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THE MANAGER'S SHARE

DAVID I. WALKER

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THE MANAGER'S SHARE

DAVID I. WALKER*

ABSTRACT

It is sometimes argued in the corporate governance literature that the total share of corporate value that can be extracted by a manager is fixed and independent of the avenues through which value is extracted. Shareholders need not worry about an activity such as insider trading, the story goes, because any profits achieved by a manager through insider trading will simply offset conventional compensation. This article challenges that idea and argues that whether one views the manager's share as being capped by external market forces, set by an optimal principal/agent contract, or limited by saliency and outrage in accordance with a managerial power view of corporate governance, the total value that can and will be appropriated by managers will be a function of the number and type of avenues through which value can be appropriated.

Although the foregoing theories provide the same overall prediction that additional avenues of appropriation increase total managerial appropriation, the factors affecting the magnitude of the effect depend on the model or mechanism employed. For example, potential avenues of appropriation that are easily monitored and under the unilateral control of the directors, such as bonuses or perks, should have little effect on incremental appropriation under an optimal contracting model, but could have significant impact under a managerial power model. A review of the relevant empirical literature suggests that additional avenues of appropriation do indeed lead to greater overall appropriation. The evidence, moreover, is largely inconsistent with the optimal contracting view.

* Associate Professor, Boston University School of Law. I have benefited from the valuable suggestions of Lucian Bebchuk, Keith Hylton, Steve Marks, Mike Meurer and participants in workshops at Harvard Law School and Boston University School of Law. I thank Sumangali Krishnan for excellent research assistance.

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INTRODUCTION

It is sometimes argued in the corporate governance literature that the total share of corporate value that can be extracted by a manager is independent of the avenues through which value is extracted. Easterbrook and Fischel put it this way:

Managers with the power to pay themselves can take their profits only once. They can't take it in salary, and a second time in options, and a third time in trading profits, and a fourth time in perks. Grant that managers can wring so much from investors; then they will take it, and the division between trading profits and skyboxes to football games matters only if the form of compensation has efficiency properties.¹

This article challenges the idea that the manager's share is fixed. I argue that whether one views managerial appropriation as being capped by external market forces, set by an optimal principal/agent contract, or limited by saliency and outrage in accordance with a managerial power view of corporate governance, the total value that can and will be appropriated by managers will be a function of the number and type of avenues through which value can be appropriated. To be sure, some avenues of appropriation are less problematic under one model of corporate governance than another, but the bottom line conclusion is the same – channels of appropriation matter.

Resistance to the fixed slack argument is not novel. Many commentators have approached various corporate governance arrangements under the assumption that total appropriation increases as channels of appropriation increase.² A primary contribution of this article, however, is to provide a rigorous analysis of and rebuttal to the fixed appropriation view.

The mechanism that controls the manager's share of corporate wealth is not perfectly understood. The optimal contracting model of the managerial agency relationship posits that the principal (the board of directors on behalf of the shareholders) can only imperfectly observe the effort, focus, and effectiveness of its agent (the manager) and negotiates a contract that minimizes the resulting agency costs, that is, the costs of 1) contracting with the manager, 2) monitoring the manager's performance, 3) bonding by the manager to maximize shareholder value, and 4) the residual slack or divergence that remains between the actions selected by the manager and those that would optimally benefit the shareholders.³

¹ Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 262 (1991). Easterbrook and Fischel are far from being alone in this view. As discussed *infra* Part I, a number of respected scholars have made similar arguments.

² See, e.g., Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 *Harv. L. Rev.* 998, 999, 1023, 1033 (1981) (suggesting without explicit explanation that managerial compensation arising from the taking of corporate opportunities would be in addition to conventional compensation).

³ See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305, 308 (1976), discussed *infra* Part III.

Recently, two colleagues and I have set forth a managerial power theory of managerial slack that can be seen as supplementing the optimal contracting theory.⁴ Under the managerial power theory, appropriation by strong managers is limited by the outrage that excessive appropriation causes among financial analysts, institutional investors, and other corporate governance watchdogs. Outside directors are sensitive to this outrage and limit managerial compensation accordingly. As a result, managers have an incentive to camouflage compensation in order to limit outrage.⁵

Under both of the aforementioned theories there is an overriding cap on managerial value extraction that is determined by external market forces – markets for corporate control, capital, products, and even the managerial labor market. However, external market forces generally are thought to permit considerable slack, leaving one to question the extent to which such forces actually limit appropriation.⁶

Given the controversy concerning which mechanism actually limits managerial appropriation, this article considers the impact of additional avenues of value appropriation under each theory. I first analyze the external market forces that are seen as placing an upper bound on managerial appropriation and rendering channels of appropriation irrelevant. If managerial labor and takeover markets limited appropriation and if these markets were perfectly transparent and competitive, avenues of appropriation would not affect a manager's overall share. Rational managers would themselves select the most efficient compensation arrangement in order to appropriate as much firm value as possible without triggering market discipline. Managers would reject inefficient compensation and would be forced to trade off equally efficient forms dollar for dollar.⁷

Markets are imperfect, however, and far from transparent. But the fact that there is market slack means only that managers would be able to take more under this model; it does not mean that channels matter. Presumably, managers operating under a slack market forces limitation would still maximize their share and trade off one form of efficient compensation for another dollar for dollar, albeit at a higher overall level. Additional opaque avenues of appropriation affect total appropriation under this model, however, because each new channel undermines the effectiveness of these external market forces. Legalizing insider trading, for example, would weaken managerial labor market discipline and permit increased managerial appropriation because private monitoring of insider trading would be difficult and costly.⁸

Next, I consider the effect of additional appropriation channels under an optimal contracting model. Stickiness in external market forces suggests that there often will be a significant gap between the minimum amount of compensation required to attract and retain a manager – the reservation wage – and the external market forces limitation on

⁴ See Lucian Arye Bebchuk, Jesse M. Fried, & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751 (2002); see also Lucian Bebchuk & Jesse Fried, *Pay Without Performance* (2004).

⁵ See *infra* Part IV.A.

⁶ See *infra* Part II.B.

⁷ See *infra* Part II.A.

⁸ See *infra* Part II.B.

appropriation. Shareholders, or boards of directors acting for them, may be able to hold appropriation and agency costs to a level below the external market forces limitation through aggressive monitoring and the use of incentive compensation. The optimal contracting model posits that shareholders will minimize agency costs through this internal labor “market.”⁹

A simple thought experiment demonstrates why additional avenues of appropriation lead to greater total appropriation under the optimal contracting theory. First, imagine a case in which a manager is paid with a mix of cash and options and has no opportunity to extract pecuniary value through any other channel, e.g., has no opportunity to engage in insider trading, self-dealing, or appropriation of corporate opportunities; but the manager can enjoy the private benefits of loafing and perquisites, which the directors cannot perfectly observe. Under the optimal contracting theory, the parties' contract would balance the manager's private benefit opportunities, risk aversion, and the cost and effectiveness of incentive compensation and would optimize the package of cash and options, the level of monitoring, and the amount of residual slack.

Now add a new avenue of value appropriation. Imagine that self-dealing becomes feasible.¹⁰ Self-dealing can conceivably benefit shareholders as well as managers, but because the incidence and extent of value diversion through self-dealing cannot be perfectly observed, self-dealing also can result in significant appropriation by management. Thus, shareholders may wish to limit or even prohibit self-dealing contractually, and a new optimal contract will be written. The manager's share of firm value may increase in two ways. First, the level of incentive compensation may increase in the new environment. If the level of incentive compensation under the old contract was optimal, it will not remain optimal in the new environment because the manager has a new source of private benefits that can be achieved through self-dealing and, unless adjusted, no additional shareholder wealth-maximizing incentives. Second, given diminishing returns on contracting and monitoring investment, some excess self-dealing will be permitted under the new optimal contract. Total agency costs will be higher in the new environment, but these costs will be borne by the principal. The manager-agent may benefit through enhanced incentive compensation *and* residual self-dealing opportunities.¹¹

Finally, I consider the effect of additional channels of appropriation under a managerial power model of corporate governance. The managerial power model recognizes that directors are not perfect agents of shareholders and presents a less optimistic view of corporate behavior. Like the optimal contracting model, the managerial power view posits that appropriation is only loosely constrained by the external market forces discussed above. The upper limit on appropriation under the managerial power view is set not by optimal contracting, but by investor and financial

⁹ See *infra* Part III.A.

¹⁰ Self-dealing could become feasible through a change in legal rules or through a change in corporate or individual circumstance.

¹¹ See *infra* Part III.D.

press outrage borne by outside directors.¹² Avoiding transparency and salience is central to maximizing appropriation under this model. Thus, it is a fairly straightforward implication of the managerial power model that increasing the number of avenues of slack will increase total managerial appropriation, because appropriation of total value X through straight salary will be more salient and outrageous than appropriation of the same amount through a multiplicity of channels. However, certain channels of appropriation (insider trading, perks) are more easily camouflaged than others (straight salary). Thus, under this model, the types of appropriation channels available to management may be as or more important than the number of avenues available.¹³

In sum, whether one believes that managerial appropriation is capped by external market forces, by an optimized contract, or by salience and outrage, increasing the avenues of appropriation should increase the total value appropriated. This is an important claim because if the fixed appropriation view is right and avenues are irrelevant, there may be little or no reason to regulate insider trading, self-dealing, or the taking of corporate opportunities. The implication of additive appropriation, on the other hand, is that total managerial appropriation is partly a function of the number and types of appropriation avenues available. The foregoing analysis may help explain why corporate law creates certain blanket prohibitions, such as the prohibition against insider trading, which limit avenues of appropriation.

Although the theories provide the same overall prediction that additional avenues of appropriation increase total managerial appropriation, the factors affecting the magnitude of the effects depend on the model or mechanism employed. Under the optimal contracting model, the important factors include the difficulty of direct monitoring, the intensity of private benefits, and the ability of directors to just say no. Avenues of appropriation that can be eliminated by directorial fiat, such as perks and benefits, should have little or no impact on total appropriation under this model. Particularly troubling under an optimal contracting model are avenues effectively under the control of the managers, such as insider trading, self-dealing, and the taking of corporate opportunities.¹⁴ Under the managerial power theory, the key issues are the opacity of the value transferred through an additional avenue of appropriation, which is similar but not identical to monitoring difficulty, and the extent to which transfers can be plausibly justified as enhancing shareholder value. The value of certain complex benefit plans, for example, may be opaque to outside observers but easily monitored by shareholder-loyal directors. Such benefits present much more of an opportunity for incremental appropriation under the managerial power model than the optimal contracting model.¹⁵ If external market forces actually cap appropriation, the extent to which an additional avenue of appropriation undermines those forces is key, and difficulty of external monitoring would again be important.¹⁶

¹² See Bebchuk et al, *supra* note x, at 786-87, and *infra* Part IV.A.

¹³ See *infra* Part IV.B.

¹⁴ See *infra* Part III.D.

¹⁵ See *infra* Part IV.B.

¹⁶ See *infra* Part II.B.

Thus, one's level of concern with multiplying channels of managerial appropriation may depend on which theory or mechanism one believes best describes the contracting environment. As a corollary, empirical evidence concerning the extent to which additional avenues of appropriation add to total appropriation should shed light on the persuasiveness of the various governance theories. This article analyzes numerous forms of current and potential value appropriation through this lens and considers the limited empirical evidence bearing on these issues.

The empirical evidence supports the view that channels matter. First, additional channels of compensation lead to more total compensation. Second, the additional compensation represents at least some appropriation of shareholder value; it is not simply a fair and efficient splitting of incremental firm value resulting from the inclusion of a share value-enhancing form of compensation. Moreover, the evidence largely is inconsistent with the optimal contracting model. Channels that should lead to little or no incremental appropriation under this model, because they are easily monitored and under the unilateral control of the directors, significantly increase total appropriation.¹⁷

For example, a recent study of bonuses paid to executives for completing acquisitions finds no relationship between deal performance and the size of the bonus paid.¹⁸ These deal bonuses do not appear to enhance shareholder value, and as a result, they should not increase overall managerial appropriation under a fixed appropriation view or even under the optimal contracting model, because they are easily monitored and the directors can eliminate them if they are inefficient. The study finds, however, that these bonuses do increase total appropriation; they do not simply replace other forms of compensation.¹⁹ This result suggests that the managerial power model better explains the deal bonus evidence than the optimal contracting model.

The remainder of this article is organized as follows: Part I describes the fixed appropriation view through examples of its invocation and importantly defines what I mean by the term "appropriation." Part II presents and critiques the view that external market forces cap total managerial appropriation and that, as a result, avenues of appropriation are irrelevant. Part III considers the effect of additional avenues of appropriation within an optimal contracting framework assuming that boards of directors can improve upon the limitation supplied by external market forces. Part IV provides the same analysis under a managerial power view of corporate governance arrangements. In Part V, I consider the limited empirical evidence bearing on the fixed appropriation question and the governance theories discussed. The weight of the evidence suggests that channels matter. Part VI briefly considers the implications of the theory and empirical evidence for shareholder advocates as well as policy makers. Part VII concludes.

Before launching into the first substantive section of the article, let me say a word about my normative perspective. This article takes the view that the goals of corporate

¹⁷ See *infra* Part V.

¹⁸ See Yaniv Grinstein & Paul Hribar, CEO Compensation and Incentives – Evidence from M&A Bonuses 3 (working paper, 2003).

¹⁹ See *id.* at 12-13.

law and corporate law scholarship should be maximization of shareholder value; not as an end in itself, but because rewarding investors encourages capital formation and grows the economic pie for all of us. Managers certainly should be compensated, fairly and creatively, for their contribution to the corporate enterprise, but the manager's share should be no larger (or smaller) than that necessary to maximize shareholder value.

I. THE FIXED APPROPRIATION VIEW AND APPROPRIATION DEFINED

Opponents of mandatory corporate law rules prohibiting certain managerial activities, such as insider trading, self-dealing, or the taking of corporate opportunities (or apologists for the lack of such prohibitions), sometimes argue that the total share of corporate value that can be appropriated by a manager is fixed and independent of the avenues through which value is appropriated. Shareholders need not worry about an activity such as insider trading, the story goes, because any profits achieved by a manager through insider trading will simply offset salary, bonus or other forms of conventional compensation. This Part provides several examples of the deployment of the fixed slack view and then prefatory to analysis of the effect of potential avenues of managerial appropriation on total appropriation defines exactly what is meant by the term "appropriation."

A. The Fixed Appropriation Argument Deployed

The "fixed appropriation" or "fixed slack" argument has been invoked in a variety of contexts. The Easterbrook and Fischel passage quoted in the introduction is taken from their analysis of the potential costs and benefits of deregulating insider trading,²⁰ but as the quotation suggests, it could apply to any avenue of managerial appropriation. Salary, options, perks, and insider trading just scratch the surface. In fact, in another article, the authors make the same fixed appropriation argument in the context of a manager appropriating a corporate opportunity.²¹

Dennis Carlton and Daniel Fischel also invoke the fixed slack argument in their analysis of insider trading,²² as do David Haddock and Jonathan Macey, who specifically focus on the role of the managerial labor market in reducing other compensation for insider trading gains.²³ Economist Nejat Seyhun has summarized this theory as follows:

²⁰ See Easterbrook & Fischel, *supra* note x, at 262.

²¹ See Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698, 734 (1982) ("Managers properly take opportunities for themselves when they can exploit them more profitably than the firm.... [T]he manager takes the venture, and the firm reduces the manager's other compensation.").

²² See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 *Stan. L. Rev.* 857, 862-63 (1983) (arguing that managers and firms will allocate inside information efficiently in the face of competitive markets).

²³ See David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 *Nw. U. L. Rev.* 1449, 1461-62 (1986) (assuming that insider trading gains will be offset dollar for dollar by salary reductions for risk-neutral, replaceable managers and by something less than dollar for dollar reductions once risk aversion is factored into the analysis).

“In competitive managerial markets, potential managers will incorporate the additional benefits of insider trading into their wage contracts, thereby bidding their wages lower.”²⁴

Recently, Einer Elhauge has argued that contributions to a manager's pet charities likely substitute for other forms of compensation and thus do not erode shareholder value. His view is that managerial discretion to make such contributions is unlikely to affect the overall level of agency costs, “because, while shareholders cannot monitor specific operational decisions or determine whether managers are maximizing profits, shareholders can and do monitor the overall level of corporate profitability.”²⁵

Albert Choi has recently presented a theoretical model of golden parachute arrangements that explains the devices as mechanisms for shifting executive compensation from target firm shareholders onto acquiring firms. Central to his argument is the idea that shareholders can reduce traditional executive compensation by the expected value of the parachute payments.²⁶

These are just a few representative examples of analyses predicated on a fixed appropriation view. Many others can be found in the corporate governance literature. However, commentators propounding this view seldom develop the argument fully or discuss the specific mechanism that they believe caps appropriation and renders sources irrelevant.²⁷ The next three Parts discuss three mechanisms – external market forces, optimal contracting, and outrage and saliency in accordance with a managerial power view of corporate governance – that may limit managerial appropriation and evaluates the fixed appropriation argument under each of them. Before turning to these mechanisms, however, it is important to define exactly what I mean by managerial appropriation.

