Current contingent compensation arrangements do not measure up to these teachings of motivation theory. As currently structured and implemented, performance-based compensation does not serve as a sufficient motivator of executive performance. The reasons for this include high base salaries, the failure to distinguish between individual and group performance, insufficiently high performance barriers, and manipulative behavior.

1. High Base Salary

Despite the increasing use of various forms of contingent compensation, the base salary of most executives remains quite high. A quick glance at the 1998 *Wall Street Journal* survey of executive pay shows many executives with 1997 base salaries in excess of \$1 million¹³²

128. See *supra* note 106 and text accompanying notes 94-101.

129. See *supra* note 113.

130. See *supra* note 116.

131. As discussed earlier, feedback affects goal commitment which is important to goal-setting theory. If pay does not in fact depend on performance, the feedback effect of pay regarding past performance is distorted.

132. See *The Boss's Pay*, WALL ST. J., Apr. 9, 1998, at R13.

(despite section 162(m) of the Code, which disallows deductions for compensation in excess of \$1 million that is not performance-based¹³³), and many more with base salaries in the \$600,000 to \$900,000 range.¹³⁴

Any attempt to motivate through compensation¹³⁵ is doomed to fail if a substantial portion of an executive's pay is fixed at a high level.¹³⁶ Guaranteeing a high base salary is inconsistent with the underpinnings of the expectancy theory because the fact that a significant portion of income is independent of performance levels weakens the executive's instrumentality perceptions, including her belief that performance will affect the outcome or attainment of reward.¹³⁷ As one former consultant quipped, "[e]ven if the rest of the CEO's pay package were fraught with risk, which it is not, how can a CEO talk about taking risk and at the same time keep a straight face when, if the worst happens, he is down to his last \$1 million per year?"¹³⁸ Even taking into account the fact that executives are likely to be overachievers for whom lots of money is important both as a symbol of achievement and as a necessity in maintaining a certain lifestyle, base salary is high enough to call into question the motivational impact of the contingent portion.

133. See *supra* text accompanying notes 36-37.

134. See *The Boss's Pay*, *supra* note 132; see also John W. Hunt, *Profits, Pay and Team Work*, FIN. TIMES, July 15, 1998, at 16 (stating that "research has shown that, at best, only about 5% of chief executives' pay depends upon the company's performance").

135. Companies may pay some executives high base salaries for reasons unrelated to an attempt to motivate the executives. For example, it might be thought necessary to pay an executive a high base salary to attract the executive or to retain her during bad economic times. The purpose of this article is not to debate the wisdom of those other goals, or to balance them against the desire to motivate. Rather, it is to suggest that if the compensation goal is to motivate executives, paying a high base salary makes it harder to achieve that goal.

136. Bonnie R. Rabin analyzed employment agreements for use in her thesis and found support for this conclusion. See Rabin, *supra* note 121. Ms. Rabin conducted a multiple regression analysis for a cross-sectional time series sample of 255 manufacturing firms and found that the use of executive employment agreements "is associated with a statistically significant adverse effect on subsequent financial performance." *Id.* at 3. The overall characteristics of the employment agreements studied included guaranteed levels of compensation independent of firm performance, a guarantee of a fixed period of employment, and takeover protections which are fairly typical in executive employment agreements. See *id.* at 13. More importantly, in terms of the results, salary was typically the largest single component of executive pay. See *id.* Ms. Rabin's conclusions suggest that it is meaningless to speak of motivating executives through contingent compensation so long as the executives continue to receive such large base salaries.

137. See *id.* at 41.

138. CRYSTAL, *supra* note 26, at 175. For example, Lee R. Raymond, CEO of Exxon, received 200,000 stock options as part of his 1994 compensation. However, the incentive impact of this receipt is extremely limited given that he also received a \$1.3 million base salary and a restricted stock grant of \$593,000. See Jack L. Lederer & Carl R. Weinberg, *Harnessing Corporate Horsepower: The New Principles of CEO Compensation*, CHIEF EXECUTIVE, Sept. 1, 1995, at 32.

On the other hand, there may be a downside to making too high a percentage of the executive's compensation contingent. The concern is not so much that a bad year for the company might result in low pay for that year,¹³⁹ but that the prospect of a low payoff may cause an executive to make decisions adverse to shareholders' interests. For example, if too large a portion of an executive's pay is based on stock performance, the executive may be less willing to undertake risky actions which might be in the best interests of shareholders in the long-run, but that may adversely affect the stock's price in the short-term.¹⁴⁰ This possibility is aggravated because, unlike a shareholder, who normally purchases a company's stock as part of a diverse stock portfolio, contingent compensation arrangements based on company stock may result in an executive having a very high percentage of her total investment capital tied up in company stock.¹⁴¹

Determining what portion of an executive's compensation should be contingent to maximize motivation and improve performance requires a delicate balance. Contingent compensation must be high enough to make a real difference to an executive. However, it cannot be so high as to have an adverse effect on executive decision-making or on the executive's desire to undertake the challenge.

2. Failure to Distinguish Between Individual and Group Performance

For pay to motivate performance, individual performance must have a significant effect on pay. However, current forms of contingent compensation do not place sufficient weight on individual performance.

Short-term incentive plans typically set target awards as a percentage of salary. Generally, the largest portion of the award is based on the achievement of certain corporate goals and a small amount is based on individual performance.¹⁴² The amount of the reward dependent on

139. Many workers are dependent on contingent pay for the bulk of their earnings. Obvious examples are salespersons paid primarily on commission and brokers, who generally have a low base salary and are paid very high bonuses dependent upon their performance. Such persons work with the understanding that their pay may be low in any given year and high in others.

140. It is not clear that the threat of takeover or of termination by shareholders would be sufficient to counter the adverse effect on decision making.

141. However, executives may always make use of the derivatives market to diversify their investment risk. See *infra* text accompanying notes 175-77.

142. See GRAEF S. CRYSTAL, QUESTIONS AND ANSWERS ON EXECUTIVE COMPENSATION 44 (1984) (noting that although most companies claim they take individual performance into account in determining executive bonus awards, individual performance usually does not count for all that much); Aggarwal & Aggarwal, *supra* note 72, at 115 (reporting that most companies tie executive raises and bonuses to annual profit level).

For example, a plan might provide that achievement of certain corporate goals yields a

individual performance is simply too small to have an effect.¹⁴³

Long-term incentive plans pose a similar problem. "Many companies do not even make an effort to adjust awards on the basis of individual performance. They simply grant all executives in the same salary grade (or title/functional level) the exact same number of stock options, performance units, or whatever."¹⁴⁴ Because the number of shares granted bears little relation to individual performance, an executive will not be personally motivated to try to affect the number of shares she will receive.

Moreover, after a stock-based form of compensation such as a stock option is granted, there is often no adjustment for individual performance. The actual size of each individual's award is based on the increase in the company's stock price, and is not directly dependent upon the individual's performance.¹⁴⁵ If two executives each receive 50,000 options and one works diligently, but the other does not, when the price of the company's stock rises by two dollars per share, each will receive \$100,000 in compensation. This result has negative implications under both equity theory (because one or both executives will feel that she is not being paid equitably in comparison to the another) and expectancy theory (since the instrumentality perception is being distorted).

This problem is not easy to address. The more a plan focuses on individual efforts rather than measures of corporate (group) performance, the more it needs to rely on more subjective views of individual performance. This is difficult to measure, especially among senior executives where the output is often collective and intangible. The reliance on subjective measures may also conflict with the concerns of equity theory because the use of such measures risks perceptions of favoritism or unfairness.

3. Insufficiently High Performance Hurdles

A major problem with the use of performance-based compensation as a means of motivating executives is the failure of such plans to set

bonus pool of which some amount is available for grant to a particular individual. Typically, something like 70-80% of that amount would be awarded automatically and the remaining 20-30% would be awarded depending upon individual performance. In the case of the CEO, failing to adjust for individual versus company performance is often justified by the fact that it is difficult to evaluate CEO performance independent of company performance. However, even for senior executive officers, the variation in award based on individual performance is generally quite small.

143. See Alan M. Johnson & Neil D. Hobart, *Why Is It So Hard to Pay for Performance?*, 4 J. COMP. BENEFITS 358, 358 (1989) (suggesting that the adjustments made for individual performance in annual incentive plans are insufficient).

144. *Id.* at 360.

