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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 the 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 analysis of each of the corporate governance mechanisms results in the same directional prediction, the magnitude of the impact of expanding channels of appropriation depends on which mechanism dominates. 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 the optimal contracting model, but could have significant impact under the 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*

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\* 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, Boston University School of Law, and the Canadian Law and Economics Association annual meeting. I thank Sumangali Krishnan and Mark Gauthier for excellent research assistance.

*inconsistent with the optimal contracting view. This analysis highlights a largely overlooked cost of compensation complexity: In all likelihood, the increasing complexity and opacity of executive compensation over the last two decades has contributed to the overall increase in managerial appropriation.*

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## INTRODUCTION

Corporate governance scholars sometimes argue that the total share of corporate value that a manager can extract 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 once only. 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.<sup>1</sup>

This Article challenges the idea that the manager's share is fixed. 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 the managerial power view of corporate governance, the total value that can and will be appropriated by managers of diffusely held public companies<sup>2</sup> 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.<sup>3</sup> A primary

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1. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 262 (1991). Easterbrook and Fischel are far from alone in this view. As discussed in Part I, a number of respected scholars have made similar arguments.

2. My concern in this Article is with the governance of Berle-Means corporations characterized by almost complete separation of ownership and control. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). I am not concerned with close corporations or other organizations in which managers may have strong ownership incentives to monitor other managers.

3. See, e.g., Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 999, 1023, 1033 (1981) (suggesting without explicit

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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup> Outside directors are sensitive to this outrage, and limit managerial compensation accordingly.<sup>7</sup> As a result, managers have an incentive to camouflage compensation in order to limit outrage.<sup>8</sup>

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. External market forces, however, are generally thought to permit considerable slack,

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explanation that managerial compensation arising from the taking of corporate opportunities would be in addition to conventional compensation).

4. 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.

5. 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, 753-61 (2002); see also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

6. See Bebchuk et al., *supra* note 5, at 786-89.

7. *Id.* at 786-88.

8. See *infra* Part IV.A.

leaving one to question the extent to which such forces actually limit appropriation.<sup>9</sup>

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 viewed 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.<sup>10</sup>

In reality, of course, markets are imperfect, and far from transparent. But the fact that there is market slack only means that managers are able to appropriate 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. However, additional opaque avenues of appropriation do affect total appropriation under this model because each new opaque 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.<sup>11</sup>

Next, I consider the effect of additional appropriation channels under the 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 appropriation. Shareholders, or boards of directors

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9. See *infra* Part II.B.

10. See *infra* Part II.A.

11. See *infra* Part II.B.



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."<sup>12</sup>

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 mix 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.<sup>13</sup> 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

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12. See *infra* Part III.A.

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

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.<sup>14</sup>

Finally, I consider the effect of additional channels of appropriation under the 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 press outrage borne by outside directors.<sup>15</sup> 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, such as insider trading or perks, are more easily camouflaged than others, such as 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.<sup>16</sup>

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.

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14. See *infra* Part III.D.

15. See Bebchuk et al., *supra* note 5, at 786-87; *infra* Part IV.A.

16. See *infra* Part IV.B.

There is a question of significance, however. Although analysis of each of the corporate governance mechanisms results in the same directional prediction, the factors affecting the magnitude of the impact of additional avenues of appropriation on total appropriation vary depending on the mechanism being considered.

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 the optimal contracting model are avenues effectively under the control of the managers, such as insider trading, self-dealing, and the taking of corporate opportunities.<sup>17</sup> 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 vigilant directors. Such benefits present much more of an opportunity for incremental appropriation under the managerial power model than the optimal contracting model.<sup>18</sup> 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.<sup>19</sup>

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.

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17. See *infra* Part III.D.

18. See *infra* Part IV.B.

19. See *infra* Part II.B.

The empirical evidence supports the view that channels of managerial appropriation 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 is largely 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.<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup> This result suggests that the managerial power model better explains the deal bonus evidence than the optimal contracting model.

So what is the upshot of this analysis and evidence? Taken altogether, the primary contribution of this Article is to highlight a largely overlooked cost of compensation complexity: In all likelihood, the increasing complexity and opacity of executive compensation over the last two decades has contributed directly to the overall increase in managerial appropriation. This realization has obvious implications for shareholders and policymakers. Shareholders and their advocates should resist management attempts to pile on new forms of compensation and perks; advocate simple, transparent pay packages; and continue the push for more detailed and timely disclosure of compensation, benefits, and perks. Lawmakers should tread carefully when considering the deregulation of potential

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20. See *infra* Part V.

21. See Yaniv Grinstein & Paul Hribar, *CEO Compensation and Incentives: Evidence from M&A Bonuses*, 73 J. FIN. ECON. 119, 120 (2004).

22. See *id.* at 127.

channels of appropriation that are difficult to monitor and outside the unilateral control of the directors, such as insider trading.

The remainder of this Article is organized as follows: Part I describes the fixed appropriation view through examples of its invocation and 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 the 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 the managerial power view of corporate governance arrangements. Part V considers the limited empirical evidence bearing on the fixed appropriation question and the governance theories discussed. Part VI briefly considers the implications of this work.

## 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, as a preface 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,<sup>23</sup> 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.<sup>24</sup>

Dennis Carlton and Daniel Fischel also invoke the fixed slack argument in their analysis of insider trading,<sup>25</sup> 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.<sup>26</sup> Economist Nejat Seyhun has summarized this theory as follows: "In competitive managerial markets, potential managers will incorporate the additional benefits of insider trading into their wage contracts, thereby bidding their wages lower."<sup>27</sup>

Einer Elhauge argues that contributions to a manager's pet charities likely substitute for other forms of compensation and, thus, do not erode shareholder value.<sup>28</sup> His view is that managerial discretion to make such contributions is unlikely to affect the overall level of agency costs "because, although shareholders cannot monitor specific operational decisions or determine whether managers are maximizing profits, shareholders can and do monitor the overall level of corporate profitability."<sup>29</sup>

Albert Choi presents a theoretical model of golden parachute arrangements that explains the devices as mechanisms for shifting executive compensation from target firm shareholders onto

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23. See EASTERBROOK & FISCHEL, *supra* note 1, at 262.

24. 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.").

25. 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).

26. 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).

27. H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J.L. & ECON. 149, 150 (1992).

28. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 805-06 (2005).

29. *Id.* at 806.

acquiring firms.<sup>30</sup> The idea that shareholders can reduce traditional executive compensation by the expected value of the parachute payments is central to his argument.<sup>31</sup>

In criticizing the prohibition against executive loans under the Sarbanes-Oxley Act of 2002,<sup>32</sup> Roberta Romano argues that the restriction will not reduce total compensation because “managers can renegotiate their contracts to make up for the loss.”<sup>33</sup>

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. Commentators propounding this view, however, seldom develop the argument fully or discuss the specific mechanism that they believe caps appropriation and renders sources irrelevant.<sup>34</sup> The next three Parts discuss three mechanisms—external market forces, optimal contracting, and outrage and saliency in accordance with the 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, but the problem is much more complex if, as Easterbrook and Fischel put it, various forms of compensation have differing “efficiency properties.”<sup>35</sup> Let us begin with the case in which corporate value is independent of the

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30. See Albert Choi, *Golden Parachute as a Compensation-Shifting Mechanism*, 20 J.L. ECON. & ORG. 170, 170 (2004).