B. Appropriation Defined

Defining “appropriation” is easy if firm value is unaffected by the form of compensation provided to the manager. However, if, as Easterbrook and Fischel put it, various forms of compensation have differing “efficiency properties,”²⁸ the problem is much more complex. Let us begin with the case in which corporate value is independent of the form of compensation. Then, if a manager receives more total compensation as a result of being offered a new form of compensation, we would say that the difference represents incremental appropriation. This is a zero-sum, fixed economic “pie” situation, so any incremental gain by the manager represents a transfer from the shareholders.

²⁴ See H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 *J. Law & Econ.* 149, 150 (1992).

²⁵ See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest* 47 (working paper, Aug. 17, 2004).

²⁶ See Albert Choi, *Golden Parachute as a Compensation-Shifting Mechanism*, 20 *J.L. Econ. & Org.* 170 (2004).

²⁷ David Haddock and Jonathan Macey's analysis of insider trading is an exception. See Haddock & Macey, *supra* note x, at 1461 (arguing that managerial labor market competition would drive down an insiders direct compensation to reflect profits achieved through insider trading).

²⁸ See Easterbrook & Fischel, *supra* note x, at 262.

The analysis is more complicated if a new form of compensation provides share value-enhancing incentives or tax savings or otherwise results in a larger pie. Now the fact that a manager gains does not necessarily imply that the shareholders lose. The manager and shareholders may be dividing the incremental gains. Does this mean that shareholders should not worry about the manager's share of incremental gains from new forms of compensation as long as the shareholders remain whole? I do not think so. Although it is more difficult to define appropriation in this scenario, I would argue that at a minimum incremental appropriation occurs whenever managers capture 100% of incremental gains or managers fail to "pay" for the low risk elements of new compensation.

There are several ways that one might think about incremental appropriation in the "growing pie" scenario. One might compare the percentage of firm value received by the manager before and after the introduction of a new value-enhancing compensation mechanism, but this seems arbitrary since there was nothing sacred about the original sharing of firm value. However, if the manager receives 100% of incremental firm value resulting from the adoption of a new form of compensation, the manager has at least appropriated the entire opportunity, although the shareholders are no worse off. I do not think we can say anything about the degree of incremental appropriation in this scenario, however, for the reason given above.

However, there is one "growing pie" scenario in which we can comfortably define and test for incremental appropriation. Suppose a manager initially receives only a cash salary of 100. Now suppose that the manager is offered a bonus based on company performance. Under the bonus formula, company performance will be assessed as "low," "medium," or "high," and the associated bonus will be 10, 30, or 50, respectively. Because the manager is guaranteed a bonus of 10, she should be willing to give up at least this amount of salary in exchange for the bonus opportunity. Under the optimal contracting framework that is discussed in Part III, we would expect the directors to require the manager to give up at least this amount.²⁹ Thus, if there is no adjustment to the manager's base salary in this scenario, we can define the overlapping risk-free compensation to be incremental managerial appropriation.

A "fixed pie" assumption appears to underlie the fixed appropriation literature, and I generally will assume that additional avenues of appropriation have no effect on firm value as I analyze the effect of these avenues on overall managerial appropriation in the next several Parts. As we have seen, defining appropriation in this context is non-controversial. Incremental managerial compensation equals incremental appropriation. In Part V, however, I will relax the fixed pie constraint and consider whether the

²⁹ In brief, the optimal contracting model assumes that the principal (the directors on behalf of the shareholders) minimizes agency costs, which include the cost of managerial compensation. Agency costs exceed the manager's reservation wage because the directors cannot perfectly observe the manager's effort or focus. Thus, the directors invest in monitoring and accept a certain amount of residual slack. Under this model, however, the directors can offer the manager a package including the bonus and reduced salary, and, under these assumptions, even the most risk-averse manager would accept the package.

empirical evidence points to incremental appropriation with respect to arguably value-enhancing compensation.

II. THE EXTERNAL MARKET FORCES LIMITATION AND FIXED APPROPRIATION

This Part first develops the external market forces limitation argument and then discusses various objections that can be levied against it. I show that market forces would cap total managerial appropriation and render channels of appropriation irrelevant if managerial labor and corporate control markets were perfectly competitive and transparent. However, given imperfect markets, high transaction costs, and, in particular, opacity, this Part demonstrates that the number and type of avenues of appropriation that are available directly impact external market forces limitations on appropriation and that additional avenues generally undermine the discipline of market forces and lead to increased total appropriation.

A. The External Market Forces Limitation Argument

Four market forces have been described that tend to limit managerial appropriation of shareholder value – managerial labor, corporate control, capital, and products markets.³⁰ Judge Easterbrook sees these markets disciplining managers “almost as if there were an invisible hand.”³¹ I will focus primarily on the managerial labor and corporate control markets, as I see these as the most plausible external market mechanisms for limiting managerial appropriation.

Imagine an industry that is highly competitive along many dimensions – an industry marked by fierce product and labor competition (including executive “labor” competition) and competition for capital. Imagine that control contests are inexpensive and frequently launched. Imagine that managerial compensation is transparent. In such an imaginary industry,³² market forces would limit managerial appropriation even if corporate directors provided no discipline at all.

1. Managerial Labor Market (Reputation)

A perfectly transparent and competitive managerial labor market in which managerial talent is fungible would provide a cap on appropriation that would render channels of appropriation irrelevant in the manner suggested by Easterbrook and Fischel. Suppose that a manager, given her appetite for risk, is willing to accept a pay package

³⁰ See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theory and Evidence*, 9 Del. J. Corp. L. 540 (1984).

³¹ See *id.* at 544.

³² I am unaware of any industry that fully fits this description. The computer industry often exhibits fierce product competition, but as the recent Oracle contest for PeopleSoft suggests, control contests are not always easy or inexpensive in that industry. [Cite. WSJ?] The airline industry is marked by cutthroat product competition as well, but executive compensation in that industry is not particularly transparent. Compensation is probably most transparent in regulated utilities, but utilities generally are insulated from control contests and strong product competition.

including fixed salary of X and incentive compensation with expected value Y . If the manager attempts to appropriate additional compensation of Z through a new channel, the directors can simply refuse or they can reduce her salary to reflect the un-bargained for appropriation. If the manager persists and refuses to renegotiate, the directors can replace her with a comparable manager.³³ As a result, the manager could not increase her overall share of corporate value by exploiting the new channel of appropriation.

Suppose, however, that the manager is insulated from being fired from her present position or having her compensation adjusted. A perfectly competitive labor market still would impose this level of discipline on the manager and render channels of appropriation irrelevant, as long as the manager had ambitions beyond her present position or was likely to reenter the labor market for any reason.³⁴ In a competitive labor market, a manager who appropriates excessive compensation as CEO of ABC Co. through non-conventional channels would find the conventional compensation offered to her by XYZ Co. reduced accordingly.³⁵ The prospect of this ex post settling up would induce a rational manager to limit appropriation of shareholder value during her tenure as CEO of ABC Co. Ultimately, this is a story about reputation, and taken to an extreme implies that no explicit measures are needed to discipline managers.³⁶

This essentially external, reputational mechanism should be distinguished from internal levers, such as incentive compensation and opportunities for promotion, which also provide labor market discipline. The strength of these internal forces depends on the strength of internal corporate governance, which I will discuss in presenting the optimal contracting and managerial power models in Parts III and IV.

2. The Market for Corporate Control

The market for corporate control is seen as disciplining managerial appropriation in a similar fashion. In a perfectly functioning and transparent market, managerial appropriation would be fully reflected in a company's share price. Any deviation of the share price from the optimal level would create an arbitrage opportunity for competing

³³ See *id.* at 543.

³⁴ There would be a final period problem under this model. If discipline derives solely from the prospect of new employment, a manager nearing retirement would not be deterred from utilizing additional channels of appropriation to increase her total share. [Cite.]

³⁵ See Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, in *Handbook to Industrial Organization* 94 (R. Schmalensee & R. D. Willig eds., 1989) (summarizing Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. Pol. Econ.* 288 (1980)). In a less than perfectly competitive labor market, the effect can be reversed for several reasons: First, XYZ Co. may be forced to match or better the compensation (explicit or implicit) received by the CEO of ABC Co. to lure her away. Thus, greater total compensation at ABC may lead to greater total compensation at XYZ. Second, greater appropriation by ABC's CEO may serve as an (inaccurate) signal of quality. Third, given the reliance on executive compensation benchmarks, increased appropriation by ABC's CEO and others like her may lead to a ratcheting up of executive compensation across the board. See John M. Bizjak, Michael L. Lemmon & Lalitha Naveen, *Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?* (working paper, Nov. 15, 2000) (describing and providing evidence of the ratcheting phenomena).

³⁶ See Holmstrom & Tirole, *supra* note x, at 94.

managers who could initiate a control contest and replace existing management.³⁷ Thus, managers that failed to maximize shareholder value, either through poor decision making or through appropriating an excessive portion of the pie, would face an external risk, even if the company's directors imposed no discipline.

Channels of appropriation would be largely irrelevant in the face of an ideal takeover market. If the share value maximizing managerial compensation package consists of salary of X and incentive compensation of Y , a manager who appropriated an additional amount Z through a non-conventional channel would have to give up other compensation or face the risk of ouster. Judge Easterbrook envisions teams of potential managers monitoring existing managers looking for these arbitrage opportunities.³⁸ Knowing that they are being watched and are at risk of losing control through a tender offer or proxy contest, incumbent managers, he believes, tend to act in the shareholders' interest.³⁹

3. Capital and Products Markets

The capital and products markets could further assist in capping overall managerial appropriation and rendering channels of appropriation irrelevant. Takeovers aside, capital markets play a separate role in disciplining managers. Managers that must enter the capital markets to raise funds will find that poor performance or excessive appropriation, or the risk thereof, raises their cost of capital. This effect provides discipline for a going concern if it envisions raising new capital⁴⁰ and also for a new firm. According to Judge Easterbrook, managers that are taking a firm public will attempt to bond themselves to reasonable appropriation in order to reduce the cost of capital.⁴¹

Finally, products markets may impose some discipline on managers. If managerial slack results in poorer performance in the market for a company's products, bankruptcy may ensue, which would leave the manager without a job and with an unfavorable reputation. Even short of bankruptcy, lack of competitiveness in products markets hurts share value, increasing the risk of takeover, and reducing the amount of firm value available for managerial appropriation.⁴²

B. Objections to the Market Forces Limitation Argument

A number of objections can be raised to the argument that market forces limit managerial appropriation and that avenues of appropriation are irrelevant. The most common objection is that these markets are not perfectly competitive, leaving managers with significant slack. While true, this observation does not fully rebut the "fixed appropriation" argument. If imperfections in these markets allow managers to

³⁷ See Easterbrook, *supra* note x, at 564; Holmstrom & Tirole, *supra* note x, at 97.

³⁸ See Easterbrook, *supra* note x, at 564.

³⁹ See Easterbrook, *supra* note x, at 564; Holmstrom & Tirole, *supra* note x, at 97.

⁴⁰ See Easterbrook, *supra* note x, at 556

⁴¹ See *id.* at 543

⁴² See *id.* at 543, 557

appropriate more than they would under a perfect market assumption, managers can be expected to push compensation to the limits permitted by these slack markets. At this point, however, further appropriation would trigger the discipline of the external market forces and bring us back to the fixed appropriation result. Thus, a more nuanced rebuttal is required.

The Easterbrook and Fischel passage suggests that avenues of appropriation matter if there are efficiency differences.⁴³ Presumably what they mean is that if one form of appropriation provides share value-enhancing incentives while another does not, the choice of compensation affects managerial and shareholder wealth. If appropriation were transparent, however, efficiency differences would have little effect. External market forces would cause managers to select the most efficient compensation package in order to maximize appropriation. Efficiency does matter under a market forces limitation model, but only in an evolutionary sense. The invention of a more efficient form of compensation, such as stock options, increases the pie for everyone, managers and shareholders. In a static analysis, however, inefficient forms of appropriation should be squeezed out under this model.

Although efficiency is something of a red herring under this model, opacity is not. Once we relax the assumption that appropriation is transparent, it can be readily demonstrated that additional avenues of appropriation generally undermine the effectiveness of external market forces and increase the total appropriation permitted by these forces even if a new channel is no more inefficient (or opaque) than an existing channel.

1. Imperfect Markets Result in Significant Slack

Markets are sticky. Replacing a manager means incurring search and training costs. Raiders are required to offer a significant premium to market price to wrest control from management. As a result, the market forces “cap” on managerial appropriation is barely a cap at all. These are the conventional responses to the market forces argument, and, to be fair, proponents of deregulation recognize that markets are imperfect. Judge Easterbrook, for example, has written that “[n]one of the competitive devices is costless or perfect. Indeed, all are quite costly, and all together leave room for occasional fraud and managerial slack.”⁴⁴

It is instructive to examine in more detail the sources of slack resulting from imperfect market discipline. The limitation on appropriation arising from the managerial labor market depends in part on the cost of replacing the manager.⁴⁵ If the manager has a great deal of firm-specific knowledge that will be difficult for a replacement to acquire or if search costs are high, the cost of replacing him will be high and slack significant. Of course, managerial performance as well as appropriation factors into the replacement

⁴³ See Easterbrook & Fischel, *supra* note x, at 262.

⁴⁴ See Easterbrook, *supra* note x, at 542.

⁴⁵ See Jensen & Meckling, *supra* note x, at 33.

decision. Difficulties in monitoring and evaluating performance further muddy the signal and generally weaken the discipline of this market.

More generally, one can question the efficiency of the managerial labor market, particularly the CEO labor market. An efficient market requires many buyers and sellers engaged in fairly anonymous, independent transactions.⁴⁶ The CEO market, by contrast, is thin. The number of candidates that a Fortune 500 firm would consider in a CEO search would be few,⁴⁷ and the number of openings each year, although perhaps growing, is few as well.⁴⁸ Rakesh Khurana argues that CEO search committees often become obsessed with attracting a particular candidate, which undermines efficient bargaining.⁴⁹ Moreover, the CEO selection process is subject to a great deal of internal political and social pressure, and boards of directors of major companies (and CEO candidates) have to be extremely careful with regard to secrecy and confidentiality, factors which further impair the efficiency of this market.⁵⁰

Slack in the discipline provided by the market for corporate control also is a function of cost. Takeovers are expensive. In recent years, takeover premiums have averaged 30% or more.⁵¹ But this figure probably underestimates the amount of slack allowed by the takeover market, because a new owner would face agency costs as well.⁵² He cannot run the firm by himself. Thus, appropriation representing a deviation of, say, 30% of firm value from some "normal" level of agency costs and slack would be needed to justify a takeover.

Several factors limit the disciplining force of the capital markets. Judge Easterbrook suggests that the prospect of an IPO will cause managers to bond themselves in the company charter to reasonable appropriation.⁵³ But even if this is so, the force of this discipline is likely to wane over time as changes in legal rules and the business environment open up new avenues of appropriation.⁵⁴

⁴⁶ See Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* 27 (2002).

⁴⁷ See *id.* at 27-28.

⁴⁸ See Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 61 *J. Fin.* 2265, 2275 (2001) (finding a modest increase in CEO turnover in large public companies between 1971 and 1994 from 10.7% annually to 11.2% annually, but finding a noticeable increase in forced successions); see also Murphy, *supra* note x, at 2549 (noting an increase in external replacement of CEOs).

⁴⁹ See *id.* at 180.

⁵⁰ See *id.* at 32-48.

⁵¹ See Lisa K. Muelbroek & Carolyn Hart, *The Effect of Illegal Insider Trading on Takeover Premia*, 1 *European Fin. Rev.* 51, 61 (1997) (finding average takeover premia of 32% for a sample of acquisitions occurring in the 1980s in which illegal insider trading was not detected and an average premia of 43% for a matched set of firms with detected insider trading); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 *Colum. L. Rev.* 891, 908 (1988) (citing studies from the 1980s reporting takeover premia in excess of 50%).

⁵² See Holmstrom & Tirole, *supra* note x at 97 (asking: "Why would the new management behave any better than the old one?").

⁵³ See Easterbrook, *supra* note x at y.

⁵⁴ In fact, the prospect of a changing business and legal environment will make it very difficult for a manager to bond himself to reasonable appropriation *ex ante* without imposing significant costs on the

But what about subsequent trips to the capital markets? Won't the prospect of having to raise new money provide discipline? No, not to a significant extent. First, the cost of issuing new debt will be increased only to the extent that excess appropriation is large enough to affect a company's risk of insolvency and debt rating.⁵⁵ Managerial appropriation is more a question of dividing the pie between managers and shareholders. Second, because mature public companies rarely make equity offerings,⁵⁶ a company's cost of equity capital is unlikely to be affected by midstream increases in managerial appropriation. Finally, even if a firm makes a later trip to the public equity market or suffers an increase in its cost of debt, any additional cost of capital is borne by the shareholders pro rata, not by the manager alone.⁵⁷

Product markets seem a very remote mechanism for imposing discipline on managerial appropriation. First, excessive managerial appropriation may not have any bearing on a firm's success in the product markets. Some avenues of appropriation, such as managerial self-dealing or the taking of corporate opportunities could conceivably impact competitiveness, but most will not.⁵⁸ In addition, the incremental risk of bankruptcy resulting from excessive managerial appropriation generally will be slight.