145. It may be indirectly dependent on the individual's performance in the sense that an executive's actions may positively or negatively affect the company's stock price.

sufficiently high performance hurdles. The biggest offender is the stock option grant. The number of stock options granted to senior executives, particularly company CEOs is often staggeringly large.¹⁴⁶ Option grants valued in excess of \$1 million are common. In fact, a number of CEOs of large corporations received awards in 1997 worth \$10 million or more.¹⁴⁷

Many more options are granted than are necessary to serve as a motivating factor. Granting an executive 100,000 options, for example, might produce a certain incentive effect. It is, however, not plausible to think that granting that same executive one million options would result in a ten-fold increase in the executive's motivation, and therefore, performance.¹⁴⁸

However, the reality is far worse than a conclusion that the large option grants are pointless. Instead, it is more likely that the size of grants diminishes their incentive effect,¹⁴⁹ a conclusion consistent with the postulate of goal-setting theory that goals need to be sufficiently challenging. Options are generally granted with an exercise price equal to the fair market value of the company's stock on the date of grant.¹⁵⁰ This means that an executive who is granted one million options does not have to do very much to reap a large return. If the company's stock goes up merely one dollar between the date of grant and the date of exercise, the executive reaps \$1,000,000 in compensation.¹⁵¹ Particularly during times

146. See Bryant, *supra* note 3, § 3, at 1 (reporting that more than half of the executives surveyed received stock option grants in 1997 worth more than \$5 million each).

147. See Jennifer Reingold, *The Folly of Jumbo Stock Options: Huge Grants Don't Always Work As Incentives*, BUS. WK., Dec. 22, 1997, at 36 (according to an analysis of 1997 proxies, "27% of CEOs at the largest 200 companies were awarded grants worth \$10 million or more, up from 17% the previous year"; option grants topping \$1 million are common).

148. Recent evidence supports the conclusion that large stock option grants do not necessarily foster impressive results. According to a study recently conducted by Graef Crystal, who analyzed the companies whose CEOs received the most valuable option grants in 1995, the top granting companies beat the S&P 500 by only four percentage points between 1995 and 1997. See *id.* at 36 (quoting Crystal as suggesting that "[i]f you're trying to retail the notion that huge grants should give you tremendous motivation, you haven't proved very much"); see also G. Bennett Stewart III., *Readers Report: A Pay Plan That Rewards Long-Term Thinking*, BUS. WK., Aug. 24, 1992, at 7 (suggesting that a plan which gives away "buckets" of stock options cannot be considered a performance-based compensation plan because it does not provide managers with incentives to think like long-term owners).

149. See Bryant, *supra* note 3, § 3, at 8 (citing critics of the current compensation system who argue that huge option grants enrich average performers as well as the top performers); Reingold, *supra* note 147, at 36 (citing Patrick S. McGurn, director of corporate programs at Institutional Shareholder Services, to the effect that mega-grants of stock options foster mediocrity).

150. See *supra* note 28 and accompanying text.

151. See Bryant, *supra* note 26, § 4, at 1 (noting that the option grants are so huge that "even a small uptake in the [company's] stock price can translate into millions of dollars in

when the stock market in general is doing well, it does not take very much effort to cause a company's stock to rise one dollar. Indeed, a company led by a recipient of a hefty enough stock option grant could do less well than the market as a whole, and still generate an enormous return to the executive, and many have.¹⁵²

The failure to set performance hurdles high enough in short-term incentive plans is also a problem. Some have suggested that bonus formulas tied to short-term profits are so undemanding that executives are rarely denied payments.¹⁵³

4. Manipulative Behavior

One of the important teachings of motivation literature is that pay must actually depend on performance. It is important that contingent pay arrangements cannot be manipulated so that executives are well paid even in situations where their performance is not up to par. Unfortunately, as currently administered, manipulation¹⁵⁴ is possible with respect to both short-term and long-term incentive plans.

Short-term incentive plans are subject to manipulation because executives can make decisions designed to affect the plan benchmarks and thus to affect the amount of their bonus payment. For example, if a short-term incentive plan uses earnings as a benchmark, an executive might decide to defer expenses that should be incurred, or might engage in a transaction designed to increase short-term earnings. If a plan uses sales or

paper profits"); Kadlec, *supra* note 5, at 59 (stating that if granted 1 million stock options, the CEO gets an instant \$1 million if stock rises one dollar, and "[t]hat's pay for showing up, not pay for performance"); Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 21, 1997, at 58 (noting that if Disney shares increased a mere two dollars annually, the value of Michael Eisner's options would be \$10 million annually).

152. For example, King World Productions, Inc.'s CEO Michael King received a grant of 1.5 million options in December, 1995. In the year after the option grant, the S&P gained 61%, while King World's stock rose 41%. Despite the lackluster company performance, King's options were worth \$24.5 million at the end of 1996. *See* Reingold, *supra* note 147, at 36 (also providing as examples the CEO's of Mirage Resorts and Grand Casinos, each of whom received one million options and each of whose companies underperformed compared to the S&P 500); *see also* Bryant, *supra* note 3, § 3, at 1 (providing examples of CEOs with large gains in accumulated stock option wealth whose companies' stocks underperformed in comparison with their peers).

153. *See, e.g.,* Anna Smith, *Bonuses Reach Factory Floor*, DOMINION, Feb. 26, 1997, at 20 (citing consultant Kira Schaffler, who determined that senior executives are likely to receive bonuses regardless of how well they perform); *Worthy of His Hire?*, ECONOMIST, Feb. 1, 1992, at 19 (stating that bonus formulas are so undemanding that a bonus is virtually a part of an executive's base salary).

154. I am speaking here about actions which have the effect of producing pay that is unrelated to performance, not the type of market manipulation that is subject to legal sanctions under the federal securities laws.

other indicators that increase with size, an executive may decide to engage in growth strategies, such as pursuing non-strategic acquisitions.¹⁵⁵ Additionally, the plans themselves may be manipulated in their administration because, as with all accounting measures, the elements used as measures in short-term incentive plans are subject to manipulation.¹⁵⁶ For example, in 1998 Green Tree Financial Corporation was forced to restate its 1996 profits, resulting in its CEO, Lawrence M. Coss, having to pay back a significant portion of his 1996 bonus payment.¹⁵⁷ Green Tree shareholders had accused the company of using overly aggressive accounting methods to boost profits, and therefore, Coss's 1996 bonus.¹⁵⁸ To the extent that contingent compensation is viewed as a means of checking managerial discretion, it is particularly problematic if managers can legally manipulate the systems which measure company performance.

The same kind of behavior is possible with stock compensation. Executives may be tempted to take steps to artificially boost stock prices to maximize their stock compensation.¹⁵⁹ However, there are even more serious ways in which stock option compensation can be, and frequently is, manipulated.

One of the ways in which stock option compensation can be manipulated is through the repricing and replacement of "underwater" stock options, options for which the market price of a stock has fallen below the option price.¹⁶⁰ Declining share values often cause a company

155. See Bok, *supra* note 3, at 245 (pointing out that it is difficult to set rewards "large enough to motivate effectively but not so large as to tempt people to resort to improper or even illegal behavior to qualify").

156. See *id.* (noting that evaluation methods must be accurate and objective so that they cannot be manipulated); Vagts, *supra* note 7, at 242-43 (noting that earnings-based compensation plans may drive executives towards illegal actions because they are calculated on increasing profit and that annualized earnings figures are manipulated).

157. See Martha M. Hamilton, *Bonus King to Pay Back Chunk of \$102 Million Take*, WASH. POST, Jan. 29, 1998, at E01 (reporting that Coss could have to repay \$30 to \$40 million of a \$102 million dollar bonus); Adam Zagorin, *Too Good to Be True: Larry Coss, the Prince of Pay, Must Give Back a Big Chunk of His Bonus*, TIME, Feb. 23, 1998, at 47 (noting that Coss could be repaying \$40 million).

158. See Hamilton, *supra* note 157, at E01 (suggesting that Green Tree's board of directors was responsible for providing a lucrative contract that gave Coss the incentive to back such optimistic accounting methods); Zagorin, *supra* note 157, at 47 (noting the company's denial that its accounting methods were designed to increase profits, and therefore, Coss' pay).

159. See Bryant, *supra* note 26, § 4, at 1 (noting that options provide incentives for CEOs to take steps to boost stock price, such as engaging in acquisitions and divestitures); Dean Foust, *The SEC's CEO-Pay Plan: No Panacea: Studies Suggest Linking Pay to Performance Actually Hurts Performance*, BUS. WK., July 6, 1992, at 37 (quoting Meredith Corp. Chairman Robert Burnett as concluding that linking pay and stock prices is just an invitation to management to manipulate figures and actions).