31. *Id.* at 172.

32. Pub. L. No. 107-204, 116 Stat. 745.

33. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1538 (2005). Romano apparently believes that total managerial utility derived from the corporation is fixed. She argues that the dollar value of the manager's total compensation will likely be increased to make up for the loss of preferred, but now prohibited, executive loans. *Id.* at 1539.

34. David Haddock and Jonathan Macey's analysis of insider trading is an exception. See Haddock & Macey, *supra* note 26, at 1461 (arguing that managerial labor market competition would drive down an insider's direct compensation to reflect profits achieved through insider trading).

35. See EASTERBROOK & FISCHEL, *supra* note 1, at 262.

form of compensation. Then, if a manager receives more total compensation as a result of being offered a new form of compensation, the increase 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.

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? No. 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 a manager before and after the introduction of a new value-enhancing compensation mechanism, but this is arbitrary because there was nothing sacred about the original sharing of firm value. But if the manager receives 100% of incremental firm value resulting from the adoption of a new form of compensation, then she has at least appropriated the entire opportunity, although the shareholders are no worse off. We cannot say anything about the degree of incremental appropriation in this scenario, however, for the reason given above.

Nonetheless, 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 discussed in Part III, we would expect the directors to



require the manager to give up at least this amount.<sup>36</sup> 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 will generally assume that additional avenues of appropriation have no effect on firm value as I analyze the impact of these avenues on overall managerial appropriation in the next several Parts. As we have seen, defining appropriation in this context is noncontroversial. Incremental managerial compensation equals incremental appropriation. In Part V, however, I will relax the fixed pie constraint and consider whether the 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.

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36. In brief, the optimal contracting model assumes that the principal (the directors on behalf of the shareholders) minimizes agency costs, including 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. As a result, 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.

### 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.<sup>37</sup> Judge Easterbrook sees these markets disciplining managers “almost as if there were an invisible hand.”<sup>38</sup> I will focus primarily on the managerial labor and corporate control markets, as these are 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 competition for executive services) and competition for capital. Imagine that control contests are inexpensive and frequently launched. Imagine that managerial compensation is transparent. In such an imaginary industry,<sup>39</sup> 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

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37. See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543, 557 (1984); Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 61, 87-101 (Richard Schmalensee & Robert D. Willig eds., 1989); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256-57, 262-73 (1977).

38. See Easterbrook, *supra* note 37, at 544.

39. 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. See David Bank, *After 18-Month Battle, Oracle Finally Wins Over PeopleSoft*, WALL ST. J., Dec. 14, 2004, at A1 (noting that hostile acquisition required eighteen months to complete and an increase in price of 66%). 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 are generally insulated from control contests and strong product competition.

package 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 unbargained-for appropriation. If the manager persists and refuses to renegotiate, the directors can replace her with a comparable manager.<sup>40</sup> 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 would still 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.<sup>41</sup> In a competitive labor market, a manager who appropriates excessive compensation as CEO of ABC Co. through unconventional channels would find the conventional compensation offered to her by XYZ Co. reduced accordingly.<sup>42</sup> 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.<sup>43</sup>

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40. See Easterbrook, *supra* note 37, at 557.

41. 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. See EASTERBROOK & FISCHER, *supra* note 1, at 169.

42. See Holmstrom & Tirole, *supra* note 37, at 94 (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 et al., *Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?* 1-2 (Nov. 15, 2000) (unpublished manuscript), available at <http://ssrn.com/abstract=252544> (describing and providing evidence of the ratcheting phenomena).

43. See Holmstrom & Tirole, *supra* note 37, at 94.

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 power of these internal forces depends on the strength of internal corporate governance, which I 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 managers who could initiate a control contest and replace existing management.<sup>44</sup> 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 an unconventional 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.<sup>45</sup> 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' interests.<sup>46</sup>

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44. See Easterbrook, *supra* note 37, at 564; Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919 (1982); Holmstrom & Tirole, *supra* note 37, at 97; Winter, *supra* note 37, at 264-66; see also Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965) (generally credited with originating this idea).

45. See Easterbrook, *supra* note 37, at 564.

46. See *id.*; Holmstrom & Tirole, *supra* note 37, at 97.

### 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 capital,<sup>47</sup> 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.<sup>48</sup>

Finally, products markets may impose some discipline on managers.<sup>49</sup> 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.<sup>50</sup>

### *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 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

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47. See Easterbrook, *supra* note 37, at 556; Winter, *supra* note 37, at 257; see also EASTERBROOK & FISCHEL, *supra* note 1, at 6, 213.

48. Easterbrook, *supra* note 37, at 543.

49. See *id.* at 557; Holmstrom & Tirole, *supra* note 37, at 95.

50. See Easterbrook, *supra* note 37, at 543, 557.

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.<sup>51</sup> Presumably, they mean 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 available for both 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."<sup>52</sup>

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51. See EASTERBROOK & FISCHEL, *supra* note 1, at 262.

52. Easterbrook, *supra* note 37, at 542.

It is instructive to examine 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.<sup>53</sup> 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 will be significant. Of course, managerial performance as well as appropriation factors into the replacement 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.<sup>54</sup> 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,<sup>55</sup> and the number of openings each year, although perhaps growing, is few as well.<sup>56</sup> Rakesh Khurana argues that CEO search committees often become obsessed with attracting a particular candidate, which undermines efficient bargaining.<sup>57</sup> 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.<sup>58</sup>

Slack in the discipline provided by the market for corporate control also is a function of cost. Takeovers are expensive. In recent years, takeover premia have averaged 30% or more.<sup>59</sup> But this figure

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53. See Jensen & Meckling, *supra* note 4, at 328-29.

54. See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* 27 (2002).

55. See *id.* at 27-28.

56. See Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 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 Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2549 (Orley Ashenfelter & David Card eds., 1999) (noting an increase in external replacement of CEOs).

57. See KHURANA, *supra* note 54, at 180.

58. See *id.* at 32-48.

59. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 908 (1988) (citing two studies

probably underestimates the amount of slack allowed by the takeover market, because a new owner would face agency costs as well.<sup>60</sup> He cannot run the firm by himself. Thus, appropriation representing a deviation of, say, 30% of firm value over some "normal" level of agency costs and slack would be needed to justify a takeover.

Several factors limit the disciplining force of capital markets. Judge Easterbrook suggests that the prospect of an IPO will cause managers to bond themselves in the company charter to reasonable appropriation.<sup>61</sup> 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.<sup>62</sup>

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.<sup>63</sup>

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from the 1980s reporting takeover premia in excess of 50%); Thomas Moeller, *Let's Make a Deal! How Shareholder Control Impacts Merger Payoffs*, 76 J. FIN. ECON. 167, 172-74 (2005) (finding average takeover premia of 30.8% for a sample of completed U.S. transactions of \$100 million or more that were announced during the 1990s); Lisa K. Muelbroek & Carolyn Hart, *The Effect of Illegal Insider Trading on Takeover Premia*, 1 EUR. FIN. REV. 51, 53-54, 61-62 (1997) (finding average takeover premia of 32.5% for a sample of acquisitions occurring in the 1980s for which illegal insider trading was not detected and an average premia of 43.1% for a matched set of firms with detected insider trading). *But see* Jay C. Hartzell et al., *What's In It for Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD. 37, 41-43 (2004) (reporting average takeover premia ranging from 22.7% to 34.8%, depending on the metric, for a sample of large U.S. deals announced during the late 1990s).