The foregoing discussion suggests that external market forces often will permit a significant degree of slack.⁵⁹ But showing that there is slack in the market forces limitations does not sufficiently rebut the fixed appropriation claim. Avenues of slack could still be irrelevant to total managerial appropriation whether external forces working perfectly limit the total to X or working imperfectly limit appropriation to $X + Y$. If market forces cap appropriation at *some* level, channels conceivably could be irrelevant to total appropriation.

2. Appropriation Efficiency and External Market Forces

company. It will be difficult for a manager to tie his own hands without tying up the company as well and risking foregoing profitable business opportunities. See Jensen & Meckling, *supra* note x, at 325.

⁵⁵ See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435, 1466 (1992); but see Naveen D. Daniel et al, *The Hidden Cost of Managerial Incentives: Hidden Costs from the Bond and Stock Markets* (working paper, Sept. 2004) (finding that firms that use more powerful incentive compensation incur greater debt costs and that this higher debt cost is not offset by reductions in executive perk consumption or selection of higher-risk, positive NPV projects. Thus, share value suffers as a result of high-powered, suboptimal incentives.)

⁵⁶ Equity offerings made subsequent to IPOs, known as seasoned equity offerings, are rare because these offerings are viewed in the market as a signal of bad news and "last resort" financing. See Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 418-19 (7th ed. 2003).

⁵⁷ See Bebchuk et al, *supra* note x, at 778.

⁵⁸ See *id.* at 778; Bebchuk, *supra* note x, at 1466-67.

⁵⁹ In addition to these arguments, Lucian Bebchuk has argued persuasively that managers will not be constrained by external market forces with respect to significantly redistributive issues, such as compensation. With respect to these issues, managers are likely to accept the small risk of takeover or ouster associated with a dollar for dollar transfer of value from shareholders to managers. See Bebchuk, *supra* note x, at 1461-67.

Easterbrook and Fischel suggest that sources of appropriation affect shareholder and manager wealth if there are differences in “efficiency properties.”⁶⁰ The idea, presumably, is that some forms of appropriation, such as stock options, create share value-enhancing incentives, while other, perhaps skyboxes, do not, and that given efficiency differences, the choice of compensation matters. Under the assumption of perfect markets and transparent compensation, however, efficiency properties would only affect total managerial appropriation in an evolutionary sense. At any time, external market forces would cause managers both to limit their appropriation and to select the most efficient form or forms of appropriation.

Suppose, for example, that the takeover market effectively caps CEO compensation at ABC Co. and that the CEO presently receives 100% incentive compensation with value of 20, producing net shareholder value of 100. If shareholder value falls below 100, a takeover will ensue. Now suppose that the CEO has access to perks worth 5 and that these perks represent a pure value transfer from the shareholders. If the CEO takes the perks in addition to his current level of incentive compensation, share value falls to 95, triggering a takeover. In order to take perks and avoid triggering a takeover, the CEO must reduce his incentive compensation, but that also reduces firm value. Suppose reducing his incentive compensation to 15 produces net firm value of 103 prior to taking the perks. The CEO could then take 3 in perks and maintain net shareholder value of 100. But, of course, the CEO's total compensation is reduced to 18. More generally, an external market forces limitation on managerial appropriation would cause the executive to select the most efficient appropriation arrangement in order to maximize appropriation.⁶¹

On the other hand, even given assumptions of perfect markets and transparency, changes in legal rules or evolution in compensation technology involving efficiency differences would affect the manager's share over time. First, imagine an environment in which incentive compensation is legally prohibited and firms offer only straight salary compensation. Now imagine that all constraints are lifted and companies begin offering stock and option incentives. Because incentive compensation is riskier than salary and managers generally are risk averse, companies would have to offer packages with greater expected value to induce managers to make the switch.⁶² But assuming that incentive compensation is effective in increasing shareholder wealth, paying managers more through incentive compensation could be attractive. Shareholders could benefit in two ways. First, existing managers would react to incentive compensation by working harder,

⁶⁰ See Easterbrook & Fischel, *supra* note x, at 262.

⁶¹ The manager would maximize his utility, not his income, but it is unlikely that a manager would value perks equally with cash compensation. Because cash can be used to purchase anything, including perks, the cash equivalent should always be more valuable to the manager. See M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption* 15, 28 (working paper, 2004) (recognizing that perks generally will be discounted by executives but proposing that in certain circumstances perks could be worth more than their cash equivalent because mental accounting allows an executive to enjoy a perk that he would not be willing to purchase with cash).

⁶² See, e.g., Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 *U. Cinn. L. Rev.* 713, 722-23 (1995).

being more creative, or taking greater risks. Second, individuals with the appropriate skills and risk preferences would migrate towards these jobs. For both reasons, as Michael Jensen and Kevin Murphy point out, “[p]aying CEOs ‘better’ would eventually mean paying the average CEO more.”⁶³

Of course, one could respond that the markets force firms and managers to adopt the most efficient compensation package given existing compensation technology and legal rules and that increased managerial remuneration in this scenario is not necessarily “appropriation” as I have defined it, since the change enhances share value. And I would agree. My point, here, however, is simply to suggest that within a market forces framework, evolution in legal rules or technology can indeed result in managers taking their profits once in salary and a second time in options.

3. Opaque Appropriation Undermines Market Discipline

The most problematic assumption relied upon in concluding that an external market forces limitation on appropriation would render channels of appropriation irrelevant is not that avenues are equally efficient, but that they are transparent. Generally they are not. Additional avenues of appropriation – particularly opaque appropriation – undermine the discipline imposed by external market forces and result in greater total managerial appropriation under a more nuanced analysis. This effect has little to do with efficiency.

Suppose, for example, that taking perks and self-dealing both represent dollar for dollar transfers from shareholders to managers and that the two avenues are equally inefficient in terms of increasing shareholder wealth. According to Easterbrook and Fischel, whether a manager appropriates value X through perks, self-dealing, or a combination of both is a matter of indifference to shareholders.⁶⁴ Shareholders will not be indifferent, however, if access to an additional avenue of appropriation undermines the discipline provided by market forces.

Legal prohibitions provide extra-contractual enforcement mechanisms and sanctions that can reduce the cost to a company or to the markets of monitoring managerial behavior.⁶⁵ Many of the avenues of appropriation that are (or formerly were) prohibited under mandatory corporate law, such as insider trading and self-dealing, are difficult to monitor directly. The value appropriated is not transparent. Imagine that insider trading is legalized, that some companies choose to regulate or even prohibit the practice contractually while others do nothing, and that managers increase appropriation via this channel generally. How will this affect market discipline?

⁶³ Michael C. Jensen & Kevin J. Murphy, *CEO Incentives – It’s Not How Much You Pay, But How*, *Harv. Bus. Rev.*, May-June 1990, at 139.

⁶⁴ See Easterbrook & Fischel, *supra* note x, at 262.

⁶⁵ See, e.g., Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in *Principals and Agents: The Structure of Business* 81, 90-95 (John W. Pratt & Richard J. Zeckhauser, eds.) (1985) (arguing that the failure of companies to contractually prohibit insider trading tells us little because the costs and limitations of private monitoring and enforcement, whereas public monitoring and enforcement may be optimal).

The managerial labor market will not work as effectively as it did prior to revocation of the prohibition. Given relaxed sanctions (firing versus firing, jail, and fines), managers will be tempted to disguise their trades and violate contractual rules prohibiting or limiting insider trading.⁶⁶ It will be more difficult for both internal and external monitors to determine how much a given manager is appropriating in total. Hidden appropriation has no effect on a manager's reputation. All else being equal, the cap on total appropriation imposed by the managerial labor market is raised with the introduction of a new channel of value appropriation that is opaque and difficult to monitor.

The discipline offered by the takeover, capital, and products markets will be undermined as well. First, reduced compensation transparency undermines the effectiveness of the takeover market just as it does the managerial labor market. If a takeover would be triggered by excessive managerial compensation, hiding some of that compensation makes it more difficult for potential acquirers to identify promising targets. It might be argued that executive compensation, even if opaque, is reflected in a company's share price, and that it is share price and not compensation per se that triggers takeovers. If the first assertion is true, however, one must ask why companies have fought so vigorously against proposed accounting rules requiring stock option compensation to be expensed rather than simply footnoted.⁶⁷ Assuming imperfect markets, obscured compensation is likely to undermine the discipline offered by the market for corporate control.

Even if a new channel of appropriation has little direct effect on the effectiveness of the takeover market, an avenue that is opened up by removal of the legal prohibition has a second, across-the-board effect on appropriation. All companies face the same change in environment and roughly the same increase in monitoring costs. The management team put in place by a successful raider will face the same temptation to trade on inside information, for example.⁶⁸ All firms in the capital markets and products markets face similar increases in managerial appropriation. This is the dark side of the changes in legal rules idea discussed above. Even if market forces fix appropriation within a given set of legal rules and business environment, all bets are off when the rules or environment change.

Of course, difficulty of monitoring or opacity could be considered part of the "efficiency properties" alluded to in Easterbrook and Fischel's caveat. However, the problem discussed here is not a function of *differences* in opacity or monitoring

⁶⁶ See *id.*

⁶⁷ See, e.g., David I. Walker, Tax Incentives Will Not Close Stock Option Accounting Gap, 96 Tax Notes 851, 853 (2002) (describing industry and congressional pressure on the Financial Accounting Standards Board to refrain from adopting a mandatory option expensing rule). The obvious implication is that many executives do not believe that the markets are sufficiently efficient to fully incorporate footnoted information. An alternative explanation is that managers are protecting compensation that is tied to accounting results rather than stock price, although, again, this explanation relies on an imperfect labor market view.

⁶⁸ See Holmstrom & Tirole, *supra* note x, at 97.

difficulty. Each new avenue of appropriation adds to the monitoring burden faced by shareholders and markets and further undermines market discipline. Even if a current channel and potential new channel of appropriation are similar in opacity, they likely will present separate monitoring challenges and will have additive, negative impacts on market discipline. The effects of insider trading and self-dealing on managerial appropriation might be similar in magnitude, for example, but efforts spent in directly monitoring insider trading may have little impact on self-dealing and vice versa, and determining appropriation via these two avenues will be independent problems.

Market forces certainly play a role in constraining managerial appropriation and in some cases may cause channels of appropriation to be irrelevant. The question is how hard or how often these constraints "bite." If two channels of appropriation are already open and are currently being utilized, it probably makes little difference if a manager appropriates a little more via avenue "A" and less via "B." However, if one avenue represents a change in compensation technology or legal rules or if a new avenue is opened that undermines the discipline of the markets, managers may indeed increase their total appropriation under this model. Opacity appears to be the most important determinant of the extent to which an additional channel of appropriation is likely to increase total managerial appropriation if external market forces actually set the cap.

III. EFFECT OF ADDITIONAL AVENUES OF APPROPRIATION WITHIN AN OPTIMAL CONTRACTING FRAMEWORK

Whether or not market discipline is affected by avenues of slack, all recognize that there is slack in market discipline. This Part examines the effect of additional avenues of appropriation on a manager's overall share of firm value under an optimal contracting framework, assuming that this mechanism actually limits managerial appropriation. The optimal contracting model assumes that the principal (here the shareholders or the board of directors) minimizes agency costs and maximizes shareholder value by minimizing the sum of the costs of contracting, monitoring, bonding, and residual loss. The optimal contracting model predicts that the manager's share of firm value generally increases with the creation or deregulation of opaque avenues of appropriation that are largely under the control of the executives themselves, e.g., insider trading, self-dealing, or the taking of corporate opportunities. Avenues of appropriation that can be eliminated by directorial fiat should have little or no effect on total appropriation under this model.

A. The Optimal Contracting Model of Managerial Compensation

This article follows Jensen and Meckling's optimal contracting theory of managerial agency costs in analyzing the impact of additional avenues of managerial appropriation.⁶⁹ The analysis begins with a sole proprietor-manager who sells shares of equity to non-managing outsiders, which creates a wedge between the manager's private incentives and the incentives of the shareholders generally.⁷⁰ The outside shareholders

⁶⁹ See Jensen & Meckling, *supra* note x.

⁷⁰ See *id.* at 312.

cannot perfectly (or costlessly) observe the manager's effort or focus, and performance results are not completely within the manager's control.⁷¹ Thus, the shareholders cannot ensure perfect fidelity to their objectives, and the manager, who now owns less than 100% of the cash flow rights, will tend to consume excessive perks, loaf and otherwise extract private benefits, since he enjoys 100% of the benefit of such activities, but only a fraction of the cost, which is borne pro rata by all shareholders.

Agency costs under this model are defined as the sum of 1) monitoring costs incurred by the principal, 2) bonding costs incurred by the manager-agent to better ensure loyalty to shareholder wealth maximization, and 3) the cost of the residual divergence between the manager's actual decisions and shareholder wealth-maximizing decisions.⁷² The costs involved in designing and negotiating the manager's contract should be added to this list as well. The optimal contract would minimize the sum of these agency costs. Jensen and Meckling assumed that increases in monitoring reduce the residual loss, but do so at a decreasing rate, in other words, incremental investment in monitoring produces diminishing returns.⁷³ Under this assumption, we would expect some divergence of goals and some residual loss under the optimal contract.⁷⁴

More specifically, contracting and monitoring costs include all agency costs incurred directly by the principal. These include the costs of writing compensation contracts and other rules and procedures to limit an executive's access to private benefits; the costs of monitoring and enforcing such rules, contracts, and procedures, such as audits; and, importantly, the cost of incentive compensation, which, under this model, is just another tool for minimizing total agency costs. Residual loss or slack represents the divergence between the manager's actions and shareholder wealth-maximizing actions. The residual loss could be comprised of management shirking,⁷⁵ pursuing only low risk opportunities,⁷⁶ taking excessive perquisites, making corporate contributions to pet charities, or otherwise extracting private benefits through insider trading, self-dealing, taking corporate opportunities, etc.

It is worth emphasizing that the agency costs in this model also result from a lack of transparency. If the shareholders could perfectly and costlessly observe the manager's effort and the impact of the manager on performance results, there would be no agency costs. With perfect transparency, a contract could be designed that would ensure managerial fidelity to shareholder objectives. Essentially, the manager would be paid or

⁷¹ See *id.*; see also Eric A. Posner, *Agency Models in Law and Economics*, in *Chicago Lectures in Law and Economics* 225 (Eric A. Posner ed., 2000).

⁷² See Jensen & Meckling, *supra* note x, at 308.

⁷³ See *id.* at 323.

⁷⁴ The agency cost relationship is presented graphically in the Appendix, Figure 1.

⁷⁵ Loafing in the executive suite may not represent a significant shareholder concern in large, public companies, but shareholders should be concerned about the amount of a manager's time and attention devoted to maximizing shareholder wealth versus that devoted to managing the manager's own portfolio, maximizing executive compensation, minimizing personal taxes, etc.

⁷⁶ Diversified shareholders are essentially risk neutral, but executives typically are risk averse because their human capital and often a disproportionate share of their financial capital are invested in the firm. [Cite.]

retained if he took shareholder regarding actions; otherwise he would not be.⁷⁷ As a result, the manager would take shareholder regarding actions. In the real world, however, actions and results are never this transparent.⁷⁸

B. Optimal Compensation Exceeds Lower Bound on the Manager's Share

The floor on the manager's share is set by the amount required to attract and retain the manager – his reservation wage. This amount is determined by the manager's other opportunities. But this amount should not be thought of as optimal compensation. A firm may wish to pay its manager more than this minimum in order to create incentives to increase firm value.⁷⁹ An example may help clarify this point. Imagine an idealized firm owned and managed by a single individual ("M") who maximizes his own utility. Suppose firm value in this situation is 100. Now imagine that M sells 99% of the equity to an outside shareholder ("SH"). Suppose SH agrees to pay M his reservation wage, a fixed amount of compensation with present value equal to 10. SH monitors M's performance through quarterly board meetings and audits, at a cost of 5, but cannot perfectly observe M's level of effort or the advisability of M's management decisions. M may worry about retaining his position, but clearly his incentive to maximize firm value is reduced. For every dollar of firm value he adds/squanders, he enjoys/suffers only one cent. Meanwhile his compensation is fixed. Thus, loafing and perk consumption (of which he enjoys 100%) will increase at the expense of firm value.⁸⁰ Suppose the value of the company in this scenario falls to 50, implying a residual loss of 50 (100 – 50) and total agency costs of 65, including monitoring costs and M's compensation. SH enjoys net value of 35; M receives 10.⁸¹

Now imagine that the parties negotiate an incentive compensation contract under which M and SH divide firm value in excess of 50.⁸² M now has a much stronger incentive to maximize shareholder value and reduce perks and loafing. Essentially, the cost of perks and loafing rises from one cent on the dollar to fifty cents on the dollar, so perk consumption and loafing will be reduced. Because M does not bear 100% of the costs of perk consumption and loafing, however, he will not work as hard and will consume more perks than he did in the sole proprietor case. Suppose that firm value in

⁷⁷ See Posner, *supra* note x, at 227.

⁷⁸ Managerial risk aversion plays a role in the creation of agency costs as well. See *id.*

⁷⁹ See James A. Mirrlees, *The Optimal Structure of Incentives and Authority Within an Organization*, 7 *Bell J. Econ.* 105, 108 (1976).