160. There are no legal impediments to the practice of option repricing. The replacement of underwater options involves no violation of state corporate law, provided directors have

either to cancel existing options and replace them with options at a lower exercise price, or to reprice existing options, keeping the original vesting and expiration dates of the option.¹⁶¹ For example, after the stock market crash of 1987, directors of Northrop allowed the company's CEO to swap 1.2 million options to buy company stock at \$45.88 per share for 1.2 million options to purchase the stock at \$29.88 per share.¹⁶²

Replacing underwater stock options is sometimes justified on the ground that such options have lost their incentive value to executives.¹⁶³ At

some justification for the decision to issue replacement options. *See generally* Cohen v. Ayers, 596 F.2d 733, 741 (7th Cir. 1979) (holding that replacement of underwater options by the board of directors of Sears, Roebuck & Co. did not constitute corporate waste); Udoff v. Zipf, 375 N.E.2d 392, 395 (N.Y. 1978) (stating that whether replacement of underwater options gave rise to a cause of action depended on an evaluation of "the directors' decision from the standpoint of the interests of the corporation and its shareholders, in light of the financial and market situation which confronted the directors at the time of their decision, with due recognition of the scope of discretion vested in a corporate board"). The replacement of underwater options is also exempt from section 16(b) of the Exchange Act so long as the option grant satisfies the requirements of the exception contained in Rule 16b-3 to the prohibition on short-swing profits. *See* 17 C.F.R. § 240.16b-3(d)(3) (1974). Nor does the cancellation and replacement of stock options have any negative federal income tax consequences to executives. There is likewise currently no accounting effect from the cancellation and replacement of underwater options because the Financial Accounting Statements Board takes the position that repricing does not convert an option into a "variable option", thus requiring expense recognition. *See* ARTHUR ANDERSEN & CO., ACCOUNTING FOR COMPENSATION ARRANGEMENTS IN THE UNITED STATES 53-54 (2d ed. 1991) (citing report of FASB Emerging Issues Task Force); *Highlights and Pitfalls: Market Opportunities: Replacing Underwater Stock Options*, CORP. COUNSEL, Nov.-Dec. 1987, at 3. However, the FASB is currently considering a proposal to require recognition of an expense when options are repriced. *See* FASB Mulls Deadline for Accounting Costs of Options Repricing, WALL ST. J., Dec. 8, 1998, at A6 [hereinafter *FASB Mulls Deadline*].

161. *See* Marcia Berss, *Reviewing Your Repricing Options*, CORP. BOARD MEMBER, Winter 1998, at 47 (noting that stock option repricing is spreading like the plague and giving Reebok International and Apple Computer as examples of companies who have recently repriced; Apple Computer has repriced four times in a five-year period); Bryant, *supra* note 26, §4, at 4 (noting that many companies respond to falling stock prices by lowering the price of options, which has the "perverse" effect of rewarding poor performance); Andres Martinez, *Moving the Goal Posts: Options Repricing Gives Companies a Powerful Tool to Retain Workers; Critics See it as Rewarding Failure*, WALL ST. J., Apr. 9, 1998, at R4 (suggesting that the practice of repricing executive stock options is becoming more prevalent); *see also* Reingold, *supra* note 147, at 36 (suggesting the investor reaction has not discouraged option repricing).

162. *See* BLAIR, *supra* note 3, at 90. This created an immediate "gain" of \$4.5 million for the CEO. *See* CRYSTAL, *supra* note 26, at 133-37 (giving as examples of "serious options swapping," Texas Air's swapping of CEO Frank Lorenzo's options and swapping of executive and employee options by Apple Computer); Elizabeth Holtzman, *CEO Pay: How Much Is Enough?*, HARV. BUS. REV., Jul.-Aug. 1992, at 130, 139 (describing repricing of options by General Dynamics in 1991, which resulted in paying twenty-three General Dynamics executives \$35 million in pay, bonuses and options—three times their 1990 compensation).

163. *See, e.g.,* Yale D. Tauber et al., *Trends, Issues and Predictions in Executive*

some level, this argument is appealing. If options are sufficiently underwater the executive may perceive that it is impossible that her efforts will bring the company's stock back above the exercise price. In that situation both goal-setting theory and expectancy theory would argue that the option has lost its incentive value. If the goal is unattainable, it cannot motivate.

However, the stock price drops that precede repricing rarely make the original exercise price unattainable. On facts similar to the Northrop example above, after the decline in stock price, it is true that the CEO held options with an exercise price well above the then-trading price of the shares. However, stock options generally have a long exercise period after they become vested—typically ten years. Even though Northrop's share price had to rise above \$45.88 from its trading price of \$29.88 before it would become worthwhile to exercise the shares, the CEO, likely had plenty of time for the stock price to rise before the options would expire. Even after the dramatic decline in share price, the options were not worthless and the CEO had an incentive to see the company's stock price rise to \$45.88 and beyond.

Moreover, the general practice is to reprice options to the level to which the company's price has fallen, magnifying the problem of insufficiently high performance hurdles. This is particularly troublesome where the decline in a company's stock is part of a general decline in the market, meaning that when the market rises again, the company's stock is likely to rise along with it, without any particular effort on the part of the executive. If one followed motivation theories, any option repricing should be to a price somewhere between the original exercise price and the price to which the company's stock had fallen. Finally, in situations where companies make annual option grants, the fact that some options will not motivate because they have become worthless means little since the executive has plenty more options to act as an incentive.

Repricing options is clearly dangerous to an attempt to use compensation to motivate executives. As one critic observed, "[o]ptions declare that if the company wins, you win. Options repricing declares that if the company loses, you still win."¹⁶⁴ Nothing could be more inconsistent

Compensation Planning Techniques and Strategies, in EXECUTIVE COMPENSATION WORKSHOP 1989, at 51-52 (PLI Tax Law & Est. Planning Practice Course Handbook Series No. 284, 1989) ("underwater options have little or no incentive value or hold (i.e., 'golden handcuff') on executives"); E.S. Browning & Laura Jereski, *In New York: Sagging Stocks Don't Penalize Some Executives*, ASIAN WALL ST. J., June 12, 1997, at 15 (suggesting that repricing maintains incentive for executives to stay with company and do things that will push up stock price).

164. E.S. Browning & Laura Jereski, *In The Money: Firms With Sagging Stocks Set New 'Repricings' of Executive Options*, WALL ST. J., June 11, 1997, at C1 (quoting Bart Naylor, head of the Teamsters' corporate affairs, who calls option repricing "the most heinous

with the teachings of motivation theory.

Option compensation can also be manipulated through granting "reload" options.¹⁶⁵ Under a reload option, an executive who exercises options is given an additional option to buy the same number of options as he exercised, at the market price on the date he exercised. These new options have the same expiration date as the original options.

An example will help to illustrate why reload options are really a guaranteed source of additional income without being a motivating incentive. Assume that an executive received an option to purchase 100 shares at ten dollars a share. The shares are now trading at fifteen dollars per share. If the executive either does not exercise, or exercises the option and holds the shares purchased, she faces the same risk faced by shareholders generally, that the price of the stock will fall below fifteen dollars. On the other hand, if she exercises the option and sells the shares she locks in the five dollar per share gain, but, having sold her shares, no longer has the ability to benefit if the price of the shares rises above fifteen dollars.

The reload option gives the executive the best of all possible worlds. The executive in my example can exercise her option and sell the shares obtained upon exercise, thus locking in the five dollar share gain. She then retains an option to purchase another 100 shares at an exercise price of fifteen dollars which was the fair market value at the time of exercise of the original option. If the stock price falls, she will not exercise the new option and thus loses nothing. However, if the stock price rises, she now has the ability to benefit from the increase.¹⁶⁶ Necessarily, this type of

hypocrisy" in executive compensation); *see also* Martinez, *supra* note 161, at R4 (noting that the repricing of stock options is opposed because it "rewards failure and undermines options' incentive power").

165. *See* CRYSTAL, *supra* note 26, at 178 (noting that granting reload options makes stock options less risky by guaranteeing the CEO that he will receive the highest possible price for his option shares); Warren F. Grienberger, *The Rise of Institutional Investors, in* INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 1996, at 317, 355 (PLI Corp. L. & Practice Course Handbook Series No. 917, 1996) (noting that the fact that reload options allow a recipient to reap the highest possible price for the option shares with almost no risk may constitute a conflict of interest between outside shareholders and the option recipient).

166. As with replacement of underwater options, there is no legal impediment to this practice. So long as the requirements of Rule 16b-3 are met, there should be no 16(b) problems created by reload options. *See* 17 C.F.R. § 240.16b-3(5) (1997). So long as the reload options are granted at the fair market value on the date of grant, no compensation expense will have to be recognized for accounting purposes. *See* ARTHUR ANDERSON, *supra* note 160, at 28 (citing report of FASB Emerging Issues Task Force). The granting of the reload option has no tax consequences, although the exercise of the options would create income recognition in the case of nonqualified options. So the difference between exercising an option with an exercise price of \$10 per share at a time when the shares are trading for \$20, and exercising the original option at \$15 per share, being granted a reload option at \$15 that is then exercised at \$20, is not one of tax amounts but rather of timing. In

compensation plan weakens the link between pay and performance and thus limits the ability of option compensation to motivate executives.