60. See Holmstrom & Tirole, *supra* note 37, at 97 (asking: "Why would the new management behave any better than the old one?").

61. See Easterbrook, *supra* note 37, at 543-44.

62. 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 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 4, at 325.

63. 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: Evidence from the Bond and Stock Markets* (Sept. 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=612921> (finding that firms that use more powerful incentive compensation incur greater debt costs that are not offset by reductions in executive perk consumption or selection of higher-risk, positive-net present value projects; thus, share value suffers as a result of high-powered, suboptimal incentives).



Managerial appropriation is more a question of dividing the pie between managers and shareholders. Second, because mature public companies rarely make equity offerings,<sup>64</sup> 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.<sup>65</sup>

Products 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 products markets.<sup>66</sup> Some avenues of appropriation, such as managerial self-dealing or the taking of corporate opportunities could conceivably impact competitiveness, but most will not.<sup>67</sup> In addition, the incremental risk of bankruptcy resulting from excessive managerial appropriation generally will be slight.

The foregoing discussion suggests that external market forces will often permit a significant degree of slack.<sup>68</sup> 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.

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64. Equity offerings made subsequent to IPOs, known as seasoned equity offerings, are rare because they 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).

65. See Bebchuk et al., *supra* note 5, at 778.

66. See *id.*

67. See Bebchuk, *supra* note 63, at 1466-67.

68. In addition to these arguments, Lucian Bebchuk argues persuasively that managers will not be constrained by external market forces with respect to significantly redistributive issues, such as compensation. See *id.* 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 *id.* at 1461-67.

*2. Efficiency Differences Affect Appropriation (But Only in an Evolutionary Sense)*

Easterbrook and Fischel suggest that sources of appropriation affect shareholder and manager wealth if there are differences in "efficiency properties."<sup>69</sup> The idea, presumably, is that some forms of appropriation, such as stock options, create share value-enhancing incentives, while others, 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 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.<sup>70</sup>

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69. EASTERBROOK & FISCHEL, *supra* note 1, at 262.

70. 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 (John M. Olin Law & Econ.

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 prohibited by law 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.<sup>71</sup> But assuming 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, 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."<sup>72</sup>

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, because the change enhances share value. And I 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.

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Working Paper Series, Paper No. 221, 2004), available at [http://www.law.uchicago.edu/Lawecon/WkngPprs\\_201-25/221-mth-jcs-heroin-new.pdf](http://www.law.uchicago.edu/Lawecon/WkngPprs_201-25/221-mth-jcs-heroin-new.pdf) (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).

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

72. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 139.

### 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 (in)efficient in terms of increasing shareholder wealth. According to Easterbrook and Fischel, whether a manager appropriates value *X* through taking perks, self-dealing, or a combination of both is a matter of indifference to shareholders.<sup>73</sup> Shareholders will not be indifferent, however, if access to an additional avenue of appropriation undermines the discipline provided by market forces.

Legal prohibitions provide extracontractual enforcement mechanisms and sanctions that can reduce the cost to a company or to the markets of monitoring managerial behavior.<sup>74</sup> 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? The managerial labor market will not work as effectively as it did prior to revocation of the prohibition. Given relaxed sanctions (firing only

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73. See EASTERBROOK & FISCHEL, *supra* note 1, at 262.

74. 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 prohibit insider trading contractually tells us little because of the costs and limitations of private monitoring and enforcement, but that public monitoring and enforcement may be optimal).

versus firing, jail, and fines), managers will be tempted to disguise their trades and violate contractual rules prohibiting or limiting insider trading.<sup>75</sup> 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 fought so vigorously against new accounting rules requiring stock option compensation to be subtracted from reported earnings rather than simply footnoted.<sup>76</sup> 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 a 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.<sup>77</sup>

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75. See *id.*

76. 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 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.

77. See Holmstrom & Tirole, *supra* note 37, at 97.

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 changes.

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 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 THE OPTIMAL CONTRACTING FRAMEWORK

Whether or not market discipline is affected by avenues of slack, all observers 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 the 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 taking 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 Part follows Jensen and Meckling's optimal contracting theory of managerial agency costs in analyzing the impact of additional avenues of managerial appropriation.<sup>78</sup> The analysis begins with a sole proprietor-manager who sells shares of equity to nonmanaging outsiders, which creates a wedge between the manager's private incentives and the incentives of the shareholders generally.<sup>79</sup> The outside shareholders cannot perfectly, or costlessly, observe the manager's effort or focus, and performance results are not completely within the manager's control.<sup>80</sup> 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, because he enjoys 100% of the benefit of such activities,

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78. See Jensen & Meckling, *supra* note 4.

79. See *id.* at 312.

80. 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).

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.<sup>81</sup> 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.<sup>82</sup> Under this assumption, we would expect some divergence of goals and some residual loss under the optimal contract.

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; and, importantly, the cost of incentive compensation, which, under this model, is just another tool for minimizing total agency costs.<sup>83</sup> Residual loss or slack represents the divergence between the manager's actions and shareholder wealth-maximizing actions. The residual loss could consist of management shirking,<sup>84</sup> pursuing only low risk opportunities,<sup>85</sup> taking excessive perquisites, making corporate contributions to pet charities, or otherwise extracting private benefits through insider trading, self-dealing, taking corporate opportunities, etc.

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81. Jensen & Meckling, *supra* note 4, at 308.

82. *See id.* at 323.

83. *See id.*

84. 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 the amount devoted to managing the manager's own portfolio, maximizing executive compensation, minimizing personal taxes, etc.

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



It is worth emphasizing that the agency costs in this model also result from a lack of transparency. If the shareholders could observe the manager's effort and the impact of the manager on performance results perfectly and costlessly, 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 retained if he took shareholder-regarding actions; otherwise he would not be.<sup>86</sup> As a result, the manager would take shareholder-regarding actions. In the real world, however, actions and results are never this transparent.<sup>87</sup>

*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.<sup>88</sup> 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.<sup>89</sup> Suppose the value of the company in this scenario

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86. See Posner, *supra* note 80, at 227.

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

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

89. As Jensen and Meckling point out, agency costs are borne by the owner/manager when

falls to 50, implying a residual loss of 50 (100 minus 50) and total agency costs of 65, including monitoring costs and *M*'s compensation. *SH* enjoys net value of 35; *M* receives 10.<sup>90</sup>

Now imagine that the parties negotiate an incentive compensation contract under which *M* and *SH* divide firm value in excess of 50.<sup>91</sup> *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 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.<sup>92</sup> 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 because he has cut back on perks and loafing.<sup>93</sup>

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he sells shares to third parties. See Jensen & Meckling, *supra* note 4, at 313. Thus, *M* has the incentive in this case to minimize agency costs. This does not mean, however, that *M* will not maximize his private benefits once the shares are sold.

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

91. 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. See Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. (SPECIAL ISSUE) 24, 27-28 (1991). 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.

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

93. 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 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 Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487 (1999) (providing a model of managerial value diversion in which shareholders provide managers with the minimum amount of fixed salary compatible with their wealth constraints); 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

### *C. Upper Bound on the 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. On the other hand, if 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.

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

As suggested above, the optimal contract will generally 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 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

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on the firm's stock price that are outside the manager's control).