⁸⁰ As Jensen and Meckling point out, agency costs are borne by the owner/manager when he sells shares to third parties. Thus, M has the incentive in this case to minimize agency costs. See Jensen & Meckling, *supra* note x, at 313. This does not mean, however, that M will not maximize his private benefits once the shares are sold.

⁸¹ To simplify the numbers, I ignore M's 1% of residual firm value here and throughout.

⁸² The ideal incentive for an agent is one that directly encourages him to maximize the principal's objective function, here firm value. Holmstrom and Milgrom have shown that where agents have multiple tasks, high-powered incentives related to one task can be counterproductive if the other tasks are difficult to monitor. Tying a manager's compensation to share value should solve this problem, however, as long as markets are reasonably efficient and managers cannot game share value. See Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 *J.L. Econ. & Org.* 24 (1991).

this scenario is 80. Although M's compensation increases to 25, total agency costs are reduced to 50 because of the large reduction in residual loss. Thus, SH enjoys net value of 50.⁸³ Note also that while M's compensation has increased from 10 to 25 under the incentive compensation scheme, the increase in his utility is less since he has cut back on perks and loafing.⁸⁴

C. Upper Bound on Manager's Share

How do we reconcile the optimal contracting model with the market forces limitations on appropriation discussed in Part II? After all, both approaches are very much within the law and economics framework. Although not generally portrayed in this fashion, it may be helpful to think of the market forces discussed in Part II as overriding external limitations and optimal contracting as a contingent internal limitation on managerial appropriation. For example, if a company were to invest too little in monitoring, it might suffer such a large residual loss as to trigger a takeover. If, on the other hand, the directors were to invest in monitoring well beyond the efficient level, this spending might represent excessive agency costs that could be eliminated via takeover.

In between, however, there may be a range of solutions – levels of contracting and monitoring and resulting residual loss – that hold total agency costs below the external market forces cap. A shareholder-regarding board of directors would select the solution that minimizes total agency costs within this subset of options. Of course, this optimal contract could be viewed as the result of market forces. If the manager refuses to accept this contract, he can be replaced, assuming the contract provides at least the reservation wage. However, *external* market forces do not dictate this result. If the board is captured, derelict, or just ill-advised, agency costs could exceed the minimal level without triggering a takeover or invoking another external market limitation.⁸⁵

D. Effect of an Additional Channel of Appropriation on the Optimal Contract

As suggested, the optimal contract generally will contain an incentive compensation element and result in the optimal manager's share exceeding his reservation wage. The manager's share will be capped by market forces, but the

⁸³ SH net value is calculated as follows: 80 (firm value) – 5 (direct monitoring) – 10 (salary) – 15 (incentive compensation). I again ignore M's 1% shareholding for simplicity.

⁸⁴ Although the optimal compensation package offered to a risk neutral manager might consist solely of incentive compensation, such a package is unlikely to be ideal for the typical manager. A fixed salary component serves as insurance for a risk averse or wealth constrained manager. Thus, while we might expect that the fixed salary component of an optimal incentive compensation contract to be less than that of an optimal contract lacking incentive compensation, we would not expect it to be zero in the former case. See David E. M. Sappington, Incentives in Principal-Agent Relationships, 5 J. Econ. Persp. 45, 63 (1991) (noting that fixed salary serves as insurance against market influences on the firm's stock price that are outside the manager's control); Lucian Arye Bebchuk & Christine Jolls, Managerial Value Diversion and Shareholder Wealth, 15 J.L. Econ. & Org. 487 (providing a model of managerial value diversion in which shareholders provide managers with the minimum amount of fixed salary compatible with their wealth constraints).

⁸⁵ See Appendix Figure 2 for a graphical representation of optimal contracting against an overriding external market forces limitation.

shareholders will seek to minimize agency costs below this level. Thus far, I have analyzed a case in which the manager has no access to any avenue of pecuniary value appropriation except for direct compensation. I will now relax that constraint and investigate the impact of additional avenues of appropriation under the optimal contracting framework.

Suppose that M initially has no opportunity to engage in lucrative self-dealing with his firm. Perhaps all transactions between companies and managers are prohibited by mandatory corporate law and monitoring is costless. Suppose the optimal contract is the incentive contract described above.

Now suppose that the prohibition on self-dealing is lifted and an overall fairness test is applied to judge whether a transaction between a firm and its manager represents a breach of fiduciary duty.⁸⁶ Suppose also that SH is incapable of detecting and preventing all such transactions without incurring exorbitant monitoring expenses. M now has a new avenue of appropriating private benefits. Because he enjoys 100% of such benefits and bears only a fraction of their cost through his incentive compensation arrangement and small ownership share of the firm, we can expect him to extract private benefits through self-dealing, increasing his overall appropriation and the agency costs faced by shareholders.

Assume for now that self-dealing represents a pure value transfer from SH to M and has no other effect on shareholder value. Imagine that M extracts private benefits of 20 through self-dealing, which reduces firm value from 80 to 60. M bears half of the cost of reduced firm value, receiving incentive compensation of only 5, but his total share of firm value increases to 35. Agency costs increase to 60, comprised of M's compensation of 15, direct monitoring of 5, and residual loss of 40. Thus, SH enjoys only 40 after agency costs.⁸⁷

Shareholders, however, need not accept this result. If SH could perfectly and costlessly observe the level of M's self-dealing or even estimate it accurately, SH could simply reduce M's compensation by 10 and restore the status quo. But monitoring is costly and, although SH suspects self-dealing, the reduction in firm value from 80 to 60 could be the result of poor market conditions or bad luck. Thus, restoration of the status quo is infeasible.

Nonetheless, direct monitoring can be increased and the terms of the incentive compensation arrangement can be revised to minimize agency costs in this new contracting environment. First, the shareholders can increase direct monitoring, which discourages M from engaging in particularly egregious self-dealing behavior. Second, although it may seem paradoxical at first, the shareholders may be better off increasing M's compensation in order to better align incentives. Suppose SH adopts both

⁸⁶ Under current law, self-dealing transactions are permitted if they can satisfy a judicial test of fairness or, in some states, if the transaction is properly approved by independent directors or shareholders. See Robert C. Clark, *Corporate Law* 160 (1986).

⁸⁷ Again, this calculation ignores M's 1% share.

approaches, increasing direct monitoring from 5 to 8 and increasing M's share of firm value in excess of 50 from 50% to 60%. Suppose as a result M reduces diversion through self-dealing to 5, resulting in firm value of 75. M's incentive compensation in this scenario is 15 (60% of 25), his salary remains 10, monitoring is 8, and residual loss is 25, for total agency costs of 58. Shareholders are better off by 2 with this revised contract, and M is worse off by 5.

Two aspects of the new optimal contract warrant further remark. First, optimality is viewed from the shareholders' perspective. In a sense the new optimal contract is less efficient than the former one: More is being spent on direct monitoring, which reduces the combined surplus of M and SH. But the idea to the optimal contract is to minimize *shareholder* agency costs.⁸⁸ If we wanted to maximize combined shareholder and manager surplus, we would eliminate direct monitoring and allow M to appropriate the entire pie. Second, one may ask why M would give up private benefits of self-dealing, of which he enjoys 100% under my assumptions, for 60% of incremental firm value. Of course, he wouldn't if that were all that was going on, but if direct monitoring is increased in conjunction with adoption of higher powered incentives, the combination could have that result.⁸⁹ The primary point is that both increased direct monitoring and higher powered incentives have the effect of raising M's cost of appropriating private benefits. The shareholders could use either lever or both to minimize agency costs in a given contracting environment.

Comparison of the hypothetical optimal contracts reached in environments with and without self-dealing reveals two sources of added managerial value appropriation. First, it is possible that shareholders may wish to increase incentive compensation in order to discourage managers from extracting private benefits. Second, given the assumption of diminishing returns from monitoring, it is unlikely that it will be optimal for shareholders to completely eliminate an avenue of appropriation of private benefits. More likely, as in the example above, some extraction of private benefits will continue under the optimal contract.⁹⁰

In the example discussed above, I have assumed that the "new" avenue of managerial appropriation represents a simple value transfer from shareholders to the

⁸⁸ See Holmstrom & Tirole, *supra* note x, at 89. But see Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 Yale L.J. 277 (1998) (noting two common approaches to optimality in the corporate governance literature, one of which focuses on shareholder wealth maximization and the other on joint wealth maximization.) For the reason discussed in the text, I believe the former approach is more appropriate in this context. Note, however, that maximizing shareholder value actually benefits the manager in this scenario because the price at which the manager can sell the equity of the firm depends on the ability of the shareholders to minimize agency costs.

⁸⁹ To see this, suppose that the increase in direct monitoring increases the likelihood that M is caught in an unfair self-dealing transaction and is fired. M must weigh the benefit of self-dealing, the risk of apprehension, and the cost of self-dealing in terms of reduced incentive compensation.

⁹⁰ The latter point is demonstrated graphically in Appendix Figure 3. For any given level of contracting and monitoring, residual loss and total agency costs in the environment permitting additional extraction of private benefits exceed those experienced in the environment with limited opportunities. Although minimized *within the contracting environment*, optimized agency costs are greater in the second environment than the first.

manager and has no efficiency effects, but this will not necessarily be the case. Transfers can have positive or negative efficiency effects.⁹¹ A corporate opportunity, for example, might be more valuable in the hands of the manager than in corporate solution.⁹² This type of positive efficiency effect clearly offsets part of the agency costs resulting from the additional avenue of slack. Similarly, access to an avenue of appropriation may in itself create incentives to increase firm value.⁹³ On the other hand, appropriation channels can create dis-benefits. A corporate opportunity may be valuable to a manager, but more valuable to the corporation. Even if a self-dealing transaction represents a pure value transfer, time spent by the manager in finding and negotiating the transaction could be better spent in improving the business. As before, I generally will assume in this analysis that avenues of appropriation represent pure value transfers, but it is important to bear in mind that this may not be the case. In the next section, I will consider a closely related issue, which is how the intensity of private benefits affects the difficulty of deterring a manager from appropriating private benefits.

E. Factors Affecting the Magnitude of Managerial Appropriation under the Optimal Contracting Model

I have argued that additional avenues of value appropriation increase the manager's share of firm value under the optimal contracting model because of shifts in the optimal contract in favor of additional incentive compensation and increased residual slack. This section analyses factors that affect the magnitude of these effects. Intuition suggests that the important factors include the relative difficulty of direct monitoring, the intensity of private benefits, and the ability of the directors to unilaterally eliminate a potential channel of appropriation.

1. Difficulty of Direct Monitoring

If an avenue of managerial appropriation can be directly monitored, perfectly and costlessly, it should not result in any incremental appropriation. To begin with a trivial, but hopefully instructive example, imagine that a bank manager is given access to the vault to assist clients but that his contract expressly prohibits removal of funds for any other purpose. Assuming that the vault is equipped with effective surveillance equipment and that the guards are instructed to stop anyone except clients from leaving the building with cash from the vault, this potential avenue of appropriation should not increase the manager's share. He cannot get away with embezzling funds and will not try. Even if the bank manager were to get past the guards, his employer could simply reduce his other

⁹¹ See Bebchuk & Jolls, *supra* note x, at 496-501.

⁹² See *id.*

⁹³ See *id.* For example, it has been argued that insider trading may facilitate the flow of accurate and timely information about firm value to the markets and may serve as an efficient compensation device for entrepreneurial activity within a company. See, e.g., Henry G. Manne, *Insider Trading and the Stock Market* (1966); Carlton & Fischel, *supra* note x at 866-72.

compensation by the amount of the embezzled funds, again eliminating the impact of this avenue of appropriation on the manager's share.⁹⁴

More generally, the more transparent the transaction, the easier the direct monitoring, and the less the incremental appropriation. Thus, cash transactions with the company and bonuses based on discrete events should prove less problematic for shareholders under the optimal contracting model than complex, long term arrangements and non-cash transfers. Take the example of cash deal bonuses that are commonly paid to CEOs for completing mergers or acquisitions.⁹⁵ These transactions should be relatively transparent and easy to monitor directly. It will be clear whether Acme has acquired Beta according to plan (although it may not be clear whether the price paid was advantageous). The payment amount is in cash and is costless to value.

At the other end of the spectrum consider self-dealing. Suppose Acme purchases widgets from Beta, in which Acme's CEO has an interest. The transfer of value to Acme's CEO may be difficult to monitor for several reasons. First, Acme's CEO's interest may or may not be disclosed. Perhaps it is indirect. Beta may be owned by a friend or relative. Second, even if Beta is wholly owned by Acme's CEO and the relationship is disclosed, the extent of the transfer is unclear unless the market for widgets is very transparent itself. If not, it may be difficult to determine whether the self-dealing transaction represents a fair, market exchange or entails a transfer of value to Acme's CEO.⁹⁶ Insider trading presents similar difficulties. Because managers can trade anonymously, insider trading is difficult to detect if managers fail to report their transactions, and even if all trades are disclosed, it may not be obvious whether a manager has exploited inside information to generate excess profits.⁹⁷

Transactions that provide psychic or other non-cash benefits present particular monitoring challenges. Consider corporate charitable giving. Suppose Acme makes a large contribution to the alma mater of its CEO or the hospital that recently hosted his quadruple bypass operation. Clearly, there is a transfer of value to the CEO, but how much value? The foregoing examples – self-dealing, insider trading, and contributions directed to pet charities – demonstrate in different ways the two general categories of monitoring difficulty – spotting the transfer and valuing the transfer.

⁹⁴ As suggested *supra* note x, depending on the composition of the bank manager's pay package, this reduction in other compensation may or may not affect the bank manager's incentives and shareholder wealth.

⁹⁵ See *infra* Part V for further discussion and empirical evidence related to deal bonuses.

⁹⁶ Theoretically, of course, the transfer of value could run in either direction. Managerial value appropriation occurs when the CEO of Acme, who bears less than 100% of residual gains and losses, transfers value to his wholly owned company Beta through a self-dealing transaction. Managerial self interest virtually ensures that value will not be transferred in the other direction.

⁹⁷ At bottom, this is an information asymmetry problem. When transactions are non-transparent and the manager has superior information regarding the participants and profit potential of trade, agency costs will increase and permit greater managerial appropriation. Cf. Talley, *supra* note x, at 310-36 (analyzing the corporate opportunity doctrine under the assumption that the manager has private and unverifiable information regarding the degree to which an opportunity fits the corporate scheme and that the manager has the incentive to misrepresent the fit).

2. Intensity of Private Benefits

Under the optimal contracting model, it should be relatively easy to deter value appropriation through channels that offer only weak private benefits and difficult to deter appropriation when private benefits are intense. Consider supplemental executive retirement programs (“SERPS”). SERPS are designed to supplement pensions for executives whose participation in qualified retirement plans is capped under federal law.⁹⁸ SERPS are essentially direct transfers from companies to executives. A dollar spent on a CEO’s SERP is a dollar in his pocket. Of course, if a dollar spent on a CEO’s SERP means that two dollars are spent on the SERPs of his lieutenants, the intensity of the private benefit is diminished, but take the extreme case in which only the CEO is offered a SERP. Because the intensity of private benefits is 100%, it will be impossible to deter the CEO from increasing the value of his SERP through incentive compensation alone.⁹⁹ No incentive compensation program will give an executive 100% of incremental value and most provide executives with only a tiny fraction of incremental value. Thus, shareholder would have to rely on direct monitoring to control appropriation that provides such intense private benefits.

Compare the deal bonus situation described above. Suppose that only the CEO is paid a deal bonus so that there is no dilution of private benefits among the troops. Does this imply that deal bonuses provide high intensity private benefits? Probably, but not necessarily. Suppose a CEO receives a \$1 million bonus for completing a \$100 million acquisition. If the acquisition itself has no effect on firm value, the deal bonus is analogous to the CEO-only SERP payment – a dollar for dollar transfer from company to executive. But what if the CEO overpaid for the target company in order to secure his bonus? Suppose the value of the CEO’s firm falls by \$30 million as a result of the acquisition. A high powered incentive compensation scheme could cause the CEO to think twice about pursuing such acquisitions.

Now consider corporate charitable giving. Let us assume conservatively that corporations receive no return on charitable giving, which reduces firm value dollar for dollar. A CEO may cause his firm to make contributions to a pet charity, but unless his psychic benefits from doing so constitute a significant portion of the dollar value of the contribution, a highly powered incentive compensation scheme could deter such behavior.

⁹⁸ Although the general idea of a SERP is to provide retirement benefits to highly compensated executives in excess of the limitations on qualified plans provided in the tax code, the contours of supplemental plans vary widely from firm to firm. SERPs may include defined benefit or defined contribution plans or some combination of both. Many plans simply mirror the provisions of qualified plans, such as a traditional defined benefit pension plan, although they lack the tax advantages associated with a qualified plan. See Janet DenUyl & Matt Leckrone, *Perspective: Executive Benefits a Governance Issue* (July 2, 2004), available at <http://www.mercerhr.com/knowledgecenter/reportssummary.jhtml/dynamic/idContent/1145295>.

⁹⁹ See Bebchuk, *supra* note x, at 1461-67 (discussing the difficulty of controlling managers with respect to highly redistributive issues).