5. Ability to Sell Shares

The ability of an executive to sell shares once options have been exercised further limits the effectiveness of stock compensation as a motivator of performance. If the executive can sell the shares, then even if the grant of an option created a link between pay and performance, the executive's fortunes, unlike those of shareholders, do not remain tied to company performance. In fact, many employees exercise options and immediately sell shares as soon as the options are vested.¹⁶⁷

This immediate selling of shares is frequently accomplished through "cashless exercise," whereby executives can exercise their options without having to use additional personal funds to purchase the shares at the exercise price of the option shares subject to the option, because the exercise price is paid from the proceeds of the sale of shares acquired upon exercise.¹⁶⁸ This practice has been facilitated by the SEC's rules under

the former case, the entire tax is delayed until the exercise at \$20 per share; in the latter, a portion of the tax is paid at the earlier exercise.

167. See Kerry Capell, *Options for Everyone*, BUS. WK., July 22, 1996, at 80, 82 (citing survey results indicating that option recipients generally sell immediately upon exercise); see also Brownstein & Panner, *supra* note 3, at 35 (stating that less than 50% of the shares acquired upon exercise of stock options are held for a significant period of time); Joann S. Lublin, *Buy or Bye*, WALL ST. J., Apr. 21, 1993, at R9 (reporting that most executives sell stock obtained upon exercise of options within a few years after exercise). *But see* CRYSTAL, *supra* note 26, at 121 (describing how the sale of company shares is considered "poor taste" or "disloyal" and many investors pay significant attention to sales by corporate insiders).

In fact, "CEO stock ownership for large public companies . . . was *ten times* greater in the 1930s than in the 1980s." Jensen & Murphy, *supra* note 9, at 139, 141 (noting that 90% of CEOs own less than one percent of their company's stock).

168. One way this is accomplished is for a company to simply give the executive a check representing the difference between the exercise price and the market value of the shares on the exercise date, that is, the amount the executive would have received by exercising her options and immediately reselling the shares. See CRYSTAL, *supra* note 26, at 65. However, the exercise is more commonly done through a broker who "loans" the executive the money to exercise the shares and sells the shares of stock acquired upon exercise on behalf of the executive. The proceeds are used to pay the broker for fronting the exercise price as well as for paying any income tax obligations associated with the exercise. The executive receives the rest. See Bryant, *supra* note 3, § 3, at 8 (describing the transaction between a broker and the executive).

There is an advantage to exercising through a broker. If the employer cashes-out the executive, there is a risk of adverse accounting consequences. The option would be treated for accounting purposes like a stock appreciation right, which requires an accounting charge. A company must recognize as an expense the cost of a stock appreciation right over its life in a manner that reflects the appreciation in the value of the stock to which the stock appreciation right relates and the rate at which it becomes exercisable. See ACCOUNTING

section 16 of the Securities Exchange Act of 1934, which no longer require that an executive hold the stock received upon exercise of an option for six-months prior to selling the shares,¹⁶⁹ and Regulation T, which allows a broker-dealer to assist in the sale of shares acquired upon exercise of an option.¹⁷⁰ Permitting executives to exercise options without laying out their own money makes it easier for executives to divest themselves of their shares as soon as the options become exercisable.

If the goal of contingent compensation is really to motivate executives by linking their fortunes to the success of the company, a better way to achieve that goal could be to focus on long-term equity ownership by executives.¹⁷¹ In fact, some companies are requiring their executives to

FOR STOCK APPRECIATION RIGHTS AND OTHER VARIABLE STOCK OPTION OR AWARD PLANS, Interpretation of Financial Accounting Standards No. 28 (Financial Accounting Standards Bd. 1978). However, cashless exercise through a broker is treated like an open market transaction not involving the issuer and thereby not resulting in any accounting expense. See ARTHUR ANDERSEN & CO., *supra* note 160, at 28-29 (stating that cashless exercise is in substance a stock appreciation right and therefore is accounted for as a variable plan. If exercised through a broker, there is no variable plan accounting because no cash is paid by the company).

169. Section 16(b) of the Securities Exchange Act (Exchange Act) of 1934 imposes strict liability on officers, directors and 10% shareholders who profit from short-swing transactions, that is, purchases and sales of securities of their company within a six-month period. See 15 U.S.C. § 78(p) (1994). However, rule 16b-3 contains an exemption for securities issued pursuant to employee benefit plans and compensation arrangements. With respect to stock options, the rules provide an exemption from the liability provisions of section 16(b) for the grant of stock options and also provide an exemption for the purchase of employer stock pursuant to the exercise of an option. See 17 C.F.R. § 240.16b-3(5) (1997). As long as the conditions for exemption are met, an executive is free to exercise an option and resell the resulting stock immediately without facing §16(b) liability.

170. See 12 C.F.R. § 220.3(e)(4) (1998). However, there may be negative consequences of a cashless exercise. The immediate sale upon exercise of an incentive stock option would be a disqualifying disposition, resulting in loss of the favorable tax treatment of such options. See I.R.C. §§ 422(a), 421(b) (1994).

171. See Jensen & Murphy, *supra* note 9, at 141 (describing how control of a meaningful percentage of a corporation's shares, will cause executives to "experience a direct and powerful 'feedback effect' from changes in market value"); Geoffrey Colvin, *How to Pay the CEO Right*, FORTUNE, Apr. 6, 1992, at 60, 65, 68 (noting that a performance-based plan that is well designed will incorporate provisions requiring the CEO to retain a large number of shares because that involves an element of risk and incentive for the CEO); Leslie P. Norton, *Velvet Handcuffs*, BARRON'S, July 24, 1995, at 21, 23 (citing Nell Minow that the only way for managers to think like shareholders is to promote executive stock ownership).

However, not everyone agrees that there is a consistently positive relationship between corporate performance and executive stock ownership. See, e.g., John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595, 603-09 (1990) (describing how corporate performance increases as management's percentage of stock ownership increases from zero to 25% but declines beyond 25%); see also Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 203, 294-95 (1988) (noting that corporate performance improves when director stock ownership increases from zero to 5%, but then declines beyond 5%).

maintain specified levels of equity in their company.¹⁷² This can be done in a number of ways. An employer can include executives in an employee stock ownership plan (an "ESOP") established for the benefit of all of its employees.¹⁷³ Another possibility is for the employer to adopt an employee stock purchase plan, pursuant to which executives would regularly purchase employer securities at a discount.¹⁷⁴

172. See Lederer & Weinberg, *supra* note 138, at 32 (citing survey results of companies whose proxies mention ownership guidelines and providing as examples of companies with such guidelines, specifically General Mills and Quaker Oats); Lublin, *supra* note 167, at R9 (discussing the fact that some businesses require CEOs and other senior executives to invest between one and ten times their annual salaries in stock, providing a period of time for the executives to reach the ownership targets); Norton, *supra* note 171, at 21 (stating that about 20% of American companies with annual revenues greater than \$1 billion have guidelines requiring certain levels of stock ownership by senior executives, including American Express, Ford Motor Co., Intel, J.C. Penny, BankAmerica, Xerox, Bell Atlantic and J.P. Morgan). See generally Reingold, *supra* note 151, at 58 (noting that companies are using CEO stock ownership to align executive and shareholder interests).

173. An ESOP is a tax-qualified pension plan which is designed to invest primarily in employer securities. The employer either contributes shares of stock to the ESOP or contributes cash, which is used by the ESOP trustee to purchase shares. At the time shares are contributed or purchased, they are placed in a suspense account and are referred to as "unallocated shares." Shares are allocated to individual plan participants on the basis of a formula, such as allocation proportional to compensation. Retirement benefits from an ESOP are generally paid in stock, although in the case of a company whose stock is not publicly traded, the employee has the option of selling shares distributed by the ESOP back to the employer. See generally JOSEPH RAPHAEL BLASI, *EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF?* 60 (1988) (explaining the basic configurations of an ESOP Plan); Henry C. Blackiston III et al., *ESOPs: What They Are and How They Work*, 45 BUS. LAW. 85 (1989) (discussing the mechanics and application of ESOPs); D. Bret Carlson, *ESOP and Universal Capitalism*, 31 TAX L. REV. 289, 299-314 (1976) (examining the legislative history of ESOPs). Both the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code ("Code") contain special rules regulating ESOPs. See 29 U.S.C. §1107; I.R.C. §423. According to the National Center for Employee Ownership, about 9,500 U.S. corporations have ESOPs, covering more than ten million employees. See Edward J. Giblin et al., *When Employees Own the Company. . . .*, ACROSS BOARD, Oct. 1, 1995, at 42.