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.<sup>94</sup> 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.<sup>95</sup> Agency costs increase to 60, consisting of *M*'s compensation of 15, direct monitoring of 5, and residual loss of 40. Thus, *SH* enjoys only 40 after agency costs.<sup>96</sup>

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

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94. 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* 160-61 (1986).

95. *M*'s share of firm value is calculated as follows: 5 (incentive compensation) plus 20 (private benefits) plus 10 (fixed compensation).

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

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 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 spent on direct monitoring, which reduces the combined surplus of *M* and *SH*. But the idea of the optimal contract is to minimize *shareholder* agency costs.<sup>97</sup> 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 would not if that were the only lever, but if direct monitoring is increased in conjunction with adoption of higher-powered incentives, the combination could have that result.<sup>98</sup> The primary point is that both increased direct

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97. See Holmstrom & Tirole, *supra* note 37, at 89. But see Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277, 319 (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.

98. To see this, suppose the increase in direct monitoring increases the likelihood that *M*

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.<sup>99</sup>

In the example discussed above, I have assumed that the "new" avenue of managerial appropriation represents a simple value transfer from shareholders to the manager and has no efficiency effects, but this will not necessarily be the case. Transfers can have positive or negative efficiency effects.<sup>100</sup> A corporate opportunity, for example, might be more valuable in the hands of the manager than in corporate solution.<sup>101</sup> This type of positive efficiency effect 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.<sup>102</sup> On the other hand, appropriation channels can create dis-benefits. A corporate opportunity may be valuable to a manager, but more valuable to the

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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.

99. 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 in the first.

100. See Bebchuk & Jolls, *supra* note 93, at 496-501.

101. See *id.*

102. 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 25, at 866-72.

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 will generally assume in this analysis that avenues of appropriation represent pure value transfers, but it is important to bear in mind that this may not always be the case.

*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 analyzes 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 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 compensation by the amount of the embezzled funds, again eliminating the impact of this avenue of appropriation on the manager's share.<sup>103</sup>

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103. Depending on the composition of the bank manager's pay package, this reduction in

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 noncash transfers. Take the example of cash deal bonuses that are commonly paid to CEOs for completing mergers or acquisitions.<sup>104</sup> 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 exchange or entails a transfer of value to Acme's CEO.<sup>105</sup> 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.<sup>106</sup>

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other compensation may or may not affect the bank manager's incentives and shareholder wealth. See Bebchuk & Jolls, *supra* note 93, at 489-90.

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

105. 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.

106. At bottom, this is an information asymmetry problem. When transactions are not 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 97, at 310-36 (analyzing the corporate opportunity doctrine under the assumption that the manager has private and unverifiable information regarding the degree



Transactions that provide psychic or other noncash 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 to pet charities—demonstrate in different ways the two general categories of monitoring difficulty—spotting the transfer and valuing it.

## *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.<sup>107</sup> 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.<sup>108</sup> No incentive compensation program will give an executive 100% of incremental value, and most provide

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to which an opportunity fits the corporate scheme and that the manager has the incentive to misrepresent the fit).

107. 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 Internal Revenue 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 traditional defined benefit pension plans, although they lack the tax advantages associated with qualified plans. See Janet DenUyl & Matt Leckrone, *Perspective: Executive Benefits a Governance Issue* (July 2, 2004), available at <http://web.archive.org/web/20041010035901/http://www.mercerhr.com/knowledgecenter/reportssummary.jhtml/dynamic/idContent/1145295>.

108. See Bebchuk, *supra* note 63, at 1461-67 (discussing the difficulty of controlling managers with respect to highly redistributive issues).

executives with only a tiny fraction of incremental value. Thus, shareholders would have to rely on direct monitoring to control appropriation that provides such intense private benefits.

Compare the deal bonus situation described above. Suppose a deal bonus is offered to the CEO alone, 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.

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.<sup>109</sup>

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

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109. Here I refer 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 toward low cost restrictive practices).

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 assumes that the principal can easily observe results, but not actions.<sup>110</sup> As a result, if the directors have unilateral control over a potential channel of appropriation, an optimal contract would not include that channel unless its inclusion 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.<sup>111</sup> 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

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110. See Jensen & Meckling, *supra* note 4, at 312-25.

111. Some companies do expressly bar certain avenues of value appropriation. For example, a recent Intel 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 or other 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." *The New Compensation Committee Responsibilities: A Roadmap for Meeting the New Standards and Avoiding Personal Liability*, CORP. COUNS., May-June 2004, at 1, 8 [hereinafter *Compensation Committee Responsibilities*] (quoting INTEL CORP., PROXY STATEMENT 21 (2003)). Note that this statement does not rule out all perks, such as access to company planes and cars.

at least this extent.<sup>112</sup> 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 in total compensation and in addition enjoys the 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 defined in Part I.<sup>113</sup>

These observations extend beyond perks and benefits. Consider again CEO deal bonuses. 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 executives may mislead them 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 arm's 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.<sup>114</sup>

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112. See *supra* Part I.B.

113. 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 *supra* Part I.B.

114. Lucian Bebchuk and Christine Jolls provide another explanation of why appropriation

Consider insider trading. Trading on the basis of material, nonpublic information is prohibited by mandatory legal rules,<sup>115</sup> and penalties for illegal insider trading can include large fines and even imprisonment.<sup>116</sup> The legal prohibition and extracontractual 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 insider trading generally is not an efficient form of managerial compensation. 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.<sup>117</sup> As a result, all else being

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through such channels leads to greater overall appropriation. Bebchuk & Jolls, *supra* note 93. They begin with the assumption that conventional compensation is optimized to ensure maximum shareholder value given wealth limitations. *Id.* at 491-92. 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. *Id.* at 496-501. Bebchuk and Jolls' analysis is correct, but under a strict optimal contracting framework, their conclusion would hold only if the directors could not unilaterally prohibit the alternative appropriation channel.

115. Unlike many state corporate law rules that are merely default provisions, *see, e.g.*, Del. Gen. Corp. Law §§ 141, 212, 214, companies cannot "opt out" of the federal insider trading rules, principally Securities Exchange Act section 16, 15 U.S.C. § 78p (2000), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2005).

116. Through the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, and the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, Congress has dramatically increased civil and criminal penalties for insider trading over the past twenty years. Current potential penalties for the worst offenders include treble damages in civil prosecutions and fines of up to \$5 million and imprisonment for up to twenty years in criminal prosecutions. *See* Securities Exchange Act §§ 21A(a)(2) (civil penalties), 32(a) (criminal penalties) (codified as amended at 15 U.S.C. §§ 78u-1(a)(2), 78ff(a) (2000)).

117. 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

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 would be more difficult and costly to monitor than simple prohibition.<sup>118</sup> 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.<sup>119</sup> Even optional deregulation could have some adverse impact, however, if reduced participation in the federal system undermined its effectiveness.

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monitoring. Even if that were the case, however, private monitors would lack important monitoring tools, such as subpoena power, that are available to the government and certainly would lack the ability to impose criminal penalties on violators.

118. See Holmstrom & Milgrom, *supra* note 91, at 38 (assuming that it is easier for the principal to exclude an activity than to restrict and monitor that activity).

119. 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 rules. For an overview of that literature and criticism thereof see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

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.<sup>120</sup> 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.<sup>121</sup> 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.<sup>122</sup>

#### 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.<sup>123</sup> 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 sharehold-

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120. See CLARK, *supra* note 94, at 160.

121. 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.