More generally, one must consider the intensity of the private benefits enjoyed by the manager in relation to the total cost to the company of producing those private benefits. The intensity of private benefits is reduced to the extent that (1) a manager must share benefits with others, (2) the transfer is not dollar for dollar, or (3) the transfer causes inefficiencies.¹⁰⁰ To take a final example, consider self-dealing. A manager may be able to shift value from Acme to Beta through self-dealing. If Acme simply overpays for widgets, the transfer will be dollar for dollar from Acme to Beta, and the intensity of the private benefits will depend on the Acme manager's relationship with Beta. (High if he is a sole proprietor; low if he is one of many shareholders.) However, if Acme buys widgets from Beta instead of the more appropriate gizmos from Gamco or reduces production because of the high cost of Beta's widgets, there may be efficiency losses as well as value transfer, which should reduce the intensity of private benefits.

3. Ability of Directors to "Just Say No"

The optimal contracting model essentially assumes that the principal can observe results, but not actions. As a result, if the directors have unilateral control over a potential channel of appropriation, an optimal contract would not include that channel unless doing so enhanced shareholder value. In other words, if the directors can just say no to a channel, providing that channel cannot increase managerial appropriation at shareholder expense under the optimal contracting model.

Suppose a certain perk or benefit (perhaps executive financial planning services) represents a pure value transfer from shareholders to the manager and has no other effect on firm value. Under the optimal contracting model, this perk will not be provided unless the manager pays for it through a reduction in other compensation. If there are tax or other advantages to the firm purchasing the perk or benefit in lieu of the executive, the savings may be shared by the parties, but, again, unless the firm is at least made whole (after tax) for the provision of such benefits, they will not be provided under the optimal contracting model.¹⁰¹ As I suggested in Part I, if the perk or benefit provides a degree of risk-free compensation to the manager, the shareholders should share in the combined surplus to at least this extent.¹⁰² The directors, who have unilateral control over the provision of the perk or benefit under the optimal contracting framework, can make a take it or leave it offer to the executive, who will accept if he is guaranteed no reduction

¹⁰⁰ Here I am referring to inefficiencies that directly reduce firm value. It may also be the case that managers incur varying levels of private costs in appropriating value through various channels. Obviously, a manager would consider these costs as well and would tend to gravitate towards low private cost avenues of appropriation. Cf., Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 *Colum. L. Rev.* 515 (1985) (making a similar argument with respect to firms with monopoly power gravitating towards low cost restrictive practices).

¹⁰¹ Some companies do expressly bar certain avenues of value appropriation. For example, Intel's most recent proxy statement notes that its executives do not have access to many of the perks that are common in U.S. public companies. It states: "We do not provide officers with reserved parking spaces or separate dining facilities, nor do we have programs for providing personal benefit perquisites to officers, such as permanent lodging or defraying the cost of personal entertainment or family travel." Reported in *The Corporate Counsel*, May-June 2004 at 8. Note that this statement does not rule out all perks, such as access to company planes and cars.

¹⁰² See *supra* note x and accompanying text.

in total compensation and in addition enjoys upside opportunity. Thus, under the optimal contracting model, potential channels of managerial appropriation that are under the unilateral control of the directors cannot result in incremental appropriation as I narrowly defined it in Part I.¹⁰³

These observations extend beyond perks and benefits. Consider the CEO deal bonuses discussed above. The payoff from acquisitions is, of course, much more uncertain than the economics of perks and benefits, but unless the expected value of paying a deal bonus is positive for the firm, directors should just say no, and these bonuses should not increase managerial appropriation under this model. In the real world, directors make mistakes and may be misled by executives into pursuing an acquisition (and paying a deal bonus) that ultimately diminishes shareholder value, but if we assume, as the optimal contracting model does, that directors are loyal agents of shareholders who negotiate at arms length, such mistakes should be the exception, not the norm.

On the other hand, incremental managerial appropriation is possible when the directors cannot just say no, and the most problematic channels of appropriation under this model are activities such as self-dealing, taking corporate opportunities, and insider trading, which are largely within the control of the manager. Even if the directors contractually restrict or prohibit these activities, they cannot compel compliance. Appropriation through these channels can be hidden. Assuming that these channels can be more effectively blocked through legal restrictions than contractual arrangements, deregulation of these activities should increase total managerial appropriation under the optimal contracting model.¹⁰⁴

Consider insider trading. Trading on the basis of material, non-public information is prohibited under mandatory legal rules, and penalties for illegal insider trading can include large fines and even imprisonment.¹⁰⁵ The legal prohibition and extra-contractual

¹⁰³ In the “fixed pie” scenario incremental managerial appropriation was defined to include any incremental compensation received by the manager as a result of the addition of a new channel of appropriation, which necessarily comes at shareholder expense. In the pie-enlarging scenario, incremental appropriation was defined narrowly to reach the failure to downwardly adjust a manager’s other compensation for the risk-free element of a new channel of appropriation. See *id.*

¹⁰⁴ Lucian Bebchuk and Christine Jolls provide another explanation of why appropriation through such channels leads to greater overall appropriation. See Bebchuk & Jolls, *supra* note x. They begin with the assumption that conventional compensation is optimized to ensure maximum shareholder value given wealth limitations. Diversion of share value to the managers via these alternative channels generally will not provide the same value maximizing incentives. Thus, even if shareholders could limit total managerial appropriation, share value would decline because of reduced incentives. In order to restore share value maximizing incentives in the face of inefficient value diversion, shareholders would likely sanction an overall increase in managerial appropriation. This assumes, of course, that the alternative appropriation channel does not provide some sort of offsetting efficiency benefit for the manager. The authors’ model reflects this possibility as well. Bebchuk and Jolls’ analysis is correct, but under a strict optimal contracting framework, their conclusion would hold only if the directors cannot unilaterally prohibit the alternative appropriation channel.

¹⁰⁵ Through the Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1986, and the Sarbanes-Oxley Act of 2002, Congress has dramatically increased civil and criminal penalties for insider trading over the past 20 years. Current potential penalties for the worst

enforcement mechanisms should reduce the amount of insider trading that takes place, the expense of direct monitoring, and the extent to which companies are required to offer incentive compensation to mitigate the private benefits available through insider trading.

Imagine that the federal rules prohibiting insider trading were simply repealed, and suppose that insider trading generally is not an efficient form of managerial appropriation. Companies might decide to prohibit the practice contractually. It is unlikely, however, that companies could impose contractual penalties that would provide the level of deterrence created under current federal law. Companies also would lack the detection and enforcement tools available to the federal government.¹⁰⁶ As a result, all else being equal, managerial appropriation of private benefits via insider trading would rise. As before, the optimal contracting framework suggests that companies would reoptimize in this new environment by increasing direct monitoring, increasing incentive compensation, or through a combination of these and other measures. Nonetheless, residual slack and value appropriation would increase under this model if the federal restrictions were lifted.

Other companies might decide that insider trading can offer benefits to the firm in certain situations and might attempt to regulate the practice contractually rather than prohibit it. A company that wished to regulate insider trading without prohibiting it would need to promulgate rules defining who may trade on inside information, how, and when; develop procedures for auditing trades of employees for compliance with such procedures; and specify penalties for noncompliance. This process will be more difficult and costly to monitor than simple prohibition.¹⁰⁷ Under the optimal contracting model, however, we assume that the directors would choose the level of private regulation that maximizes shareholder value, so increases in monitoring cost and residual slack would be accepted only if these were offset by efficiency gains. In other words, a decision to permit but regulate insider trading could not result in share value decreasing appropriation under this model.

If instead of wholesale deregulation of insider trading, Congress were to permit companies to opt out of or into the federal regulatory system, this shift would have little effect on incremental appropriation under the optimal contracting model. Presumably, companies would opt out of a more effective public regulatory environment only if the benefits exceeded the costs.¹⁰⁸ Even optional deregulation could have some adverse

offenders include treble damages in civil prosecutions and fines of up to \$5 million and imprisonment for up to 20 years in criminal prosecutions. See Securities Exchange Act of 1934 §§ 21A(a)(2)(civil penalties) and 32(a)(criminal penalties).

¹⁰⁶ Conceivably a market for monitoring insider trading could develop in the absence of a legal prohibition, and privatized monitoring could be more efficient than governmental monitoring. Even if that were the case, however, private monitors would lack important monitoring tools, such a subpoena power, that are available to the government and certainly would lack the ability to impose criminal penalties on violators.

¹⁰⁷ See Holmstrom & Milgrom, *supra* note x, at 38 (assuming that is easier for the principal to exclude an activity than to restrict and monitor that activity)

¹⁰⁸ There is an extensive literature grounded in the optimal contracting model that argues for the replacement of mandatory corporate law with a system permitting firms to opt into or out of corporate law

impact, however, if reduced participation in the federal system undermined its effectiveness.

Except for insider trading, the avenues of value appropriation discussed in this article are permitted by law, and there are no opportunities to opt into legal prohibitions. Companies may prohibit or regulate these practices as they see fit. Formerly self-dealing was prohibited by mandatory corporate law.¹⁰⁹ But the law has evolved in favor of a more lenient fairness test. This analysis suggests that such a move may have been costly for shareholders, but of course the benefits may have outweighed the costs.¹¹⁰ Generally, however, self-dealing, taking corporate opportunities, and insider trading pose the most significant threats of increasing agency costs and managerial appropriation under the optimal contracting model because the directors cannot just say no.¹¹¹

IV. EFFECT OF ADDITIONAL AVENUES OF APPROPRIATION UNDER THE MANAGERIAL POWER MODEL

The previous part analyzed stylized contractual arrangements between a manager and a homogeneous group of shareholders. There are at least two problems with this model. First, shareholders and their goals are not homogeneous.¹¹² Second, shareholders do not negotiate directly with management; they act through the company's board of directors. As a result, the agency problems in the modern publicly traded corporation are actually much more daunting than those described in the optimal contracting model. The managerial power model of corporate governance attempts to reflect the reality of this situation – the limited power of shareholders, the incentives and behavioral forces faced by the board, and the power of management resulting from informational and positional advantages – and describe the effect on managerial appropriation.¹¹³ This part will apply the managerial power model to the specific questions whether and how additional avenues of value appropriation contribute to the manager's overall share of firm value.

A. Description of the Managerial Power Model

rules. For an overview of that literature and criticism thereof see the November 1989 symposium issue of the *Columbia Law Review*.

¹⁰⁹ See Clark, *supra* note x, at 160.

¹¹⁰ It is conceivable that the cost associated with the over-inclusiveness of a blanket prohibition against managerial self-dealing exceeded the agency costs associated with deregulation. The foregoing analysis suggests, however, that an opt in or opt out approach might have been superior.

¹¹¹ One may be tempted to think that executive compensation falls into this category as well. After all, managers must be paid. Does this mean that compensation arrangements are fertile sources of incremental managerial appropriation? No, not under the optimal contracting model. Managers can be paid in cash. Under this model, firms would elect to pay managers by other means only if doing so increased shareholder value. As in the case of deal bonuses, stock options, restricted stock, and other compensation arrangements cannot increase managerial appropriation to the shareholders' detriment under this model.

¹¹² I am not very concerned about the shareholder heterogeneity issue. In large, public companies, shareholders generally want to maximize share value and can select their portfolios to achieve the desired level of risk. See Holmstrom & Tirole, *supra* note x, at 87.

¹¹³ See generally Bebchuk et al, *supra* note x.

The managerial power model suggests that we should not expect public companies to reach optimal contracts with managers.¹¹⁴ The reasoning, in brief, is as follows: Boards are imperfect agents of shareholders. Although well paid, directors generally have relatively weak financial incentives to maximize firm value.¹¹⁵ The incentive to retain a board position generally outweighs the incentive to maximize shareholder value.¹¹⁶ As a result outside directors are encouraged to acquiesce to executives who have the power to hire and fire them.¹¹⁷ In addition, a number of psychological forces at play in the boardroom tend to foster an attitude of deference to the CEO.¹¹⁸

What does this model have to say about executive compensation and managerial value appropriation generally? First, as with the optimal contracting model, this model recognizes that market forces place an upper bound on value appropriation.¹¹⁹ Despite imperfect contracting, however, this model does not suggest that management necessarily will be able to appropriate firm value up to the market forces bound. The model posits that directors are subject to an outrage constraint. Although directors have a strong incentive to please management, they also have a public reputation to maintain. Most outside directors of large public companies are CEOs in their own right or other noted professionals. As such, they will tend to resist compensation policies or practices that bring disrepute. Of course, all of this is relative. Compensation practices of major companies are judged by the practices of their peers.¹²⁰

As a result, the managerial power model suggests the critical importance of transparency and salience of compensation or other value appropriation. If all channels of appropriation were perfectly transparent and equally salient, channels would be irrelevant under this model. Outrage would be a function only of total appropriation. But appropriation is not transparent, and managers may be able to increase their share by

¹¹⁴ However, the managerial power model should be seen as complementing the optimal contracting model, not as a mutually exclusive view of corporate governance. Proponents of a managerial power view would not deny that agency costs and incentives play some role in setting managerial compensation. Perhaps the managerial power view should be termed the (sub)optimal contracting view. See Bebchuk et al, *supra* note x, at 755.

¹¹⁵ See *id.* at 769-70

¹¹⁶ See *id.* at 770-71.

¹¹⁷ Corporate executives obviously cannot hire and fire outside directors in the traditional sense of the terms, but they have considerable power over the director nomination process, which in most cases is tantamount to a director appointment process. See *id.* at 766-67.

¹¹⁸ Traditionally outside directors have been expected to support their CEO unless and until circumstances arise in which it becomes necessary to replace him. See Brian E. G. Main, et al, *The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives*, 11 *Indus. & Corp. Change* 293, 304 (1995). The social dynamics within the board room are marked by norms of reciprocity and deference to authority. Outside directors, for example, tend to reciprocate for their appointments by deferring to and supporting the CEO. See *id.* at 304.

¹¹⁹ See Bebchuk et al, *supra* note x, at 787.

¹²⁰ See *id.* at 789-91. In addition, corporate directors are increasingly subject to standards of corporate governance imposed by Congress under the Sarbanes-Oxley Act of 2002 and by the stock exchanges, including standards of independence and diligence. Directors serving on audit and compensation committees are affected particularly. These directives ultimately may complement and even reinforce the outrage constraint. [Cite NYSE & NASDAQ websites and SOX.]

camouflaging compensation and avoiding outrage.¹²¹ They will tend to follow the herd and avoid significant deviations from industry pay practices, but they will take advantage of low salience means of extracting additional value.

B. Avenues of Value Appropriation Under the Managerial Power Model

The number and types of channels of value appropriation available clearly affect the manager's overall share of firm value under the managerial power model. Cash salary, the compensation paradigm, is the most transparent and salient form of compensation available. Thus, dividing compensation between salary, bonuses, perks, golden parachutes, and the like tends to reduce salience and outrage and permit greater overall appropriation. This can be thought of as a "divide and prosper" strategy. In addition, certain channels of value appropriation provide greater camouflage than others. In some cases it may be difficult to discern the value transfer or the extent of the transfer. In others, the transfer may be transparent, but a plausible justification exists for adding this transfer to the manager's existing share. The more opaque and/or plausibly justifiable the transfer, the less the outrage, and the greater the value appropriation via that channel.

1. Opaque Value Transfer

In the previous Part, I argued that monitoring difficulty – challenges in identifying or valuing transfers to managers – is a key factor in determining the extent to which an added avenue of appropriation will increase a manager's share of firm value under the optimal contracting model. Opacity is a similar concept within the managerial power framework, and generally lack of transparency has similar effects under the two models, but there is an important difference that follows from the differing mechanisms. Under the optimal contracting model, the opportunity for incremental value transfer arises because the principal has difficulty spotting or valuing the transfer, but we assume that it is in the principal's interest to find and evaluate these transfers in order to minimize agency costs. Under the managerial power model, the issue is opacity of transfers to the financial analysts and institutional investors who provide the outrage that limits appropriation.¹²² Under this model, both managers and directors have an interest in camouflaging compensation. As a result, the factors that make it difficult to monitor transfers also tend to make them opaque to corporate critics, but opacity also can arise from deliberate obfuscation.

Insider trading, self-dealing, and directing corporate contributions to pet charities can each provide for opaque value transfer to managers for the reasons discussed in Part III – the transfers can be difficult to spot (insider trading and perhaps self-dealing) and even if spotted difficult to value, particularly if non-cash benefits are involved (self-dealing and directed contributions). But even when the manager is clearly the sole beneficiary of a cash-only arrangement, the value transfer may remain opaque. Supplemental executive retirement programs, which are discussed above, provide an

¹²¹ See Bebchuk et al, *supra* note x, at 789.

¹²² See *id.* at 787.

instructive example. SERPs are extraordinarily complex, and the expected payoffs are far from transparent. A leading executive compensation expert has written that “[f]rom proxy disclosures, even sophisticated compensation consultants have been unable to figure out exactly how much the [company executives] will actually receive under a company’s SERP.”¹²³ If value transfer by way of SERPs is opaque to compensation experts, it seems likely that these will serve as a low outrage means of increasing the manager’s share.¹²⁴

Note that SERPs do not necessarily present a monitoring problem under the optimal contracting framework. The fact that SERPs are difficult to value based on the information contained in required proxy *disclosures* does not mean that the principal would have difficulty determining the expected value of these commitments, although surely this is somewhat more difficult and costly than evaluating salary payments.