174. Employers generally have a large amount of flexibility in designing employee stock purchase plans even though such plans create securities law issues since they involve the purchase and sale of a security. Section 423 of the Code provides favorable federal income tax treatment for employees who participate in such plans, so long as certain conditions are met. See I.R.C. §423. The tax treatment is similar to the favorable tax treatment for incentive stock options under §422 of the Code, that is, that the exercise of the option has no tax consequences; instead, taxation is deferred until the sale of the shares acquired upon exercise. See MICHAEL J. CANAN & WILLIAM D. MITCHELL, *EMPLOYEE FRINGE AND BENEFIT WELFARE PLANS* § 7.3 (1991 ed.); Giblin, *supra* note 173, at 42. At that point, the gain realized on the option is taxed as capital gains, rather than as ordinary income. See CANAN & MITCHELL, *supra* §7.1.

One big difference between an ESOP and an employee stock purchase plan is that an ESOP, because it is a qualified plan, must benefit a large class of employees in order to comply with non-discrimination rules in the Code. An employer could limit participation in an employee stock purchase plan to executives only if it were willing to forego the favorable

However, even these suggestions may not work. The presence of an active derivatives market, which allows executives to retain shares in the company while diversifying their investment risk, may operate to defeat the motivational effect of stock compensation.¹⁷⁵ An example will illustrate how the goal of executive stock ownership can be disturbed through the use of derivatives. Assume an executive holds 500,000 shares of her company's stock, a large enough number that the performance of that stock has a significant effect on the overall financial well-being of the executive. The stock is currently worth \$10 million. If the executive is not free to sell the shares, she can enter into a commonly-used derivative product, an equity swap.¹⁷⁶ Instead of selling the shares of the company, the executive "swaps" the performance of the shares over a specified period with the performance of a diversified portfolio of stocks. For example, the executive finds a counter-party willing to enter into a contract whereby the executive pays the gain from the 500,000 shares of stock over a five-year period and the counter-party agrees to pay the executive the income from an investment of \$10 million in a diversified portfolio of stocks.¹⁷⁷ This effectively transforms the executive's risk from the performance of the company's shares to the performance of a diversified portfolio.

There may be other means whereby the executive can accomplish the same thing. The essential point is that while the executive continues to hold the shares, she is not affected by the results of the company's performance in the same way an ordinary shareholder of the company is affected.¹⁷⁸

tax treatment provided for by §423.

175. Derivatives are contracts which derive their value from the value of the underlying asset, such as interest rates, equities, currencies, or commodities, to which the contract is related. See Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 947 n.185 (1997); see also Bank, *supra* note 8, at 314.

176. Swaps, or notional principal contracts, allow hedging against risks relating to movement in interest or foreign exchange rates or against risks of other market factors. Parties to a swap contract "swap" their positions with respect to a risk associated with specific assets, in this case equity. See Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1274 n.4 (1991) (noting that swaps are instruments which hedge against risks such as interest rates, commodity prices, and currencies; in 1990 more than \$656.1 billion of swaps were entered into). For an explanation of the operation of a typical interest rate swap, see EDWARD F. GREENE, ET AL., 2 U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKET §13.03(2) (3d ed. 1995).

177. What really happens is that the positions are netted out. If the gain from 500,000 shares of stock over a five-year period is \$100,000 and the income from an investment of \$10 million in a diversified portfolio is \$120,000, the counter-party would pay the executive \$20,000.

178. See generally Bank, *supra* note 8 (exploring the use of the derivatives market by executives).

IV. UTILIZING THE LEARNING FROM MOTIVATION THEORIES: BETTER WAYS TO ACHIEVE THE MOTIVATION AIM OF CONTINGENT COMPENSATION

A. *Improving the Effectiveness of Contingent Compensation Plans*

The discussion in Section IIIB of this article regarding some of the major deficiencies in how contingent compensation is currently structured and administered suggests that we are not currently maximizing the motivating potential of contingent compensation. That discussion, together with the discussion in Section IIIA of prevalent motivation theories, suggests that there are ways the system can be improved.

The logical place to start improvement is with suggestions for reform aimed at option compensation. Options are the most prevalent form of long-term contingent compensation¹⁷⁹ and the way option plans are currently structured minimizes the ability to achieve the goal of motivating executives. There are several strategies that would improve the ability of options to successfully motivate executives.

The first suggestion is that options be granted with an exercise price greater than the fair market value of the stock on the date of grant of the option. As is clear from the prior discussion, granting options with an exercise price equal to the fair market value on the date of option grant is inconsistent with prevalent motivation theories. The insufficiently high performance hurdle violates both goal-setting and expectancy theory. Moreover, equity theory tells us that for options to function as a means of incentive, compensation received from them must be truly related to performance, and not to non-performance related functions such as simple movements in the market.

One means of raising the bar would be to grant options with a fixed premium over the fair market value at the date of grant, which has been

To the extent an executive does not diversify his company stock exposure through the use of derivatives or other means, shareholders may also suffer because "management may have an incentive to pursue strategies such as diversification that will reduce these risks. But shareholders, through the diversification of their portfolios, have already reduced these risks to the extent they deem appropriate. Thus, further risk reduction by managers may be contrary to the best interests of shareholders." Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 207-08 (1996); see also Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, in 24TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1992, at 647, 665-66 (PLI Corp. L. & Practice Course Handbook Series No. 792, 1992) (stating that because shareholders can diversify their portfolios, they are risk neutral regarding external influences on company stock price; because executives are less diversified, they bear the risk of such influences and thus become risk averse).

179. See sources cited *supra* note 26.

recommended by shareholder groups.¹⁸⁰ In fact, some companies have begun to engage in the practice.¹⁸¹ Premium pricing raises the performance bar over fair market value options, but is not a perfect means since it requires an assumption about what the market will do. A better alternative would be not to grant options with a fixed premium price, but rather, to grant performance or indexed options.¹⁸² This would ensure that the amount of compensation received by the executive is truly a function of outstanding performance by the executive in leading the company, and not to positive performance by a particular industry or the market in general. Granting such options means that if the company does no more than keep pace with its competitors or the market, the options are worthless.¹⁸³ For example, the CEO of Level 3 received options that will be valueless if both the S&P index and Level 3's stock rise ten percent. If Level 3's stock outperforms the S&P index by five percent, the CEO's 1998 options will be worth \$1.55 million. However, if Level 3's stock outperforms the S&P index by fifteen percent, the options will be worth \$11 million.¹⁸⁴ Similarly, at a time when Transamerica Corporation shares were trading at \$93.19 a share, its CEO was granted 645,000 options that will pay off only if the company's stock rises to more than \$150 a share within five years and only if the company's total shareholder return from the date of grant is at least at the median of its industry peer group.¹⁸⁵

180. See Bryant, *supra* note 3, § 3, at 8 (reporting that Council of Institutional Investors has proposed that "incentive pay should be structured so that executives cash in only if they outperform the overall market").

181. See *id.* § 3, at 9 (naming Transamerica, Monsanto and BankAmerica as examples of companies who have granted options with exercise prices at greater than fair market value on the date of grant); see also Shawn Tully, *CEO Pay*, FORTUNE, June 8, 1998, at 272, 276 (noting that Colgate-Palmolive and Ecolab CEOs receive "premium priced" options. The Colgate-Palmolive CEO received a mega-grant of 2.6 million premium priced options which replaces annual option awards for seven years).

182. An indexed option ties the exercise price of the option to an external measure, such as the S&P index. The exercise price changes proportionately to the change in the index. See Joseph E. Bachelder III, *Premium-Priced, Hurdle and Indexed Options*, N.Y.L.J., June 29, 1993, at 3; Clawson & Klein, *supra* note 26, at 32-33 (arguing that instead of granting options with fixed exercise prices, options should be granted with an adjustable exercise price that is indexed to the appreciation of the granting company's stock price relative to the appreciation of the company's industry peers). Professors Clawson and Klein argue that it is not enough to simply fix the exercise price of an option at a value greater than fair market value, because the exercise price is fixed without regard for external influences on stock price. Indexing ensures that only increases in stock value attributable to executive performance rather than simply to favorable market or industry conditions result in increased pay. See *id.* at 46-47.

183. Indexing options also avoids the problems faced by companies that use premium priced plans in times of bad stock markets forcing good executives to leave because they are not getting paid. See Tully, *supra* note 181, at 278.