122. 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, compensation delivered via stock options, restricted stock, or other arrangements cannot increase managerial appropriation to the shareholders' detriment under this model.

123. 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 37, at 87-88.

ers, 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.<sup>124</sup> This Part will apply the managerial power model to the specific questions of 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*

The managerial power model suggests that we should not expect public companies to reach optimal contracts with managers.<sup>125</sup> 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.<sup>126</sup> The incentive to retain a board position generally outweighs the incentive to maximize shareholder value.<sup>127</sup> As a result, outside directors are encouraged to acquiesce to the executives who have the power to retain or fire them.<sup>128</sup> In addition, a number of psychological forces at play in the boardroom tend to foster an attitude of deference to the CEO.<sup>129</sup>

What does this model have to say about executive compensation and managerial value appropriation generally? First, as with the

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124. See generally Bebchuk et al., *supra* note 5 (setting out the managerial power approach to executive compensation).

125. 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 the managerial power view do not deny that agency costs and incentives play some role in setting managerial compensation. See *id.* at 755. Perhaps the managerial power view should be termed the (sub)optimal contracting view.

126. *Id.* at 769-70.

127. *Id.* at 770-71.

128. Obviously, corporate executives 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.

129. 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 G.M. 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 boardroom 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. *Id.*



optimal contracting model, this model recognizes that market forces place an upper bound on value appropriation.<sup>130</sup> 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.<sup>131</sup>

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 camouflaging compensation and avoiding outrage.<sup>132</sup> 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

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130. See Bebchuk et al., *supra* note 5, at 787.

131. 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, Pub. L. No. 107-204, 116 Stat. 745, 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.

132. *Id.* at 789.

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 detect 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 the opacity of transfers to financial analysts and institutional investors who provide the outrage that limits appropriation.<sup>133</sup> Under this model, both managers and directors have an interest in camouflaging compensation. Of course, 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 noncash benefits are involved (self-dealing and contributions to pet charities). But even

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133. See *id.* at 787.

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,<sup>134</sup> provide an 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.”<sup>135</sup> 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.<sup>136</sup> 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.

In Part II, I also argued 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.

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134. See *supra* Part III.E.2.

135. *Compensation Committee Responsibilities*, *supra* note 111, at 6; see also DenUyl & Leckrone, *supra* note 107 (providing an example in which the lump sum value of a SERP for a fifty-seven-year-old CEO retiring after twenty 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).

136. 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 5, at 99-100.

## *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.<sup>137</sup> 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.

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 is the argument that stock and options provide incentives that cause managers to grow the pie. 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? Once outrage is deflected through the plausible justification of incentive alignment, however, 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

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137. See *supra* text accompanying note 104.

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.<sup>138</sup> 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.<sup>139</sup>

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 executives if the aggregate value exceeds \$50,000.<sup>140</sup> Suppose a company spends \$100,000 per year on a limo and driver for the CEO. One would think that this perk must be disclosed, but by making the car and

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138. 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. BEBCHUK & FRIED, *supra* note 5, 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 (2004) (making the same argument with respect to equity compensation).

139. See, e.g., Zvi Bodie et al., *For the Last Time: Stock Options Are an Expense*, HARV. BUS. REV., Mar. 2003, at 63, 65-68; Lingling Wei, *What's the Cost of a Stock Option?*, WALL ST. J., Mar. 4, 2004, at C3 (noting that experts view the more complicated "binomial valuation" as more accurate than the simpler Black-Scholes formula).

140. For executives receiving less than \$500,000 combined annual salary and bonus, the threshold for disclosure is 10% of salary plus bonus. See SEC Reg. S-K, Item 402(b)(2)(iii)(C)(1), 17 C.F.R. § 229.402 (2005).

driver "available" to other executives, the company can treat only the CEO's personal use as a perk and thus avoid disclosure.<sup>141</sup>

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.<sup>142</sup> The incentive rationale 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.<sup>143</sup> 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.<sup>144</sup> 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 § 280G, the anti-golden parachute provision of the Internal Revenue Code.<sup>145</sup> Thus, even if they can be calculated, the face value of parachute payments typically understates 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

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141. See *Compensation Committee Responsibilities*, *supra* note 111, at 7.

142. Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 39 (1988).

143. See *id.* at 39-41.

144. See Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 131 (2001).

145. See *id.* at 136, 139.

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, for instance. Thus, managers should be somewhat concerned with the intensity of private benefits under the managerial power model, but perhaps to a lesser extent than the optimal contracting model would predict. Finally, the extent to which a potential channel of appropriation is under the control of the board or the managers 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 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 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 a handful of empirical studies that allow us to test the theory developed above and the explanatory power of the various models.<sup>146</sup>

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146. I should stress that this Part is by no means intended as an exhaustive review of the extensive empirical literature on executive compensation and perks, but rather is designed to focus on specific evidence that supports or refutes the claims of this Article. For a more complete review of the empirical literature on executive compensation, see Bebchuk et al.,

Although this limited body of evidence can in no way be considered conclusive, it is suggestive. 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 appear to lead to increased transfers of wealth from shareholders to managers. Moreover, the evidence is largely 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 the managerial power view (and possibly the external market forces view).

*A. The Empirical Evidence Suggests that Unconventional Compensation Increases Total Compensation*

Recent evidence suggests that stock options, CEO deal bonuses, executive loans, and certain perks do not substitute for other forms of compensation but represent incremental managerial compensation. One recent study does suggest that insider trading profits may substitute for other compensation, but the weight of this limited 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%.<sup>147</sup> This reflected a 335% increase in option compensation and about a 55% increase in salary and bonus.<sup>148</sup> Put another way, options increased from 19% of the median CEO's pay

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*supra* note 5.

147. 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).

148. See *id.*



package in 1992 to 32% in 1998,<sup>149</sup> at which point options had become the single largest component of CEO compensation.<sup>150</sup>

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 § 162(m) of the Internal Revenue Code, which limits the deductibility of executive compensation that is not performance-based.<sup>151</sup> Second, the rate of increase in total CEO compensation across the period is much more dramatic than anything experienced before the widespread adoption of executive stock options.<sup>152</sup>

This intuition is confirmed by two recent studies that fail to find substitution of option grants for non-option compensation.<sup>153</sup> 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.<sup>154</sup> The

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149. See *id.*

150. See Murphy, *supra* note 56, at 2515.

151. See Perry & Zenner, *supra* note 147, at 145 tbl.1; Tod Perry & Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62 J. FIN. ECON. 453, 460 (2001).

152. 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 seventy-seven 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 \$1 million year-2000 dollars across the earlier period and then rose at an average annual rate of almost 11% between 1992 and 2002. Carola Frydman & Raven E. Saks, *Historical Trends in Executive Compensation, 1936-2002*, at 38 fig.7 (Nov. 14, 2004) (unpublished manuscript, on file with author). 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 CEO pay explosions did not occur during the 1920s or 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.

153. See Matthias Benz et al., *Are Stock Options the Managers' Blessing? Stock Option Compensation and Institutional Controls* (Zurich Inst. for Empirical Research in Econ., Working Paper No. 61, 2001), available at <http://ssrn.com/abstract=251009>; Marianne Bertrand & Sendhil Mullainathan, *Do CEOs Set Their Own Pay? The Ones Without Principals Do* (Nat'l Bureau of Econ. Research, Working Paper No. 7604, 2000), available at <http://ssrn.com/abstract=228095>. But see Murphy, *supra* note 71, at 724 (relating several anecdotal episodes of executives accepting reduced salary for stock and options).