I also argued in Part II that external market forces limitations on managerial appropriation are undermined by the introduction of opaque channels of appropriation. The effect of opacity under these two models is similar, but not necessarily identical. One might imagine, for example, that it is harder to hide appropriation from corporate raiders, who have a strong profit incentive for ferreting out such information, than from the financial press and other less interested observers, in which case opacity could have a larger impact on total managerial appropriation under the managerial power model than the external market forces limitation model.

2. Plausible Justifications for Additional Transfers

Certain value transfers to managers are perfectly transparent but nonetheless may produce less outrage than equivalent salary payments because a plausible justification exists for the specific incremental transfer. Deal bonuses are a prime example. As noted, many firms provide executives with one-time bonuses for completing the acquisition of a target company or for similar specific transactions.¹²⁵ The skeptic may ask why a CEO receives salary and options if not to pursue value-added acquisitions, but a plausible story can be told that a specific deal bonus opportunity is justified in order to focus an executive’s attention on an acquisition. This is similar to the logic used to justify incentive compensation generally, but applied to a specific project.

¹²³ See The Corporate Counsel, *supra* note x at 6. See also DenUyl & Leckrone, *supra* note x (providing an example in which the lump sum value of a SERP for a 57 year old CEO retiring after 20 years of service and earning \$1 million base salary and \$1 million annual incentives immediately before retirement could range from \$9.5 million to \$68.3 million depending on changes in assumptions concerning adjustments to reflect commencement of benefits prior to normal retirement age, payment over the joint lives of the CEO and spouse, credits for years of service prior to joining the company, inclusion of long-term incentive compensation in pensionable earnings, and discount rates.

¹²⁴ Transparency is further undermined by the fact that SERP payouts occur after an executive’s retirement and thus are not reported in the annually published tables that are the most visible marker of executive compensation. See Bebchuk & Fried, *supra* note x, at 99.

¹²⁵ See *supra* note x and accompanying text.

In fact, equity compensation can be viewed in the same light. Although equity programs also can be complex and certainly are much less transparent than cash compensation, the primary outrage deflector, I think, is the argument that stock and options provide incentives that cause managers to grow the pie. And of course, there is more than a grain of truth to this. Equity compensation does provide incentives that are valuable to shareholders. The appropriate questions are: How much stock? How many options? At what price? In what fashion? However, once outrage is deflected through the plausible justification of incentive alignment, it is easier for executives to extract value through these programs.

While plausible justification reduces outrage under the managerial power model, it should have no effect under the optimal contracting model. As discussed in Part III, the optimal contracting model assumes that the principal cannot be fooled into providing the manager with additional compensation at the expense of shareholders.

3. Both Opaque and Plausibly Justified

Of course many avenues of value appropriation exhibit both properties – the transfer is opaque and plausibly justified as a valuable addition to the compensation smorgasbord. SERPs and stock options certainly have elements of both. In addition to being complex, SERPs can be plausibly justified on fairness or efficiency grounds as follows: Despite the tax code limitations, executives require pensions proportional to their salary just like rank and file employees if they are to maintain their standard of living in retirement.¹²⁶ In addition to being plausibly justifiable on incentive grounds, option values obviously are less transparent than cash. Despite the widespread adoption of the Black-Scholes option pricing model to traded options, experts continue to debate the accuracy of that model in the context of compensatory options.¹²⁷

Several other common avenues of value appropriation fall into this category as well. Management perks generally can be plausibly justified on efficiency grounds. Executive time is extremely valuable, and company cars and planes free up time for busy executives. Country club memberships and company apartments provide quiet venues for entertaining company clients. But executives receive personal enjoyment and psychic benefits from these perks and the status they signal. Valuing these personal benefits is difficult, and the challenge for outside analysts is compounded when companies obscure the cost of these perks. For example, companies are required by the Securities and Exchange Commission (“SEC”) to disclose the value of perks provided to certain senior

¹²⁶ SERPS, however, may be a tax inefficient means of providing executive retirement benefits if the choice is between an executive investing after-tax dollars at favorable capital gains rates and the company making the same investments but paying the higher corporate tax rate. See Bebchuk & Fried, *supra* note x, at 97-98. On the other hand, SERPS may be tax efficient if the employing company has large losses and is effectively tax exempt. Cf. David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. Rev. 695, 737-38 (making the same argument with respect to equity compensation).

¹²⁷ See, e.g., Lingling Wei, *What's the Cost of a Stock Option?*, *Wall St. J.*, March 4, 2004, at C3; Zvi Bodie et al, *For the Last Time: Stock Options are an Expense*, *Harv. Bus. Rev.*, Mar. 2003, at 63, 65-68.

executives if such value exceeds \$50,000.¹²⁸ Suppose a company spends \$100,000 for a limo for the CEO and hires a driver. One would think that this perk must be disclosed, but by making the car and driver “available” to other executives, the company can treat only the CEO’s personal use as a perk and thus avoid disclosure.¹²⁹

Golden parachute contracts provide another example. A golden parachute provides an executive of an acquired company a comfortable financial landing if she is displaced as a result of the acquisition.¹³⁰ The incentive rational is straightforward. Management positions are valuable to incumbents. All else being equal managers will fight to retain position even if that means foregoing an opportunity for the company to be acquired at a premium to share price. Because managers have a great deal of discretion to combat takeovers under corporate law, golden parachutes enhance shareholder value by encouraging managers to step aside when a potential buyer comes offering a premium.¹³¹ In addition, however, golden parachute contracts are difficult to value. These contracts typically provide for severance payments, acceleration of option and retirement program vesting, and various other goodies.¹³² Recent contracts also require the company to “gross up” the executive for any taxes that are incurred by the executive as a result of the payments under section 280G, the anti-golden parachute provision, of the tax code.¹³³ Thus, even if they can be calculated, the face value of parachute payments typically understate the expected value transfer to the covered executive in the event of a takeover and displacement.

C. Other Factors Affecting Managerial Appropriation under the Managerial Power Model

In the previous part of this article, I argued that under the optimal contracting model the impact of an avenue of value appropriation on the manager’s share would depend on the difficulty of direct monitoring, the intensity of private benefits, and the ability of the directors to just say no. The first two factors also play a role under the managerial power model. I have already noted the similarity between the monitoring difficulty problem and the opacity issue under the managerial power framework. Intensity of private benefits probably plays less of a role under the managerial power model. On first inspection, a manager might not seem to care about the “efficiency” of an avenue of value appropriation under this model. Whether the cost to the firm is dollar for dollar of value transferred or ten dollars per dollar transferred, the manager should take the opportunity. Efficiency may affect saliency and outrage, however. If a firm enters into a disastrous string of acquisitions in order to generate deal bonuses for its CEO, the underlying transactions as well as the bonuses may generate outrage. In addition, inefficient transfers may introduce market discipline – a takeover or bankruptcy,

¹²⁸ See SEC Reg. S-K, Item 402(b)(2)(iii)(C)(1), 17 C.F.R. § 229.404 (2005).

¹²⁹ See *The Corporate Counsel*, supra note x at 7.

¹³⁰ See Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 *J. Econ. Perspectives* 21, 39 (1988).

¹³¹ See *id.* at 39-41.

¹³² See Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?* 21 *Va. Tax Rev.* 125 (2001).

¹³³ See *id.* at 136, 139.

for instance. Thus, managers should be somewhat concerned with intensity of private benefits under the managerial power model, but perhaps to a lesser extent than the optimal contracting model would predict. Whether a potential channel appropriation is under the unilateral control of the board, or the managers, or is somewhere in between, would not appear to have any bearing on incremental appropriation under this model.

V. EMPIRICAL EVIDENCE

As we have seen, added avenues of managerial appropriation directionally lead to greater total managerial appropriation, whether appropriation is capped by external market forces, an optimal principal/agent contract, or saliency and outrage in accordance with the managerial power theory. However, certain potential channels of appropriation that are easily monitored and that are under the unilateral control of the directors should result in little incremental appropriation under the optimal contracting model, but could result in significant incremental appropriation under the managerial power or external market forces models. This Part examines empirical evidence that allows us to test the theory developed above and the explanatory power of the various models.

In brief, the evidence suggests that additional channels of appropriation lead to increased total managerial compensation and that incremental managerial compensation cannot be fully explained by enhanced efficiency. In other words, additional channels of appropriation lead to increased transfers of wealth from shareholders to managers. Moreover, the evidence largely is inconsistent with the optimal contracting model. Channels that should lead to little or no incremental appropriation under this model, because they are easily monitored and under the unilateral control of directors, significantly increase total appropriation. This evidence better supports a managerial power view (and possibly an external market forces view).

A. The Empirical Evidence Indicates that Unconventional Compensation Increases Total Compensation

Recent evidence indicates that stock options, CEO deal bonuses, and certain perks do not substitute for other forms of compensation, but represent incremental managerial compensation. One study does suggest that insider trading profits may substitute for other compensation, but the weight of this evidence runs counter to the fixed appropriation view.

1. Stock Options

Stock option compensation for CEOs and other senior corporate executives increased dramatically in the 1990s. Between 1992 and 1998, the median compensation of S&P 500 company CEOs increased by 160%.¹³⁴ This reflected a 335% increase in option compensation and about a 55% increase in salary and bonus.¹³⁵ Put another way,

¹³⁴ See Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment of Shareholder Expropriation?*, 35 Wake Forest L. Rev. 123, 145 tbl 1 (2000).

¹³⁵ See *id.*

options increased from 19% of the median CEO's pay package in 1992 to 32% in 1998,¹³⁶ at which point options had become the single largest component of CEO compensation.¹³⁷

It is highly unlikely that the boom in options substituted for other forms of CEO pay or that, in the absence of options, median CEO compensation would have reached the same level in 1998. First, median salary and bonus pay continued to rise steadily throughout this period despite the explosion in options and the 1993 enactment of section 162(m) of the Internal Revenue Code, which limits the deductibility of non-performance based executive compensation.¹³⁸ Second, the rate of increase in total CEO compensation across the period is much more dramatic than anything experienced before the invention and widespread adoption of executive stock options.¹³⁹

This intuition is confirmed by two recent studies that fail to find substitution of option grants for non-option compensation.¹⁴⁰ After adjusting for company performance and other factors, these studies find that companies that grant more options to senior managers tend to provide more non-option compensation as well.¹⁴¹ The authors of one of the studies worry about a potential omitted variable problem – some factor not observed that would cause a company to want to increase a manager's overall compensation through options and other means.¹⁴² Nonetheless, these results suggest little or no substitution of options for other forms of compensation.

¹³⁶ See *id.*

¹³⁷ See Kevin J. Murphy, Executive Compensation, in *Handbook of Labor Economics* 2485, 2515 (Orley Ashenfelter & David Card eds., 1999).

¹³⁸ See Perry & Zenner, *supra* note x at 145 tbl 1; see also Tod Perry & Marc Zenner, Pay for Performance? Government Regulation and the Structure of Compensation Contracts (working paper, 1998) at 9.

¹³⁹ Since its inception in 1934, the SEC has required publicly held companies to disclose annually the compensation of top executives. A recent study of the compensation of the three most highly paid executives in a sample of 77 large firms from 1936 to 1969 (hand collected data) and from 1992 to 2002 (Compustat Execucomp data) reveals that average total real compensation was essentially flat at around one million year-2000 dollars across the earlier period and then rose at an average annual rate of almost 11% between 1992 and 2002. See Carola Frydman & Raven E. Saks, *Historical Trends in Executive Compensation: 1936-2002* 38 Fig. 7 (working paper, Nov. 2004). The authors are currently working to collect data for the 1970s and 1980s, but any increases over these periods will be dwarfed by the 1990s pay explosion. Unfortunately, executive compensation data is not generally available prior to passage of the Securities Exchange Act of 1934. Thus, one cannot prove that 1990s-style CEO pay explosions did not occur during the 1920s or during earlier market booms, but I am skeptical that executive pay increases during these periods approached the magnitude of the option-driven pay increases of the 1990s.

¹⁴⁰ See Marianne Bertrand & Sendhil Mullainathan, *Do CEOs Set Their Own Pay? The Ones Without Principals Do* (NBER Working Paper 7604, 2000); Matthias Benz et al, *Are Stock Options the Managers' Blessing? Stock Option Compensation and Institutional Controls* (working paper, Apr. 2001); but see Murphy, *supra* note x, at 724 (relating several anecdotal episodes of executives accepting reduced salary for stock and options).

¹⁴¹ See Bertrand & Mullainathan, *supra* note x, at 33 (finding a positive relationship between the value of options granted and non-option compensation for CEOs of 792 large companies between 1984 and 1991); Benz et al, *supra* note x, at 5 (finding a small but statistically significant positive relationship between the value of stock options grants and base salary of senior managers of S&P 500 companies between 1992 and 1997).

¹⁴² See Bertrand & Mullainathan, *supra* note x, at 31.

2. Deal Bonuses

In a recent study, Grinstein and Hribar analyzed bonuses paid to CEOs for completing mergers or acquisitions.¹⁴³ M&A deal bonuses are fairly common. 39% of acquiring firms in their sample of 327 large U.S. M&A deals between 1993 and 1998 compensated their CEO for completing the deal.¹⁴⁴ The authors found that these bonuses represent incremental compensation and do not substitute for other forms of pay.¹⁴⁵

3. Corporate Aircraft

David Yermack has recently investigated private use of corporate aircraft.¹⁴⁶ Yermack found a very small and only marginally significant negative relationship between personal use of planes and a CEO's other compensation.¹⁴⁷ His regressions predict that an extra \$1000 in perk consumption reduces other compensation by only ten cents.¹⁴⁸ In other words, Yermack's data suggests essentially no substitution of perks for other compensation.

4. Insider Trading

Running counter to the foregoing, however, is evidence concerning insider trading that recently has been compiled by Darren Roulstone. Although trading by insiders on the basis of material, non-disclosed information is prohibited by law, it is well established that corporate executives trading in securities of their companies generally outperform the market by several percentage points.¹⁴⁹ Responding to pressure from institutional investors, regulators, and potential litigation, many companies have acted to curtail informed trading by limiting insiders to buying and selling within a window of a month or less following earnings announcements.¹⁵⁰ A recent analysis by Roulstone suggests that firms that restrict trading in this fashion pay their executives 4% to 13% more than firms that fail to restrict trading, after controlling for other factors.¹⁵¹ This trade off between insider trading profits and compensation is in line with Easterbrook and Fischel's fixed slack argument.

¹⁴³ See Grinstein & Hribar, *supra* note x.

¹⁴⁴ See *id.* at 3.

¹⁴⁵ See *id.* at 12-13.

¹⁴⁶ See David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns 7-9* (working paper, Apr. 2004).

¹⁴⁷ See *id.* at 15 and tbl 3.

¹⁴⁸ See *id.*

¹⁴⁹ See, e.g., Seyhun, *supra* note x, at 159 (finding a 7% average abnormal return during the year following insider open market purchases and sales in the five years following the passage of the Insider Trading Sanctions Act of 1984); but see Dan Givoly & Dan Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence*, 58 *J. Business* 69 (1985) (arguing that insider excess returns are due more to the response of other investors to transactions by insiders than to yet to be disclosed news).

¹⁵⁰ See Roulstone, *supra* note x, at 532 (citing studies).

¹⁵¹ See *id.* at 526.

B. The Empirical Evidence Suggests At Least Some Incremental Appropriation

The fact that stock options, deal bonuses, and perks represent incremental compensation does not necessarily imply incremental appropriation as I have defined it. It is conceivable that options, bonuses, and perks result in incentives that lead to increased shareholder value, and that the division of the gains between managers and shareholders is fair and efficient. The evidence, however, does not support this benign explanation. First, deal bonuses do not appear to result in increased shareholder value. Thus, incremental compensation resulting from deal bonuses clearly represents incremental appropriation. Second, stock options undoubtedly create share value-enhancing incentives. The absence of *any* substitution of option compensation for conventional compensation, however, indicates that at least some share value reducing appropriation is occurring unless one believes that options are exceptionally risky and that executives are exceptionally risk averse. It is unclear whether the effect of perk compensation is more similar to deal bonuses or options, but the conclusion is the same: Evidence that perks represent almost pure add-on compensation suggests at least some incremental appropriation.

1. Deal Bonuses

Let us begin with deal bonuses. If an acquisition increased the value of their shares, shareholders might be happy to incrementally compensate CEOs for completing the deal. The evidence suggests that M&A deals are not value enhancing for acquiring firms on average, but some acquisitions are more successful than others, and thus there still might be an efficiency explanation for deal bonuses.¹⁵² However, Grinstein and Hribar found that deal performance did not explain the cross-sectional variation in deal bonuses.¹⁵³ Deal bonuses do not appear to be driven by efficiency enhancement. If deal bonuses do not increase the pie, and the evidence suggest that this is the case, the fact that deal bonuses represent incremental managerial compensation indicates that they result in managers taking larger slices of the pie, i.e., in incremental managerial appropriation.