184. See *id.*

185. See Bryant, *supra* note 3, § 3, at 9.

One reason more companies have not engaged in imaginative option pricing strategies is concern that doing so will result in adverse accounting consequences. To fully appreciate this point, it is necessary to understand that as a general matter options are costless from an accounting point of view.¹⁸⁶ The accounting treatment for stock options is specified in Accounting Principles Board Opinion 25, which essentially provides that so long as options are granted with an exercise price that is at least equal to the fair market value of the shares subject to the grant, no compensation expense needs to be recognized with respect to the options.¹⁸⁷ Stock options are the only type of compensation that generate an expense that is deductible for tax purposes¹⁸⁸ but that does not have to be expensed for financial accounting purposes.¹⁸⁹

Although it appeared for a time that the Financial Accounting

186. Because options generally involve no compensation expense, they are sometimes referred to as "stealth compensation." See *Executive Compensation: Draft Bill Seeks Options Expensing in Return for Favorable Tax Treatment*, Pensions & Benefits Daily (BNA) No. 24 (Mar. 13, 1997); see also *Hearings on S. 1198*, *supra* note 8, at 9-10.

Options are not completely costless. As with all stock compensation, they carry a cost to shareholders in terms of dilution. But there is no cost to the company in granting options.

187. See APB OPINION NO. 25, *supra* note 27, ¶10. The expense does not need to be recognized because ¶10 specifies that the measurement date for determining compensation costs in stock option plans is the first date on which both the number of shares that an individual is entitled to receive and the option price are known. Thus, the compensation expense is zero for an option granted with an option price equal to the fair market value of the shares.

Under certain circumstances, options will give rise to an accounting charge. In the case of performance options, where the number of shares or the exercise price is contingent upon future performance, the measurement date does not occur at the grant date. Similarly, if options are granted subject to later shareholder approval, there is no measurement date until approval is obtained. See *id.* However, changes in the terms of outstanding options due to certain equity restructurings pursuant to anti-dilution provisions do not give rise to a new measurement date and thus do not require recognition of an accounting expense. FINANCIAL ACCOUNTING STANDARDS BOARD, EMERGING ISSUES TASK FORCE, Minutes of Nov. 8, 1990 Meeting, Issue 90-9.

188. An employer receives a deduction equal to the amount of ordinary income required to be recognized by an employee in connection with the exercise of an option. See 26 U.S.C. § 83(h) (1994).

189. To give a sense of the constraint that might be imposed if companies had to expense options, accounting for the cost of stock options would have reduced the 1996 reported earnings of MCI Communications by 5% and would have completely wiped out all of Netscape's current earnings. See Roger Lowenstein, *Coming Clean on Company Stock Options*, WALL ST. J., June 26, 1997, at C1.

Options also have favorable accounting in another respect. The FASB recently announced a change to the basic earnings-per-share calculation. When a company calculates its earnings per share, it need not adjust the number of shares for options that are outstanding and in the money. So, not only is the grant of options "costless" from an accounting point of view, but the large number of outstanding options in the hands of executives has no impact on earnings per share. See Elizabeth MacDonald, *FASB Rules to Lift Firms' Per-Share Net*, WALL ST. J., Mar. 14, 1997, at A3.

Standards Board ("FASB") would amend Opinion 25 to require that companies recognize an expense in connection with options granted,¹⁹⁰ it abandoned that notion in December, 1994.¹⁹¹ Instead, it adopted a much more limited rule in 1995, giving companies the choice of either expensing options based on fair market value or providing footnote disclosure of the cost of options granted.¹⁹² That means that a company granting an option at

190. In April, 1993, the FASB voted to issue new rules that would require immediate increased disclosure of stock option compensation and beginning on January 1, 1997, would require the recognition of an expense for stock options. *See Accounting, FASB Approves Stock Compensation Rules, but Postpones Effective Date on Expense*, Pensions & Benefits Daily (BNA) (Apr. 8, 1993) [hereinafter *FASB Approves Stock Compensation Rules*]. At the time of the vote, the FASB indicated that it expected to issue an exposure draft of the proposed rules in June. It also designated a six-month comment period, to be followed by a public hearing, expected to be held in early 1994. *See id.*; *see also* FINANCIAL ACCOUNTING STANDARDS BOARD, FINANCIAL ACCOUNTING FOUNDATION, Proposed Statement of Financial Accounting Standards: Accounting for Stock-Based Compensation (Financial Accounting Series No. 127-L, 1993).

191. The FASB appeared to retreat from its position in response to concerns about whether options could be reliably valued as well as concerns with potential adverse effects on high technology firms of expensing options. A number of arguments were voiced by corporate leaders during the FASB hearings. Some argued that options have no value, or at least none that can be fairly measured. Additionally, representatives of high technology firms expressed the concern that expense recognition prevents them from being able to offer stock-based compensation. *See FASB Abandons Bid to Require Expensing of Employee Stock Options*, Sec. Reg. & L. Rep. (BNA) No. 26, at 1725 (Dec. 23, 1994) [hereinafter *FASB Abandons Bid*].

Opposition to the FASB proposal was not limited to corporate leaders. At the time it was initially announced, then Treasury Secretary Lloyd Bentson expressed "reservations" about the proposal, suggesting that increased disclosure was more appropriate than requiring companies to take a "highly debatable" earnings charge when granting options. *See FASB Approves Stock Compensation Rules, supra* note 190. Nor was Bentson alone in terms of government opposition. One FASB member implied that the introduction of several bills in Congress, including one that would have given the SEC veto power over the FASB's rulemaking was part of the reason for the FASB's backing off from its proposal. *See FASB Abandons Bid, supra*. The Senate was not monolithic on this issue. In June 1993, Senator Lieberman introduced the Equity Expansion Act, a bill that opposed the FASB proposal, while senator Levin introduced two bills which would have mandated inclusion of stock options as expenses. *See Steve Burkholder, Executive Compensation: Draft Bill Seeks Options' Expensing in Return for Favorable Tax Treatment*, Pensions & Benefits Daily (BNA) at d5 (Mar. 13, 1997).

192. *See ACCOUNTING FOR STOCK-BASED COMPENSATION*, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995). Statement 123 encourages companies to accrue a compensation expense over the period of an employee's service for the increase in the value of options granted based on the fair market value of the stock. Such accrual is not required if a company makes specified supplemental disclosure about the options.

This may not be the end of the story. Senators Levin and McCain have introduced a bill, S. 576, entitled "Ending Double Standards for Stock Options Act," which would prevent companies from treating option pay as an expense for tax purposes unless they also took an expense for accounting purposes. *See Sindhu G. Hirani, Associations Unite Against Bill Tying Favorable Tax Treatment to Expensing*, Daily Tax Rep. (BNA) No. 105 at d9

a fixed option price has no accounting charge, but if a company chooses to grant a performance option, for example, it would incur a charge.¹⁹³

This means that in order to eliminate the disincentive to companies to price options in a manner that would allow them to operate as an incentive, it is necessary to make a change to the accounting rules so that companies are forced to recognize an accounting expense upon the granting of options, a suggestion that has been made by a number of commentators.¹⁹⁴ In addition to allowing for better option pricing, this can improve the motivational effect of options in another way. Unless there is a compensation charge in connection with the granting of options, boards feel free to give out as many as they choose. If companies had to recognize a charge, there would be an effective check on the number of options granted each year; boards would be constrained from granting too many options for fear of adversely affecting corporate earnings.¹⁹⁵ Since the effect of mega-option grants is to provide a significant amount of

(June 2, 1997); see also Joan Pryde, *Levin, McCain Seeking Support For Senate Bill On Compensation*, Pensions & Benefits Daily (BNA) (Apr. 14, 1997). Consistent with the opposition to the earlier FASB proposal to require expensing of options, a number of associations and stock exchanges have expressed the view that the legislation "is misguided and would have a harmful effect on emerging companies." Hirani, *supra*. The bill only affects non-qualified options, since a company gets no tax deduction in connection with an incentive stock option absent a disqualifying disposition. See *supra* note 188.

The SEC has decided not to interfere in the accounting issue. The SEC position on disclosure and accounting issues was expressed in a speech of then Chairman Roberts on May 20, 1992. Essentially, he said that the SEC is concerned only about the disclosure of compensation and not about the amount of compensation, that the valuation of options creates difficult issues, and that the SEC should defer to the FASB on accounting for stock options. See Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, Remarks at the WESFACCA Afternoon with the SEC (May 20, 1992).

193. Under current accounting rules, if a company granted performance options, where the number of shares or the exercise price is contingent upon future performance, the measurement date does not occur at grant, with the result that an accounting charge would occur at the time the number of options and the price became fixed. See APB OPINION NO. 25, *supra* note 27, ¶10(b) (noting that a measurement date may be later than the date of grant and may depend on events occurring after grant award date).