154. Benz et al., *supra* note 153, at 5 (finding a small but statistically significant positive

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.<sup>155</sup> Nonetheless, these results suggest little or no substitution of options for other forms of compensation.

## 2. Deal Bonuses

In a recent study, Grinstein and Hribar analyzed bonuses paid to CEOs for completing mergers or acquisitions.<sup>156</sup> M&A deal bonuses are fairly common. Thirty-nine percent of acquiring firms in their sample of 327 large U.S. M&A deals between 1993 and 1999 compensated their CEO for completing the deal.<sup>157</sup> The authors found that these bonuses represent incremental compensation that does not substitute for other forms of pay.<sup>158</sup>

## 3. Corporate Aircraft

David Yermack recently investigated personal use of corporate aircraft.<sup>159</sup> Yermack found a very small and statistically insignificant *positive* relationship between personal use of planes and a CEO's other compensation.<sup>160</sup> This data obviously provides no support for the view that personal aircraft use substitutes for other compensation.

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relationship between the value of stock options grants and base salary of senior managers of S&P 500 companies between 1992 and 1997); Bertrand & Mullainathan, *supra* note 153, 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).

155. See Bertrand & Mullainathan, *supra* note 153, at 31.

156. Grinstein & Hribar, *supra* note 21.

157. *Id.* at 125-26.

158. *Id.* at 127. As far as I am aware, this is the only published study addressing this issue.

159. David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, J. FIN. ECON. (forthcoming), available at <http://ssrn.com/abstract=529822>.

160. *Id.* (manuscript at 23-24, 48 tbl.IV).

#### 4. *Executive Loans*

Loans from a company to its executives can increase a manager's compensation in two ways. Executive loans generally are made at below market interest rates, and many of these loans are forgiven. In a study of seventy firms with loans outstanding to one or more of their executives listed on Standard and Poor's ExecuComp database between 1996 and 2000, Kathleen Kahle and Kuldeep Shastri found that, on average, stock purchase loans were issued at 2.3% below the prime rate and that 12.6% of the loans were forgiven.<sup>161</sup> Clearly, the average executive loan contains an element of compensation. Nonetheless, in comparing the compensation of executives who did and did not receive loans, Kahle & Shastri's "results indicate that executives who receive loans are not giving up other forms of compensation in return for receiving these loans."<sup>162</sup>

#### 5. *Insider Trading*

Running counter to the foregoing, however, is evidence concerning insider trading recently compiled by Darren Roulstone.<sup>163</sup> Although trading by insiders on the basis of material, nondisclosed information is prohibited by law, it is well established that corporate executives trading in the securities of their companies generally outperform the market by several percentage points.<sup>164</sup> Responding

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161. Kathleen M. Kahle & Kuldeep Shastri, *Executive Loans*, 39 J. FIN. & QUANTITATIVE ANALYSIS 791, 795, 798-800 (2004).

162. *Id.* at 802.

163. Darren T. Roulstone, *The Relation Between Insider-Trading Restrictions and Executive Compensation*, 41 J. ACCT. RES. 525 (2003).

164. See, e.g., Leslie A. Jeng et al., *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. ECON. & STAT. 453, 455-57 (2003) (finding in a study of open market trades reported to the SEC between 1975 and 1996 that insider purchases earned average abnormal returns of 6% per year, but finding no abnormal returns associated with insider sales); Bin Ke et al., *What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades*, 35 J. ACCT. & ECON. 315, 316-17 (2003) (noting "[a] robust result of the literature on insider trading is that insiders subject to the filing requirements of section 16 of the U.S. Securities and Exchange Act of 1934 earn abnormal stock returns on their trades" and providing evidence that insiders trade on undisclosed accounting information); Seyhun, *supra* note 27, 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*

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.<sup>165</sup> 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.<sup>166</sup> This trade-off between insider trading profits and compensation is in line with Easterbrook and Fischel's fixed slack argument.<sup>167</sup>

*B. The Empirical Evidence Suggests At Least Some Incremental Appropriation*

Evidence that stock options, deal bonuses, aircraft perks, and executive loans represent incremental compensation does not necessarily imply incremental appropriation as I have defined it. It is conceivable that these programs 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 loan and perk compensation is more similar to deal bonuses or options, but the conclusion is the same: Evidence that loans and jet perks represent pure add-on compensation suggests at least some incremental appropriation.

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*Empirical Evidence*, 58 J. BUS. 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).

165. See Roulstone, *supra* note 163, at 532 (citing studies).

166. *Id.* at 526.

167. See *supra* Part I.A.

### 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.<sup>168</sup> However, Grinstein and Hribar found that deal performance did not explain the cross-sectional variation in deal bonuses.<sup>169</sup> Deal bonuses do not appear to be driven by efficiency enhancement. If deal bonuses do not increase the pie, as this evidence suggests, then evidence that deal bonuses represent incremental managerial compensation suggests 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 are generally thought to provide incentives that result in increased firm value.<sup>170</sup> Thus, it is difficult to assess the extent to which increased total managerial compensation resulting from the introduction of options represents appropriation of shareholder wealth or a fair and efficient division of incremental gains with shareholders. Nonetheless, evidence that

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168. See Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757 (2005) (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 Economic Gains of Mergers and Acquisitions: Is It Time for a Change?* (Feb. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=579841> (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).

169. See Grinstein & Hribar, *supra* note 21, at 120; see also Jerry Coakley & Stavroula Iliopoulou, *CEO Compensation for Bidders in UK M&As* 28 tbl.3 (Feb. 2005) (unpublished manuscript), available at <http://www.uc3m.es/uc3m/dpto/EMP/seminar/Iliopoulou.pdf> (finding no positive correlation between market perception of M&A deal performance and acquiring company CEO pay in a sample of one hundred completed U.K. acquisitions between 1998 and 2001).

170. See, e.g., Murphy, *supra* note 56, at 2510 ("Stock options provide a direct link between managerial rewards and share-price appreciation ....").

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 the options.<sup>171</sup> However, if option compensation were 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.<sup>172</sup> 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 shareholder-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 preexisting salary of 100, then incremental appropriation is at least 20. Incremental appropriation may be much larger than 20, but 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 typically granted at-the-money with a fixed exercise price and a ten-year life.<sup>173</sup> Thus, even if the issuer's performance lags, executives can cash in on general upswings in the market. Moreover, if an issuer's stock price falls precipitously, its options

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171. See, e.g., Murphy, *supra* note 71, at 723.

172. Clearly conventional executive stock options that pay on the basis of overall stock market improvements, as well as company-specific improvements, provide low risk compensation, particularly given the conventional practice of reducing option exercise prices following a market downturn. See Bebchuk et al., *supra* note 5, at 796-98, 821-24.

173. See Murphy, *supra* note 56, at 2508.

often are repriced or replaced to restore the incentive.<sup>174</sup> Thus, even exceptionally risk-averse managers should be expected to sacrifice some 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.<sup>175</sup>

### 3. *Perks*

It is unclear whether the corporate jet perk situation is closer to that of deal bonuses or of options, but the conclusion is the same either way: David Yermack's data on this perk suggests at least some incremental appropriation. As noted above, Yermack's data suggests that corporate jet consumption represents incremental compensation.<sup>176</sup> In my view, it is very unlikely that personal use 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 for other compensation would represent incremental appropriation from a fixed pie.