2. Stock Options

Unlike deal bonuses, stock options generally are thought to provide incentives that result in increased firm value.¹⁵⁴ Thus, it is difficult to say whether increased total managerial compensation resulting from the introduction of options represents appropriation of shareholder wealth or a fair and efficient division of incremental gains

¹⁵² See Sara B. Moeller et al, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, [] J. Fin. [] (200X) (finding that during the 1990s shareholders of U.S. acquiring firms lost an aggregate of \$216 billion on the transactions, although the loss was skewed late in the period and concentrated among a relatively small number of spectacularly disastrous acquisitions); Antonios Antoniou et al, *Measuring the Wealth Effect of Mergers and Acquisitions: Time for Change!* (working paper 2004) (criticizing event study methodology, but reporting that such studies have found that mergers and acquisitions are much more beneficial to target firm than acquiring firm shareholders).

¹⁵³ See Grinstein & Hribar, *supra* note x, at 3.

¹⁵⁴ See, e.g., Murphy, *supra* note x, at 2510 (“Stock options provide a direct link between managerial rewards and share-price appreciation....”).

with shareholders. Nonetheless, evidence that option compensation represents purely incremental compensation suggests that at least some incremental appropriation results.

One would expect total compensation to increase with increased reliance on options, because an executive pay package that relies strongly on options in lieu of salary must provide the executive with greater expected value to make up for the higher risk associated with options.¹⁵⁵ However, if option compensation was driven solely by efficiency considerations, one would expect to observe *some* substitution of options for non-option compensation, because stock options provide a degree of low risk compensation.¹⁵⁶ Thus, empirical evidence suggesting zero substitution of options for other forms of compensation indicates that options result in at least some incremental appropriation.

To see this, imagine that an executive is initially paid cash salary of 100. Now imagine that in order to provide share value-enhancing incentives, the directors offer the executive an "option" with three possible payoffs: 20, if the outcome is "low;" 50, if the outcome is "average;" or 100, if the outcome is "high." The executive is certain that the outcome will be high, average, or low. In this case, even an extremely risk averse executive should be willing to give up 20 of cash salary in exchange for the option, and shareholders regarding directors should insist that the manager accept a salary reduction at least equal to 20. If the option is granted on top of the pre-existing salary of 100, we can be sure that incremental appropriation is at least 20. Incremental appropriation may be much larger than 20, but we know that it is at least 20.

Of course, executive stock options do not guarantee a payout, and some options expire unexercised. However, conventional options come about as close to guaranteeing a payout as possible. Options are almost always granted at-the-money with a fixed exercise price and have a ten year life.¹⁵⁷ Thus, even if the issuer's performance lags, executives can cash in on upswings in the market generally. Moreover, if an issuer's stock price falls precipitously, its options often are repriced or replaced to restore the incentive.¹⁵⁸ Thus, even exceptionally risk averse managers should be expected to sacrifice some salary or other compensation for the receipt of stock options, and the lack of substitution reported in the empirical literature is evidence of incremental appropriation resulting from options.¹⁵⁹

¹⁵⁵ See, e.g., Kevin J. Murphy, Politics, Economics, and Executive Compensation, 63 U. Cinn. L. Rev. 713, 723 (1995).

¹⁵⁶ It is clear that conventional executive stock options that pay off on the basis of overall stock market improvements, as well as company-specific improvements, exhibit this feature, particularly given the conventional practice of reducing option exercise prices following a market downturn. See Bebchuk et al, supra note x, at 795-98, 821-24.

¹⁵⁷ See Murphy, supra note x, at 2508.

¹⁵⁸ See Bebchuk et al, supra note x, at 821-24.

¹⁵⁹ The incompatibility of zero substitution and an efficiency explanation for equity compensation is probably easier to see with restricted stock than options. Many companies grant stock to executives that is forfeitable if the employment relationship is severed before a vesting date. See Murphy, supra note x, at 2516. Such "restricted stock" grants increase pay for performance sensitivity and provide incentives that are similar to those provided by stock options. The value of a restricted stock grant tracks the company's share price, but unless the company enters bankruptcy, the restricted stock always has positive value. Thus,

3. Perks

It is unclear whether the perk story is more similar to that of deal bonuses or options, but the conclusion is the same either way: Perks result in at least some incremental appropriation. As noted above, David Yermack has shown that corporate jet consumption represents almost purely incremental compensation.¹⁶⁰ In my view, it is very unlikely that the acquisition of corporate jets increases shareholder value. If this is true, jet use would be analogous to the deal bonus situation described above, and the lack of substitution of jet consumption by executives for other compensation would represent incremental appropriation from a fixed pie.

There is some evidence, however, that perks may be efficiency enhancing. In a study of 300 publicly traded U.S. firms over the years 1986 through 1999, Raghuram Rajan and Julie Wulf found some support for the view that perks are used to enhance productivity.¹⁶¹ For example, they found that time-saving perks (such as corporate cars and planes) were more likely to be used in settings in which the time saved by the perk is greater (e.g., when company headquarters is more distant from a major airport).¹⁶² Assuming, however, that corporate jet use provides risk free consumption value to executives, we would expect them to forego at least some conventional compensation in exchange for the jets, even if the perk increases the pie. Yermack's data suggesting essentially no substitution indicates that jet use increases appropriation even if Rajan and Wulf are correct.

C. The Empirical Evidence Generally is Inconsistent with an Optimal Contracting Model (and Consistent with a Managerial Power Model)

Neither deal bonuses, stock options, nor perks should result in significant incremental appropriation under an optimal contracting model. Evidence that they do contribute to an increased manager's share is more consistent with a managerial power or even an external market forces view of corporate governance.

1. Deal Bonuses

The deal bonus evidence is most clearly in conflict with an optimal contracting model. If mergers and acquisitions increased the value of acquiring firms, we would expect CEOs to be incrementally compensated for completing these deals under an optimal contracting model.¹⁶³ Recall, however, that the evidence suggests that deal

one would expect restricted stock grants (or stock option grants for analogous reasons) to replace other forms of managerial compensation to some extent, and not act as pure "add-ons" if equity compensation grants were fully explainable as efficiency enhancers.

¹⁶⁰ See supra note x and accompanying text.

¹⁶¹ See Raghuram G. Rahan & Julie Wulf, *Are Perks Purely Managerial Excess?* 31 (NBER Working Paper 10494, May 2004).

¹⁶² See *id.*

¹⁶³ Even if this were the case, however, deal bonuses would be somewhat problematic under an optimal contracting theory. Holmstrom and Milgrom show that high-powered incentives directed at

bonuses are not efficiency enhancing. They do not lead to increased share value, but they do result in incremental compensation for CEOs, which means that deal bonuses result in an incremental transfer of a slice of a fixed pie from shareholders to managers.¹⁶⁴

The optimal contracting theory suggests that managerial appropriation through deal bonuses should be modest or nonexistent. Deal bonuses are transparent and relatively easy to monitor and can easily be avoided. If, as the evidence suggests, deal bonuses simply represent an incremental transfer of shareholder wealth to managers, directors acting in accordance with an optimal contracting model simply would not sanction them.

The deal bonus evidence is much more consistent with a managerial power model. Deal bonuses are plausibly justified as specific incentive compensation, i.e., if the CEO completes the deal, she gets a bonus. Shareholders are told that the deal will be value enhancing, (although market reaction and retrospective analysis tells us that few are). Thus, deal bonuses are a means of increasing CEO compensation without increasing outrage, and the fact that these bonuses produce incremental compensation bolsters the persuasiveness of the managerial power model.¹⁶⁵ This conclusion is bolstered by another Grinstein and Hribar finding that cross-sectional variation in M&A deal bonuses correlates with measures of CEO power.¹⁶⁶

2. Stock Options

Because stock options arguably are pie-expanding, it is more difficult to isolate incremental managerial appropriation and test the applicability of the corporate governance models. I argued above, however, that evidence that option compensation does not substitute for other compensation but is granted as a pure add-on suggests some incremental appropriation. This incremental appropriation is inconsistent with an optimal contracting model.

The fact that options *exist* is not inconsistent with an optimal contracting model unless options can be shown to reduce shareholder value, and this has not been shown. Options may result in both increased shareholder value and incremental managerial appropriation, however, if they increase the pie. In this case, shareholders would not be expected to just say no to stock option compensation.

Under the optimal contracting model, options, and incentive compensation generally, are seen as part of the solution to the managerial agency cost problem.¹⁶⁷

managerial activity *A* can be counterproductive if managerial activities *B*, *C*, and *D* are difficult to monitor. See Holmstrom & Milgrom, *supra* note x. Thus, in order for deal bonuses to be value enhancing under an optimal contracting model, we would have to assume that a manager's share-based incentives were sufficient to prevent excessive focus on deals and the neglect of other important tasks.

¹⁶⁴ See *supra* note x and accompanying text.

¹⁶⁵ See also Bebchuk & Fried, *supra* note x, at 127-30 (discussing managerial power explanation for deal bonuses).

¹⁶⁶ See Grinstein & Hribar, *supra* note x, at 4, 22.

¹⁶⁷ See, e.g., Holmstrom & Tirole, *supra* note x, at 93; Murphy, *supra* note x, at 2515.

Issuance of options should reduce managers' tendency to shirk and extract private benefits, and shareholders benefit by using incentive compensation to increase corporate wealth, even if part of the incremental value is transferred to the managers. Under this model, the arrangement reached is always optimal, by definition, but it is optimal within the specific contracting environment. As a result, additional avenues of appropriation that change the contracting environment can result in additional managerial value appropriation under the optimal contracting model. Thus, the fact that option compensation has supplemented (rather than substituted for) non-equity compensation does not run counter to the optimal contracting theory.

Two factors, however, undermine the optimal contracting explanation of stock options grants. First, the lack of *any* substitution of options for non-option compensation is inconsistent with this model. As noted, conventional options provide a degree of low risk compensation. Under an optimal contracting model, one would expect substitution of options for non-option compensation at least to that extent.¹⁶⁸ One would expect managerial appropriation of this overlap to be small for the reasons discussed in Part III: Direct monitoring of option compensation should not be difficult. Option payoffs are uncertain, but the expected value of options can be modeled with reasonable certainty. Moreover, option grants are within the unilateral control of directors.

Second, many option features vary from those expected under an optimal contracting model, such as a lack of indexation of option exercise prices to markets and the practice of repricing options following downturns.¹⁶⁹ Other features, such as reload rights, unnecessarily complicate option assessment and valuation.¹⁷⁰ Through increasing the difficulty and cost of monitoring, these features may increase managerial appropriation via options, but under an optimal contracting model, directors should strip options of these extraneous, complicating features, unless these features increase the pie, which is doubtful. Thus, the apparently unwarranted degree of complexity observed in practice further undermines the optimal contracting explanation for options.

By contrast, observed option practice is consistent with a managerial power view of corporate governance. Options can be plausibly justified as incentive compensation, which reduces outrage and permits executives to increase their total compensation.¹⁷¹ As discussed, the justification for options is much more than just plausible, it is compelling. Thus, one would expect the option boom to have led to significantly enhanced managerial appropriation under this model. The managerial power explanation for stock option practice is bolstered by findings in the two empirical studies described above that the cost to managers of increased option grants is greater in well-governed companies¹⁷² and by

¹⁶⁸ See supra note x and accompanying text.

¹⁶⁹ See Bebchuk et al, supra note x, at 796-817, 821-24.

¹⁷⁰ Options with a reload feature result in the issuance of new options to executives who exercise options by surrendering stock. See id. at 831-34.

¹⁷¹ See Bebchuk et al, supra note x, at 812-15.

¹⁷² See Bertrand & Mullainathan, supra note x, at 38 (finding that factors suggesting better corporate governance, such as the presence of large shareholders or smaller boards, are associated with increased "charges" for options grants); Benz et al, supra note x, at 3 (finding that weak institutional controls are associated with greater stock option grants).

findings in another study that significant shareholder opposition to a proposed stock option plan results in reduced CEO pay in the following year.¹⁷³ This latter finding suggests that shareholder outrage is doing more work than optimal contracting.

3. Perks

Yermack's finding that personal aircraft use is essentially free also seems more consistent with the managerial power view than optimal contracting.¹⁷⁴ First, if we assume that corporate jets do not increase the pie, but instead transfer a slice from shareholders to managers, directors acting in accordance with an optimal contracting model should simply eliminate the perk. Second, even if one believes that perks of this sort are efficiency enhancing, the lack of any significant substitution of perk consumption for other compensation suggests incremental appropriation that is inconsistent with an optimal contracting model since internal monitoring of perk consumption should not be difficult. The pure add-on nature of the corporate jet perk is much more consistent with a managerial power view.

The perk case is not completely closed, however. Yermack did not find perk consumption to be associated with weak corporate governance, unlike the studies of deal bonuses and stock option grants discussed above.¹⁷⁵

4. Insider Trading

As noted, a recent study by Darren Roulstone has found evidence that insider trading substitutes to some extent for conventional compensation. This evidence is consistent with both a fixed slack view and optimal contracting. Interestingly, however, Roulstone also shows that firms that restrict insider trading with trading windows rely more heavily on incentive compensation than other firms.¹⁷⁶ This observation runs counter to the optimal contracting idea that firms will combat private benefit opportunities (such as those associated with insider trading) with greater incentive compensation. What are we to make of this finding? Perhaps, insider trading actually does provide managerial incentives along the lines suggested by Manne¹⁷⁷ and by Carlton and Fischel,¹⁷⁸ or does so at the fairly low level of informed trading that is permitted under current U.S. law, in which case firms might want to provide other incentives when they restrict insider trading. Alternatively, perhaps firms that restrict insider trading to

¹⁷³ See Kenneth J. Martin & Randall S. Thomas, When is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation 24, 26 (working paper, 2002) (examining stock option proposals made during the 1998 proxy season).

¹⁷⁴ See Yermack, *supra* note x, at 15 and tbl. 3.

¹⁷⁵ See *id.* at 4.

¹⁷⁶ See Roulstone, *supra* note x, at 540-41.

¹⁷⁷ See Henry Manne, *Insider Trading and the Stock Market* (1966) (arguing that insider trading can improve the efficiency of securities markets and of managerial compensation).

¹⁷⁸ See Carlton & Fischel, *supra* note x, at 866-72. See also Jie Hu & Thomas H. Noe, 25 *J. Bank. & Fin.* 681 (2001) (developing a model in which, under certain circumstances, permitting insider trading results in an improved correlation between employee wealth and firm value thus increasing shareholder wealth).

trading windows are better governed, tend to believe in and rely more heavily on incentive compensation, and thus tend to provide more total compensation.

VI. IMPLICATIONS

The evidence described in the previous Part suggests that channels of appropriation affect total managerial appropriation. Directors may believe that a multifaceted executive compensation scheme with lots of bells and whistles represents state of the art compensation design, but there is a largely unrecognized cost to this complexity – incremental managerial appropriation. This Part will briefly highlight the implications. The most obvious implication is that institutional investors and shareholder advocates must recognize the link between compensation complexity and managerial appropriation and require compelling justification for the inclusion of new forms of compensation. Because opacity is central to appropriation under the external market forces and managerial power models, a second implication for those who are skeptical of the optimal contracting story is that enhanced disclosure may help limit appropriation. A third implication is that legal rules matter: Deregulation of certain channels of appropriation that are difficult to monitor and outside the unilateral control of directors are problematic under any of the models considered in this article. Moreover, if one is skeptical of the optimal contracting model, even limited deregulation permitting firms to opt out of or into public enforcement schemes is troubling.

A. Channels Matter

If added channels of appropriation increase total managerial appropriation as the evidence suggests, institutional investors and shareholder advocates must recognize the link and demand that complex compensation schemes be justified. This analysis does not suggest that firms should restrict themselves to paying straight cash salaries; some incentive compensation clearly is worth the cost of additional managerial appropriation. But incentive compensation can be simple or complex. Option reloads and other complicating features should not be accepted at face value. Moreover, even if a new form of compensation creates firm-value enhancing incentives, one can reasonably ask whether the new compensation element should replace an existing form of compensation, rather than being added to an ever more complex array of devices. For example, is firm value enhanced by granting restricted stock in addition to stock options?

Of course, if the optimal contracting model adequately described managerial compensation in publicly traded U.S. companies, shareholders would not need to worry about a large class of potential avenues of appropriation that are not efficiency enhancing and are under the unilateral control of directors. Directors would not provide these benefits unless executives paid for them. Obviously one's level of concern about increasing compensation complexity and the increases in executive benefits, perks, and similar compensation elements depends on how seriously one takes the managerial power model. The evidence seems sufficient, however, to suggest that shareholders and their advocates should demand compelling justification for the inclusion of new compensation techniques and devices that may increase managerial appropriation.

B. Disclosure Matters

Because opacity is central to appropriation under the external market forces and managerial power models, detailed and timely mandatory disclosure of compensation elements could help limit appropriation. Managers have an interest in concealing compensation and will respond to new disclosure requirements by inventing new, opaque compensation elements. Thus, adequate disclosure will be a continuing race between regulators and corporate executives and their compensation consultants. This Part will consider just two areas in which enhanced disclosure is needed: termination payments and corporate contributions to a manager's pet charity.