194. See Colvin, *supra* note 171, at 60 (referring to Graef Crystal's examination of CEO option gains compared to performance of company stock and suggesting the failure to charge options in financial statements is part of the problem); Thomas A. Stewart, *The Trouble with Stock Options*, FORTUNE, Jan. 1, 1990, at 93, 95 (noting that current accounting treatment of options obscures their costs).

195. According to calculations of the London advisory firm, Smithers & Co., if the 100 largest U.S. companies had recognized a charge to their income statements for their stock compensation, profits in 1995 would have been 30% lower than reported and profits for 1996 would have been 36% lower. See David Tice, *Employee Stock Option Costs Don't Show on Bottom Line: Lax Accounting Standards Help Companies Hide Big Expenses*, ON WALL STREET, Jan. 1, 1999, available in 1999 WL 7285009 (noting that in 1998, stock option compensation amounted to 13.2% of the outstanding shares for all U.S. public companies). That is a result many boards seek to avoid.

compensation even if a company's stock rises only slightly, fewer options require more effort to produce the same level of compensation.

Second, either in addition to or in lieu of increasing the exercise price of options, companies should consider restructuring option plans such that post-grant adjustment is possible. The theory behind options acting as a motivator is that executives will have an incentive to act in ways that will benefit shareholders. However, as already discussed, when an option is granted with a fair market value exercise price, the executive has to do very little to benefit from the option. One way to address the limited incentive of fair market options is to structure option plans so that the option grant can be reduced or even voided if performance does not warrant reward, thus correcting a real potential for loss if the executive does not perform. In addition, an executive whose performance is superior could potentially be rewarded by accelerating the vesting of her options.¹⁹⁶ Under current accounting rules, these types of arrangements are not appealing, since they would likely result in a company having to expense options.¹⁹⁷ However, if the accounting rules were changed so that a charge must be recognized upon option grant, these possibilities lose their comparative disadvantage. As an aside, although my focus in this discussion is on option reforms, companies could do the same thing with bonus stock—forfeit the award in the case of poor performance and accelerate vesting in the case of superior performance.

The final suggestion regarding options is that the practice of replacing underwater options be restricted and the practice of granting reload options be disallowed.

Reload options are easy; it is hard to find any justification for granting reload options and they are inconsistent with any attempt to motivate executives. Repricing options is a bit more difficult, since it is true that if an option is so underwater that there is no hope during the life of the option that the stock price will ever exceed the exercise price, the option has no incentive value. In that instance, option repricing serves the same function as a new option grant. Thus, it is consistent with motivation theory to allow repricing only in those circumstances. Yet even then, the option price should be something in excess of the price to which the company's stock has fallen.

The question then is what is the best means to achieve a restriction on option repricing and a ban on reload options. To agree that the unrestricted use of these practices defeats attempts to use options to motivate executives

196. See Johnson & Hobart, *supra* note 143, at 361.

197. If the number of shares or the exercise price is contingent upon future performance, the measurement date does not occur at grant and an accounting charge would occur at the time the number of options and the price became fixed. See APB OPINION NO. 25, *supra* note 27.

is not necessarily to recommend that the law enact restrictions. Instead, we could allow the shareholder proxy process to deal with them. The argument against an outright ban or restriction is that both repricing and reload options can be dealt with by shareholder proposals and, in fact, shareholders have had some success in preventing manipulation of option compensation through their use of the proxy process.¹⁹⁸ Under that argument, if a corporation's shareholders are concerned about manipulation of compensation through these mechanisms, they can voice their displeasure by passing a proposal prohibiting the board from engaging in the practice. The SEC has made it easier for shareholders to do that by improving the disclosure of executive compensation,¹⁹⁹ requiring that shareholder proposals regarding executive compensation be included in management's proxy statement at company expense,²⁰⁰ and making it easier

198. One example is the success of the Wisconsin State Pension fund in its objection to option repricing by Mentor Graphics. In November 1996, in response to its stock falling to its lowest level since 1992, Mentor Graphics repriced options to the market price of \$7 3/4. The "repricing 'didn't sit very well with the State of Wisconsin,'" and when the Wisconsin State Pension Fund (which owns 10% of Mentor Graphics' stock) objected, the Company promised never again to reprice without shareholder approval. See Browning & Jereski, *supra* note 163, at C1. The Wisconsin State Pension Fund has received the same promise from other companies. See *id.*

199. See *supra* notes 33-35 and accompanying text.

200. In 1992, the SEC decided that the issue of executive compensation had become such a significant policy issue that companies could no longer exclude shareholder proposals regarding such compensation as ordinary business matters. See *Statement of Richard C. Breedon on Executive Compensation Issues*, SEC News Release 92-12, (Feb. 13, 1992), available in 1992 WL 37025. Since then, the SEC has routinely ruled that shareholder proposals addressing executive and director compensation must be included in a company's proxy. See, e.g., General Electric Co., SEC No-Action Letter, (Jan. 28, 1997), available in 1997 WL 37671 (proposing that no executive be compensated more than \$1 million per year, unless paid in accordance with a performance based plan approved by a majority shareholder vote and included in a company's proxy); General Motors Corp., SEC No-Action Letter, (Mar. 3, 1997), available in 1997 WL 91442 (proposing that all options, rights and SARs must be disclosed); Sigma-Aldrich Corp., SEC No-Action Letter, (Mar. 4, 1994), available in 1994 WL 66849 (proposing that base salary of the CEO does not exceed \$500,000 and that the CEO does not receive more than 20% of incentive bonus units pursuant to the Incentive Stock Bonus Plan must be disclosed); Wendy's International, Inc., SEC No-Action Letter, (Mar. 7, 1997), available in 1997 WL 109573 (proposing that the board study and report on the pay, benefits, perks, stock options, and special compensation arrangements for top officers; that such compensation be linked to shareholder returns; that it be compared to the lowest and average wages for company employees in the U.S. and Mexico; and that a cap be placed on executive compensation packages, all of which must be included in a company's proxy).

The SEC views option repricing as raising significant policy issues and therefore not excludable as an ordinary business matter. See *General DataComm Industries, Inc.*, SEC No-Action Letter, (Dec. 9, 1998), available in 1998 WL 883796. However, the shareholder process may only work to prevent option repricing without shareholder approval if the stock plan in question covers only executives. See *Shiva Corp.*, SEC No-Action Letter, (Mar. 10, 1998), available in 1998 WL 111158 (allowing omission of shareholder proposal seeking a

for shareholders to communicate with each other.²⁰¹ On the other hand, if these practices do nothing but allow boards to manipulate executive compensation, it is hard to justify the expense and inefficiency of using a company-by-company shareholder proposal process. There are two other choices, namely, use legislative means to ban reload options and restrict repricing or amend FASB principles to discourage the practices by forcing recognition of an accounting expense. Given competitive factors that may discourage states from acting—the race to the bottom may prevail—FASB action may be superior, and in fact, the FASB is currently considering a proposal to force companies who reprice options to record as an expense the difference between the new option exercise price and any subsequent increase in the share price.²⁰²

Although this article emphasizes reforms aimed at options, changes in the structure and implementation of short-term incentive plans would be desirable as well. Such plans should place more emphasis on individual performance than they currently do. This is consistent with goal setting and expectancy theory. However, it creates a risk regarding equity theory to the extent that executives perceive subjectivity in how the individual portion of the award is determined. Thus, while placing emphasis on individual performance, to the extent the criteria for individual adjustments are objective, problems of perceptions in inequity can be minimized.

Second, short-term incentive plans should set realistic, but challenging goals. Only then can such plans actually have any motivational impact. Third, some creative thinking should be done to come up with benchmarks that are less susceptible to manipulation.

B. A Suggestion for Further Research: How Much Should We Be Paying to Achieve the Desired Goal?

The central point of this article's discussion has been the form of compensation, rather than the amount executives are paid. However, it would be a mistake to completely ignore the issue of amount because it affects attempts to use pay to ultimately improve the financial well-being of a company.

by-law amendment on the repricing of options on the grounds that the proposal is related to the company's ordinary business because the company plan gave stock options to employees, officers, directors, consultants and advisers and not just executives). *See Resolution of Stock Option Repricing Omissible as Relating to Ordinary Business*, Corp. Couns. Wkly. (BNA) at 2 (Apr. 1, 1998).

201. *See Regulation of Communications Among Shareholders*, 57 Fed. Reg. 48,276 (1992) (codified at 17 C.F.R. pt. 240, 249) (amending proxy rules to allow for communication among most shareholders of public companies with respect to issues of mutual interest and concern without the mechanism of the proxy system being invoked).

202. *See FASB Mulls*, *supra* note 160, at A6.