There is evidence, however, that some 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.<sup>177</sup> 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

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174. See Bebchuk et al., *supra* note 5, at 821-24.

175. The incompatibility of zero substitution and an efficiency explanation for equity compensation is probably easier to see with restricted stock than with options. Many companies grant stock to executives that is forfeitable if the employment relationship is severed before a vesting date. See Murphy, *supra* note 56, 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, 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.

176. See *supra* Part V.A.3.

177. Raghuram G. Rajan & Julie Wulf, *Are Perks Purely Managerial Excess?*, 31 (Nat'l Bureau of Econ. Research, Working Paper 10494, 2004), available at <http://ssrn.com/abstract=546291>.

headquarters is more distant from a major airport).<sup>178</sup> Assuming, however, that corporate jet use provides risk-free consumption value to executives, we would expect managers to forego at least some conventional compensation in exchange for the jets, even if the perk increases the pie. Yermack's data finding no substitution indicates that jet use increases appropriation even if Rajan and Wulf are correct.

#### 4. *Executive Loans*

The stated justifications for executive loans generally fall into two broad categories. Most loans are made with the stated purpose of assisting executives with the purchase of stock or the exercise of options and are justified as a means of increasing managerial ownership of the firm's stock and thereby better aligning incentives.<sup>179</sup> The second category consists of loans that are used to defray the cost of relocation and purchase of an executive's residence.<sup>180</sup> Relocation loans are justified as a useful tool in attracting and retaining executives.

It is conceivable that some executive loans increase shareholder value, but there are reasons to be skeptical. Of course relocation loans can help attract executives, but they are no different from cash in that respect. Unless an executive has poor credit, providing a loan at a discounted interest rate should be equivalent to not providing the loan and simply increasing the manager's cash compensation by the amount of the discount. There is nothing efficiency enhancing about compensating executives with loans per se.

The same can be said for loans made to facilitate the purchase of stock or exercise of options, but here we have additional evidence that suggests that the stated rationale is suspect. Kahle and Shastri found that on average a stock purchase loan that enabled a manager to purchase one hundred shares resulted in increased share ownership of only eight shares.<sup>181</sup> In other words, at the same time

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178. *See id.*

179. Eighty-six percent of loans with a stated purpose in Kahle and Shastri's sample fall into this category. *See Kahle & Shastri, supra* note 161, at 798-99.

180. *Id.*

181. *Id.* at 804-07. Kahle and Shastri did find that for a subset of executives with low



that managers have been taking advantage of low interest loans to acquire stock, they have been selling almost an equivalent number of shares. If loans have little effect on a manager's overall exposure to stock price, they do little to align incentives.

Because loans apparently do little to increase the pie, Kahle and Shastri's evidence that these loans generally do not substitute for other forms of compensation suggests that loans have resulted in incremental managerial appropriation.

*C. The Empirical Evidence Is Generally Inconsistent with the Optimal Contracting Model (and Consistent with the Managerial Power Model)*

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

*1. Deal Bonuses*

Grinstein and Hribar's deal bonus evidence is most clearly in conflict with the 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 this model.<sup>182</sup> Recall, however, that the evidence suggests that deal bonuses are not efficiency enhancing.<sup>183</sup> They do not appear to lead to increased share value, but they do result in incremental compensation for CEOs, which means that deal

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ownership of stock prior to the grant of new stock or options, loans made to facilitate purchase or option exercise had a substantial impact on share ownership. See *id.* Thus, I do not rule out the possibility that executive loans could be pie enhancing in some cases.

182. Even if this were the case, however, deal bonuses would be somewhat problematic under the optimal contracting theory. Holmstrom and Milgrom showed that high-powered incentives directed at managerial activity *A* can be counterproductive if managerial activities *B*, *C*, and *D* are difficult to monitor. See Holmstrom & Milgrom, *supra* note 91, at 50. Thus, in order for deal bonuses to be value enhancing under the 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.

183. See *supra* Part V.B.1.

bonuses result in an incremental transfer of a slice of a fixed pie from shareholders to managers.<sup>184</sup>

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

The deal bonus evidence is much more consistent with the managerial power model. Deal bonuses are plausibly justified as specific incentive compensation: 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.<sup>185</sup> This conclusion is reinforced by another Grinstein and Hribar finding that cross-sectional variation in M&A deal bonuses correlates with measures of CEO power.<sup>186</sup>

## 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. However, evidence that option compensation does not substitute for other compensation but is granted as a pure add-on suggests some incremental appropriation.<sup>187</sup> This incremental appropriation is inconsistent with the optimal contracting model.

The fact that options *exist* is not inconsistent with the optimal contracting model unless options can be shown to reduce shareholder value, and this has not been shown. Options may result in

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184. See *supra* Part I.B.

185. See also BEBCHUK & FRIED, *supra* note 5, at 127-30 (discussing managerial power explanation for deal bonuses).

186. See Grinstein & Hribar, *supra* note 21, at 121, 136-39.

187. See *supra* Part V.A.1.

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.<sup>188</sup> 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 the optimal contracting model, one would expect substitution of options for non-option compensation at least to that extent.<sup>189</sup> 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 the optimal contracting model, such as a lack of indexation of option exercise prices to markets and the practice of repricing options following downturns.<sup>190</sup> Other features, such as reload rights, unnecessarily complicate option assessment and valuation.<sup>191</sup> By

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188. See, e.g., Holmstrom & Tirole, *supra* note 37, at 93; Murphy, *supra* note 56, at 2515.

189. See *supra* Part III.E.3.

190. See Bebchuk et al., *supra* note 5, at 796-817, 821-24.

191. See *id.* at 831-34. Options with a reload feature result in the issuance of new options

increasing the difficulty and cost of monitoring, these features may increase managerial appropriation via options. Under the optimal contracting model, however, 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 the 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.<sup>192</sup> As discussed above, 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 companies<sup>193</sup> and by findings in another study that significant shareholder opposition to a proposed stock option plan results in reduced CEO pay in the following year.<sup>194</sup> This latter finding suggests shareholder outrage is doing more work than optimal contracting.

### 3. *Perks and Loans*

Evidence that executive loans and personal aircraft use do not reduce traditional compensation also seems more consistent with the managerial power view than optimal contracting.<sup>195</sup> First, if we assume that loans and jets do not increase the pie, but instead

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to executives who exercise options by surrendering stock. *Id.* at 832.

192. *See id.* at 812-15.

193. *See* Benz et al., *supra* note 153, at 3 (finding that weak institutional controls are associated with greater stock option grants); Bertrand & Mullainathan, *supra* note 153, 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).

194. *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*, 11 J. CORP. FIN. 61, 75-77 (2005) (examining stock option proposals made during the 1998 proxy season).

195. *See* Kahle & Shastri, *supra* note 161, at 802; Yermack, *supra* note 159 (manuscript at 15, 33 tbl.III).

transfer a slice from shareholders to managers, directors acting in accordance with the optimal contracting model should simply eliminate these programs. Second, even if one believes that programs of this sort are efficiency enhancing, the lack of any substitution of loans and perk consumption for other compensation suggests incremental appropriation that is inconsistent with the optimal contracting model, because internal monitoring of loan issuance and perk consumption should not be difficult. The pure add-on nature of the loan and corporate jet perk is much more consistent with the managerial power view.