Severance payments, whether or not accompanied by a change of control, represent a surging form of executive compensation. I have discussed the opacity of supplemental executive retirement programs and golden parachute arrangements and the need for enhanced disclosure of these items.¹⁷⁹ David Yermack recently has investigated non-contractual executive severance benefits, colloquially known as golden handshakes.¹⁸⁰ His findings are similar. In a study of golden handshakes provided to Fortune 500 CEOs who left their jobs between 1996 and 2002, Yermack found that many of the benefits provided were opaque to shareholders.¹⁸¹ Particularly opaque were enhancements to pension programs, which constituted over 20% of the total benefits paid in his sample.¹⁸² In addition, about 40% of the benefits took the form of consulting or non-competition arrangements or compensation as board chairman, all of which are somewhat opaque and plausibly justifiable to shareholders.¹⁸³ The SEC should require listed companies to value and clearly disclose all contractually promised severance benefits at the time such arrangements are negotiated and annually thereafter, as well as any non-contractual benefits provided.¹⁸⁴ The latter, which are particularly suspect, should be separately disclosed.

Corporate charitable contributions generally are not covered by the SEC's mandatory disclosure regime and generally are not disclosed to shareholders.¹⁸⁵ This

¹⁷⁹ See supra notes x and y and accompanying text.

¹⁸⁰ See David Yermack, *Golden Handshakes: Rewards for CEOs Who Leave* (working paper, Aug. 2004).

¹⁸¹ See *id.* at 3.

¹⁸² See *id.* at 35 tbl. IV.

¹⁸³ See *id.* Yermack found in addition that larger golden handshakes tended to be more opaque. See *id.* at 3. Other evidence was mixed. Yermack found no evidence that golden handshakes served as ex post settling up for past over- or under-compensation, but he did find that payments were associated with foregone future compensation and evidence that payments in the case of involuntary termination serves as damage control. These latter findings are consistent with optimal contracting theory generally. See *id.* at 4.

¹⁸⁴ In fact, the SEC should mandate such disclosure of all executive compensation elements. See Bebchuk & Fried, *supra* note x, at 193.

¹⁸⁵ See Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 *UCLA L. Rev.* 581 (1994) (noting that "the federal securities regulations do not require disclosure of whether a corporation has made any charitable contributions, what the value of such contributions may have been, or which organizations may have received such contributions"); Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 *U. Chi. L. Rev.* 1191, 1201 (2002) (noting

lack of disclosure enables executive to direct contributions to pet charities and receive psychic and perhaps material benefits without triggering shareholder outrage. Of course, some corporate contributions will be trumpeted. The whole idea behind sponsorship of the Metropolitan Opera¹⁸⁶ or Masterpiece Theater¹⁸⁷ is public exposure and approbation. Other contributions may provide private benefits to managers, however, without broad public disclosure and the attendant outrage. Large contributions to the CEO's alma mater or favorite hospital are likely to fall in this category and prove problematic under the managerial power model.

Mandated public disclosure of significant corporate charitable contributions and officer or director ties with recipients would help combat managerial appropriation under the managerial power model. Once disclosure is made, large contributions will tend to produce outrage unless these contributions can be plausibly justified, and it would seem to be even more difficult to justify large payments to the CEO's favorite charities than it is to justify ostensibly business-related perks. This analysis bolsters the case for mandatory disclosure of significant corporate contributions.¹⁸⁸

Enhanced disclosure is a double-edged sword. Increased disclosure requirements concerning compensation element "A" may lead executives to favor less efficient, but more opaque, compensation element "B". Thus, in order for mandatory disclosure to enhance shareholder value, disclosure practice must stay tightly attuned to compensation practice, effectively preventing executives from circumventing the requirements.¹⁸⁹ In addition, enhanced disclosure may lead to executive compensation ratcheting upwards as firms benchmark compensation off of one another.¹⁹⁰ Nonetheless, the benefits of enhanced disclosure seem to outweigh the costs, and disclosure remains the most promising avenue of attack against runaway compensation and appropriation.

C. Legal Rules Matter

For most of the twentieth century, the dominant theme in the evolution of corporate law was the movement from mandatory rules to an enabling framework.¹⁹¹

general rule and explaining that charitable awards that constitute executive compensation are an exception to the general rule). But see NYSE Listed Company Manual Section 303A.02 (2003) (requiring a listed company to disclose in its annual proxy statement or annual report any contribution to a charitable organization in which a director serves as an executive officer, if such contribution exceeds the greater of \$1 million or 2% of such charitable organization's gross revenues).

¹⁸⁶ Prior to the withdrawal of its sponsorship in 2004, Texaco underwrote radio broadcasts of the Metropolitan Opera for 63 years. See Verena Dobnik, *Met Opera, Texaco End Partnership After 63 Years*, *Pittsburgh Post-Gazette*, Apr. 29, 2004, at E3.

¹⁸⁷ Mobil (and subsequently ExxonMobil) sponsored PBS presentations of Masterpiece Theater for 30 years prior to ending its association with the show in 2004. See David Bianculli, *Television: No One Bidding on Masterpiece*, *N.Y. Daily News*, Jan. 12, 2004, at 79.

¹⁸⁸ See, e.g., Kahn, *supra* note x (arguing for mandatory disclosure of corporate contributions amounts, identities of recipients, and director interlocks).

¹⁸⁹ See Bebchuk & Fried, *supra* note x, at 194.

¹⁹⁰ See Bebchuk et al, *supra* note x, at 791.

¹⁹¹ This is an often told story. See, e.g., Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 *Harv. L. Rev.* 1911, 1974 (1996) (describing the evolution from a set of rigid

Shareholders may have benefited from this movement generally, but it is likely that managerial appropriation has increased as a result, as well. This section focuses on three potential channels of managerial appropriation that are problematic under either the optimal contracting or managerial power models, and argues that deregulation of these channels has led or could lead to further increases in managerial appropriation. Moreover, if one is skeptical of the optimal contracting view, even limited deregulation allowing companies to opt-into or out of prohibitory legal regimes is problematic.

The taking of corporate opportunities, self-dealing transactions, and insider trading have similar implications under the models presented. These transactions present a high risk of significant value appropriation under either model. The availability of these avenues of appropriation tends to shift the optimal contract in favor of the manager and provide a low salience outlet for additional compensation.

As noted, it is difficult to monitor the appropriation of private benefits through these channels. Insider trading can be concealed. Self-dealing can be concealed and, even if disclosed, the profits from self-dealing transactions can be opaque. Managers may misrepresent the degree of fit between a potential opportunity and the corporate plan in order to appropriate such opportunities for their own accounts.¹⁹² Thus, these avenues of appropriation are problematic even under the optimal contracting model.

I argued in Part III that mandatory legal prohibitions could provide extra-contractual enforcement mechanisms and sanctions that could reduce the agency costs associated with these practices under an optimal contracting model. I also suggested that “opt-out” deregulation should not be problematic under this model because directors could simply opt back into the public regulatory system if doing so increased shareholder value. However, if after reviewing the evidence presented in Part V, one is skeptical of the optimal contracting model, this type of opt-out deregulation might be no better than wholesale deregulation.

In other words, if one subscribes to the managerial power view, one would not expect directors to pick the regulatory regime that maximizes shareholder value. Because insider trading, self-dealing, and the taking of corporate opportunities offer easily camouflaged compensation, and the private benefits from these activities may represent a large fraction of the corporate cost, managers could be expected to persuade directors to allow them to utilize these low saliency channels to increase their overall appropriation.

Of course, there also is a plausible justification for permitting the practices or at least permitting case-by-case determinations instead of reintroducing or maintaining mandatory corporate law prohibitions. For example, self-dealing could be mutually beneficial if the manager is also the owner of a key supplier. Allowing the manager to

formal rules to an enabling approach). In recent years the tide has reversed, although recent regulation places much more emphasis on disclosure than substantive obligations. See, e.g., Sarbanes Oxley Act of 2002.

¹⁹² See Talley, *supra* note x, at y.

take a corporate opportunity can be a win-win if the corporation is less able or unable to exploit the opportunity.¹⁹³

In my view, however, these justifications are too weak to counteract the agency costs resulting from the lack of mandatory corporate law prohibitions, at least in the case of public companies where mutually beneficial appropriation of corporate opportunities or other self-dealing should be rare.¹⁹⁴ In any event, policy makers should recognize the potential for appropriation offered by these channels and the insufficiency of opt-in regulation if the optimal contracting model is not fully descriptive of the contracting environment.

VII. CONCLUSION

If the most striking trend in executive compensation over the past several decades has been its seemingly inexorable rise upward,¹⁹⁵ a close second is its steadily increasing complexity and opacity. These trends may be related. As little as twenty years ago, cash salary was the dominant form of compensation.¹⁹⁶ Today executive stock options have supplanted cash salary as the largest single component of the average large company CEO's pay package,¹⁹⁷ but options are only a small part of the picture. Modern CEO compensation packages include cash, options, restricted stock, phantom stock and options, a wide variety of bonus opportunities, not to mention an ever expanding array of benefits and perks, many of which, such as SERPs and deferred compensation plans, represent significant financial commitments by shareholders.

In addition to the increasing complexity of conventional compensation and benefit programs, relaxation of corporate fiduciary law has led to increased executive access to non-conventional appropriation channels such as self-dealing and the taking of corporate opportunities. Even with enhanced SEC disclosure requirements, quantifying and evaluating executive compensation today is a much more difficult proposition than it was twenty years ago. This article has argued that this increasing complexity and opacity has been costly for shareholders. Even if one subscribes to the optimal contracting model of corporate governance, access to certain of these channels of appropriation has likely led to an overall increase in managerial appropriation. If one is skeptical of the optimal contracting story and think it more likely that compensation is limited by external market forces or saliency and outrage in accordance with a managerial power view, then one must conclude that this increased complexity and opacity has led to a very significant rise in the manager's share of corporate value.

¹⁹³ However, these justifications are much more persuasive in the close corporation context. See Brudney & Clark, *supra* note x, at 1001-06.

¹⁹⁴ See Brudney & Clark, *supra* note x, at 1022-24 (presenting a cost-benefit analysis supporting a categorical prohibition against executives taking corporate opportunities).

¹⁹⁵ See Perry & Zenner, *supra* note x, at 123-24 (documenting dramatic increase in CEO compensation during the 1990s); Murphy, *supra* note x, at 2486 (same).

¹⁹⁶ See Murphy, *supra* note x, at 2487 fig. 1.

¹⁹⁷ See *id.* at 2515.

APPENDIX

Note: In the diagram below, the optimal investment in contracting and monitoring occurs at point a resulting in residual slack of b and total agency costs of c .

Figure 1
Minimizing Managerial Agency Costs

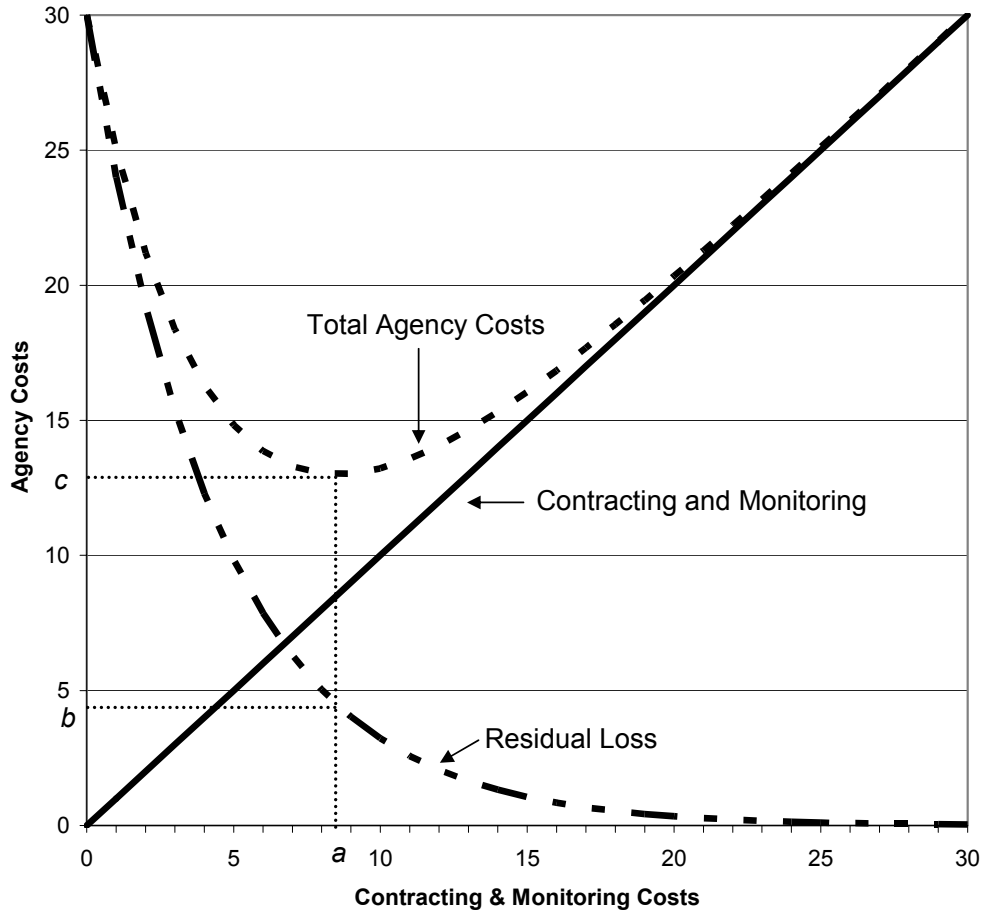
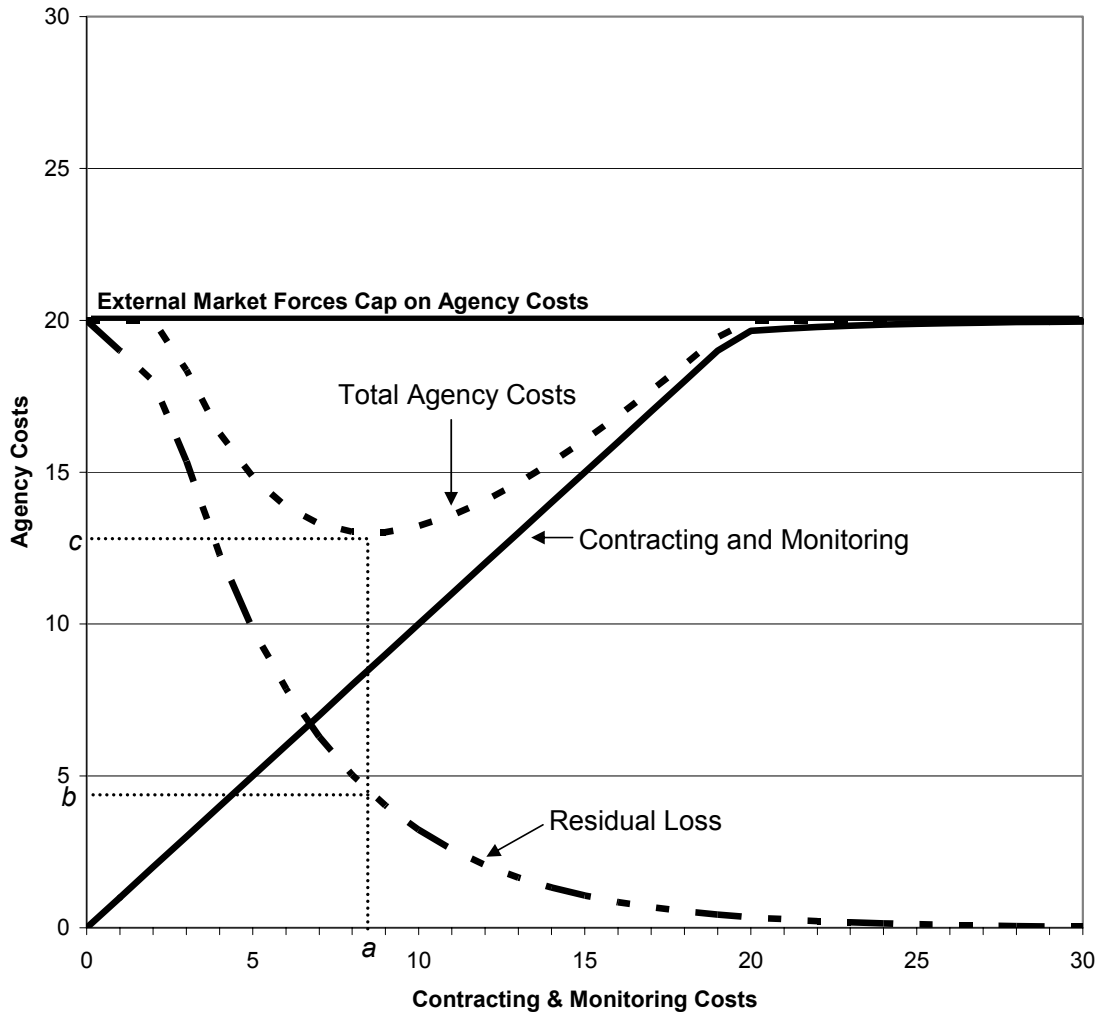


Figure 2
Optimal Contracting Against an External Market Forces Limitation



Note: As depicted in the diagram below, for a given level of contracting and monitoring expenditure, the addition of an avenue of appropriation results in increased residual slack and total agency costs. Agency costs are minimized in the new environment with investment of a in contracting and monitoring, resulting in residual loss of b and total agency costs of c .

Figure 3
Effect of an Added Avenue of Appropriation on the Optimal Contract