It is clear from the previous discussion that the theories do not help answer the question of how much to pay executives. Except for the equity theory, which addresses the amount of pay in relative terms, the application of motivation theories to the attempt to use compensation as a motivator speak to the form in which compensation is paid. Even if we accept that pay may be motivating, very little work has been done on how much pay is necessary to achieve the desired motivation.²⁰³ It may be that paying a CEO a base salary of \$500,000 and contingent compensation with a potential value of \$1 million, if the company does well, will provide an incentive for the CEO to perform at a very high level. That, however, does not mean that she would perform any better if the potential value of the contingent portion of her compensation were \$2 million or \$3 million, or that she would perform any less well if the potential value were only \$900,000.²⁰⁴ It is likely that executives are being paid more than is necessary to motivate them.²⁰⁵

203. See Herbert G. Heneman III & Rebecca A. Ellis, *Behavioral and Industrial Relations Perspectives on Compensation: Contributed Papers: Correlates of Just Noticeable Differences in Pay Increases*, 33 LAB. L.J. 533, 533-34 (1982) (discussing the concept of "just noticeable difference," or the minimum or threshold pay increase that would be perceived to make a difference to an employee and suggesting that very little work has been done on how much of a pay increase is necessary); Mitra et al., *supra* note 46, at 71 (commenting that it is not known if a raise of .5% or 20% is large enough to motivate employees).

204. See Kohn, *supra* note 1, at 36 (while it may be true that if an employee's pay were cut in half he might be demoralized and work less, it does not necessarily follow that if the employee's pay were doubled he would work twice as hard). The only psychological theory that speaks at all to amount is equity theory, which would suggest that the executive might work less with a potential contingent award of \$900,000 if other comparable executives all had potential contingent awards of \$2 million.

205. To the extent executives are being paid more than is necessary to motivate them, corporations are making inefficient economic decisions. According to the marginal productivity theory, employers should pay executives at the value of their marginal products. An executive's marginal product is "the excess of a firm's total profit under that person's direction over what it would be under the direction of the best alternative executive, plus the amount that would have to be paid to secure the latter's services. This total amount represents the upper limit the firm would be willing to pay the executive." Luis R. Gomez-Mejia et al., *Managerial Control, Performance, and Executive Compensation*, 30 ACAD. MGMT. J. 51, 52 (1987); see also HENEMAN, *supra* note 3, at 36 (commenting that under the marginal productivity theory, employers pay larger salaries to those employees whose performance results in larger profits for the company management and that these increases of salary will be given only to the extent it equals the employee's performance contribution to the company). Paying executives on the basis of their marginal productivity accrues certain benefits. Doing so acts not only as an incentive to executives to expend greater effort, but tends to attract and retain workers who are able and willing to work hard. See *id.* at 36. Marginal productivity theory implies that executive performance must be carefully measured and that pay increases should be set consistent with market demands. See *id.*; see also Randy R. Grant, *Measuring Corporate Power: Assessing the Options*, 31 J. ECON. ISSUES 457 (1997) (commenting that the marginal productivity theory bases itself on the assumptions of a neoclassical model; account has to be taken, however, of

However, that is not the only reason compensation amounts are important. There is a danger that if compensation is successful in motivating executives, it may go too far. The unstated assumption behind using compensation to increase motivation is that increasing motivation increases performance. It assumes that there is a linear relationship (or something approaching a linear relationship) between motivation and performance.

It is, however, worth noting that the assumption that the level of performance is a constantly increasing function of the level of motivation is not unassailable. Vroom has suggested that although it is difficult to determine accurately the relationship between motivation and performance, there are two alternatives to the assumption of a linear relationship.²⁰⁶ The first is a “negatively accelerated curve approaching an upper limit,” which implies a law of diminishing returns.²⁰⁷ The notion is that “succeeding increments in motivation of identical amounts result in smaller and smaller increments in performance until a point is reached at which there is no further increase in performance.”²⁰⁸

The second alternative, which has been supported by a number of investigators, is an “inverted U-function,” which implies a reduction in performance under high levels of motivation. The notion here is that “performance is low at low levels of motivation, reaches its maximum point under moderate levels of motivation and then drops off again under high levels of motivation.”²⁰⁹ Vroom suggests two possible reasons for this

the fact that there are gaps between real wages and labor productivity resulting from “imperfect competition and corporate power”). Paying executives greater than their marginal productivity, therefore, is inefficient according to this theory.

Yet, a different economic theory, the efficiency wage theory, supports paying an executive a wage somewhat higher than his marginal productivity. The efficiency wage theory posits that effort is determined by the level of wages and that employers pay employees a premium wage to ensure that employees perform to maximum levels. See HENEMAN, *supra* note 3, at 39-40. According to the literature on efficiency wage theory, an individual who is paid a higher wage than they could obtain with other companies would work harder than if just paid what he could earn elsewhere. See Kahn & Sherer, *supra* note 44, at 108-S.

It is possible that the efficiency wage theory has a physiological origin. The level of pay which will motivate employees might therefore be better determined by sociologists and political scientists than by economists because it deals with insight into social attitudes. See Mark G. Kelman, *Progressive Vacuums*, 48 STAN. L. REV. 975, 986 (1996) (reviewing MICHAEL J. PIARE, *BEYOND INDIVIDUALISM* (1995)) (suggesting that under the efficiency wage theory employers may seek to lower the minimum wage in an effort to lower efficiency wage level, thereby paying employees less money than they have to pay).

206. See Vroom & Deci, *supra* note 14, at 229.

207. *Id.*

208. *Id.*

209. *Id.* at 232. This may account for the suggestion that pay in excess of a certain level may actually result in lower performance levels. See Clyde P. Oliver, *Letters to the Editor: CEO Pay Just Greed?*, HARV. BUS. REV., Sept.-Oct. 1992, at 194. However, if so, that

effect. First, a high level of motivation may be accompanied by a "narrowing of the cognitive field," leading a person to ignore relevant information to a novel or difficult task. Second, high levels of motivation to attain a goal tend to be associated with anxiety or other strong emotional states which may impair performance.²¹⁰

I make this point as a reminder that guaranteeing superior executive performance is not simply a matter of establishing the link between pay and performance. This suggests that more work needs to be done to assess the impact of contingent compensation.

V. CONCLUSION

Based on the empirical evidence, it is difficult to form a conclusion as to whether contingent compensation improves motivation and thus corporate performance. The psychological theories of motivation considered in this article suggest that contingent compensation has the potential to positively affect managerial performance, but that such compensation is not now being used in a way that will maximize the motivating effect. However, the potential does exist and changes can indeed be made in how contingent compensation plans are structured and implemented so as to increase their positive effect. The same is true of Congress and its agencies, which, if they intend to act in ways to encourage the use of contingent compensation, should consider requiring that such compensation arrangements be structured and operated in a more effective way.

Furthermore, although the focus in this article has been on executives, theories of motivation certainly have implications for compensating lower level executives and rank and file employees as well. Companies are increasingly using contingent compensation for a wider range of employees,²¹¹ and serious thought should be given to whether there is value in doing so. As I suggested earlier, the motivational impact of contingent compensation for rank and file employees will not be the same as the impact on executives.²¹² Still, we need to give consideration to how these motivational theories affect our view of the use of contingent compensation

result may be the result of performance goals that are too low; for example, the problem could be the nature of the link between pay and performance, not the absolute level of performance.

210. See Vroom & Deci, *supra* note 14, at 232-33.

211. See Berss, *supra* note 161, at 47 ("even the lowest level employees get 13% of compensation from long-term incentives"); Carey Gillam, *Incentive Pay Plans Going Deeper in Banks Rosters*, AM. BANKER, Dec. 2, 1997, at 4 (reporting that incentive bonuses are "filtering down through the ranks" in the banking industry); Tice, *supra* note 195 (noting how IBM, Intel, Microsoft, and AT&T give stock options to 100% of their employees).

212. See *supra* text accompanying notes 40-42.

for rank and file employees.²¹³

213. It is particularly interesting to consider equity theory in this regard, given the tremendous gap in pay between executive and rank and file employees. According to one survey, CEOs of the largest American companies earned 209 times the pay of the average employee. *See* Reingold, *supra* note 151, at 59 (noting that for 1997, CEO average pay rose 54% to \$5,781,300, 209 times that of a factory employee, who gained a 3% raise). The gap between the highest and lowest paid workers has been steadily rising. *See* Kadlec, *supra* note 151, at 59 (noting that pay disparity between CEOs and rank and file employees is five times greater than it was 30 years ago and is still growing); KEVIN PHILLIPS, *THE POLITICS OF RICH AND POOR* 179-80 (1991) (stating that in 1979, CEOs made 29 times the income of the average manufacturing worker; by 1985, the multiple was 40 and in 1988 total compensation of CEOs had increased to 93 times the earnings of the average factory worker).