The corporate jet perk case is not completely closed, however. Yermack did not find perk consumption to be associated with weak corporate governance,<sup>196</sup> unlike the studies of deal bonuses and stock option grants discussed above.

#### 4. *Insider Trading*

As noted, a recent study by Darren Roulstone has found evidence that insider trading substitutes to some extent for conventional compensation.<sup>197</sup> 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.<sup>198</sup> 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 Manne<sup>199</sup> and by Carlton and Fischel,<sup>200</sup> or does so at the fairly low level of informed trading that is permitted under

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196. See Yermack, *supra* note 159 (manuscript at 24-25).

197. See Roulstone, *supra* note 163, at 526.

198. *Id.* at 540-41.

199. See MANNE, *supra* note 102 (arguing that insider trading can improve the efficiency of securities markets and of managerial compensation).

200. See Carlton & Fischel, *supra* note 25, at 866-72; see also Jie Hu & Thomas H. Noe, *Insider Trading and Managerial Incentives*, 25 J. BANKING & 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).

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 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 is 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 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, on the one hand, and corporate executives and their compensation consultants, on the other. This section 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. The opacity of supplemental executive retirement programs and golden parachute arrangements and the need for enhanced disclosure of

these items has been discussed above.<sup>201</sup> David Yermack has recently investigated noncontractual executive severance benefits, colloquially known as golden handshakes.<sup>202</sup> 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.<sup>203</sup> Particularly opaque were enhancements to pension programs and adjustments to previously awarded executive compensation, which together constituted about 54% of the total benefits paid in his sample.<sup>204</sup> In addition, about 18% of the benefits took the form of consulting or non-competition arrangements, both of which are somewhat opaque and plausibly justifiable to shareholders.<sup>205</sup> 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 noncontractual benefits provided.<sup>206</sup> The latter, which are particularly suspect, should be separately disclosed.

Generally, corporate charitable contributions are not covered by the SEC's mandatory disclosure regime and are not disclosed to shareholders.<sup>207</sup> This lack of disclosure enables executives to direct contributions to pet charities and receive psychic and perhaps

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201. See *supra* Part IV.B.

202. David Yermack, *Golden Handshakes: Separation Pay for Retired and Dismissed CEOs* (Sept. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=594423>.

203. *Id.* at 3.

204. *Id.* at 3, 43 tbl.V.

205. See *id.* Although Yermack recognized that payments to a departing CEO for services as non-executive board chairman for several years following his departure at times represents additional disguised severance pay, Yermack excluded these payments from his study because of the possibility that some of this pay was earned for additional services. See *id.* at 24.

206. In fact, the SEC should mandate such disclosure of all executive compensation elements. See BEBCHUK & FRIED, *supra* note 5, at 192-94.

207. See Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHI. L. REV. 1191, 1201 (2002) (noting the general rule and explaining that charitable awards that constitute executive compensation are an exception to the general rule); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 581-82 (1997) (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"). But see NYSE LISTED CO. MANUAL § 303A.02 (2004) (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).



material benefits without triggering shareholder outrage.<sup>208</sup> Of course, some corporate contributions will be trumpeted. The whole idea behind sponsorship of the Metropolitan Opera<sup>209</sup> or Masterpiece Theatre<sup>210</sup> 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 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 should be more difficult to justify large payments to the CEO's favorite charities than to justify ostensibly business-related perks. This analysis strengthens the case for mandatory disclosure of significant corporate contributions.<sup>211</sup>

However, enhanced disclosure is a double-edged sword. Increased disclosure requirements concerning compensation element *A* may lead executives to favor a less efficient, but more opaque, compensation element *B*. Thus, in order for mandatory disclosure to increase shareholder value, disclosure practice must stay tightly attuned to compensation practice, effectively preventing executives from circumventing the requirements.<sup>212</sup> In addition, enhanced disclosure may lead to executive compensation ratcheting upwards as firms benchmark compensation against each other.<sup>213</sup> Nonetheless, the

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208. James Boatsman and Sanjay Gupta provide empirical evidence that managers "invest" in corporate charitable giving beyond the profit-maximizing level. See James R. Boatsman & Sanjay Gupta, *Taxes and Corporate Charity: Empirical Evidence from Micro-Level Panel Data*, 49 NAT'L TAX J. 193, 206 (1996). This evidence is consistent with the view that managers derive utility from charitable contributions.

209. Prior to the withdrawal of its sponsorship in 2004, Texaco underwrote radio broadcasts of the Metropolitan Opera for sixty-three years. Verena Dobnik, *Met Opera, Texaco End Partnership After 63 Years*, PITTSBURGH POST-GAZETTE, Apr. 29, 2004, at E3.

210. Mobil (and subsequently ExxonMobil) sponsored PBS presentations of Masterpiece Theatre for thirty years prior to ending its association with the show in 2004. David Bianculli, *No One Bidding on 'Masterpiece'*, N.Y. DAILY NEWS, Jan. 12, 2004, at 79.

211. See, e.g., Kahn, *supra* note 207, at 586 (arguing for mandatory disclosure of corporate contributions amounts, identities of recipients, and director interlocks).

212. See BEBCHUK & FRIED, *supra* note 5, at 194.

213. See Bebchuk et al., *supra* note 5, at 791.

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.<sup>214</sup> Shareholders may have benefited from this movement generally, but managerial appropriation has likely increased as a result of this movement 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 out of or into 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

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214. 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 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, Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 15 and 18 U.S.C.).

their own accounts.<sup>215</sup> Thus, these avenues of appropriation are problematic even under the optimal contracting model.

I argued in Part III that mandatory legal prohibitions could provide extracontractual enforcement mechanisms and sanctions that could reduce the agency costs associated with these practices under the 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 one is skeptical of the optimal contracting model after reviewing the evidence presented in Part V, then 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 is also a plausible justification for permitting these 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 take a corporate opportunity can be a win-win if the corporation is less able or unable to exploit the opportunity.<sup>216</sup>

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.<sup>217</sup> In any event, policymakers should recognize the potential for appropriation offered by these channels

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215. See Talley, *supra* note 97, at 282.

216. However, these justifications are much more persuasive in the close corporation context. See Brudney & Clark, *supra* note 3, at 1001-06.

217. See *id.* at 1022-24, 1028-32 (presenting a cost-benefit analysis supporting a categorical prohibition against public company executives taking corporate opportunities).

and the insufficiency of opt-in regulation if the optimal contracting model is not fully descriptive of the contracting environment.

### CONCLUSION

If the most striking trend in executive compensation over the past several decades has been its seemingly inexorable rise upward,<sup>218</sup> 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 executive compensation.<sup>219</sup> Today executive stock options have supplanted cash salary as the largest single component of the average large company CEO's pay package,<sup>220</sup> 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 nonconventional 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 channels of appropriation has likely led to an overall increase in managerial appropriation. If one is skeptical of the optimal contracting story and thinks it more likely that compensation is limited by external market forces or saliency and outrage in accordance with the managerial power view, then one must conclude

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218. See Perry & Zenner, *supra* note 147, at 123-24 (documenting the dramatic increase in CEO compensation during the 1990s); see also Murphy, *supra* note 56, at 2486 (providing similar information).

219. See Murphy, *supra* note 56, at 2487 fig.1.

220. *Id.* at 2515.

that this increased complexity and opacity has led to a very significant rise in the manager's share of corporate value.