**Stanford University**

**From the SelectedWorks of John Donohue**

December, 1997

# Executive Compensation

John Donohue, *Yale University*

Available at: https://works.bepress.com/john_donohue/30/

# Executive Compensation

John J. Donohue*

A critical function of law is to establish ground rules that will provide incentives for individuals to pursue their own advantage in a way that will ultimately further the interests of society as a whole. Countries, such as the United States, that have generally chosen wisely in providing this legal structure have experienced great prosperity, while countries that have made poor choices have experienced strife and hardship. One subset of the vast aggregation of rules and institutions that have effectively promoted economic growth in this country is the system of American corporate law (broadly conceived), which has the primary function of channeling the productive capacities of the corporate sector in a socially desirable direction by encouraging the managers of corporate assets to make an infinite array of choices about the use and allocation of these assets in a way that will increase the firm's value without infringing on important public interests. The regulations governing the compensation of corporate executives are an important component of this broad and elaborate set of legal ground rules.

In crafting the most socially desirable rules governing executive compensation, the legal architect hoping to array the incentives of corporate managers in a socially desirable way soon runs into the problem of "who will guard the guardians?" For example, if professors graded their own papers, grades would be very high indeed.[1] Even if professors did not grade their own papers, but instead chose a group of their friends to grade them, grades would still be higher than some objective standard would warrant. If instead of choosing their friends, professors simply asked others who they suspected would be favorably disposed toward them and then promised to pay them handsomely and continuously for the act of grading, we would again expect the grades to be too

---

* John J. Donohue, Professor of Law and John A. Wilson Distinguished Faculty Scholar at Stanford Law School, has a Ph.D. in economics from Yale University and a law degree from Harvard Law School. He is currently a member of the Labor Studies section of the National Bureau of Economic Research. His broad focus is on the empirical evaluation of public policy issues, including executive compensation.

[1] The General Counsel to the California Public Employees' Retirement System (CalPERS) has observed that having the CEO serve as Chairman of the Board is "like grading your own papers." Edward Iaccobucci and Michael Trebilcock, *The Law and Economics of Executive Compensation*, (forthcoming 1997) (manuscript at 45-46, on file with author).



HeinOnline -- 3 Stan. J.L. Bus. & Fin. 1 1997

high. Of course, while excessively generous grading is a problem in itself, the first problem spawns a second: if papers are valued highly without regard to merit, then quality will tend to fall because it is always easier to coast than to struggle to achieve.

The analogy to the issue of executive compensation should be obvious. We know that institutional steps will be taken to limit the exercise of complete personal discretion to set compensation. But we also know that, when all is said and done, it is not likely, nor ultimately desirable from a profit maximizing perspective, to limit all the perks and benefits that the average executive will receive to what he or she truly deserves.[2] At the same time, if compensation is not structured in a way to encourage good performance by the CEO, then the problem of excessive compensation will be compounded by the problem of inadequate performance.

Interestingly, it has become increasingly clear that the use of options indexed to some comparative industry benchmark will provide the correct set of incentives for corporate executives while eliminating the overcompensation generated by recent massive awards of standard options during a period of very rapid stock market price rises. The question of law is how best to encourage the shift toward the most socially desirable method of corporate compensation, which should enhance social wealth by the billions of dollars each year, given that top executives will have every incentive to maintain the current system that has benefited them so handsomely at the expense of their shareholders. Without doubt, the goal of achieving the optimal social policy in this area of executive

---

[2] It is not profit-maximizing to limit compensation to what the executive deserves, because it is costly to do so. At some point the monitoring expense will exceed the cost of the loss flowing from the overcompensation. Therefore, the expected result is that CEOs of public corporations will be overcompensated.

The case of Peter Grace is illustrative. Despite his enormous enthusiasm for pointing out waste in government, Grace was not particularly abstemious when it came to spending corporate money on his private nurses, Manhattan apartment, private cook, security services, and private use of the corporate jet and limousine services—all after stepping down as Chief Executive in 1992.

When his hand-picked successor J.R. Bolduc tried to stop Grace's wasteful expenditures of corporate resources, Bolduc was nailed by Grace's efforts to dig up dirt on Bolduc. The charge was sexual harassment of female employees, and it led to Bolduc's departure. The story shows that even when a CEO shows loyalty to his position and to the corporation rather than to his benefactor, the cost of trying to restrain excessive compensation is often high. In Bolduc's case, he was bounced out of his job—although he did walk off with an annual pension of $848,000, and a large severance payment of $15 million plus an "extra $5 million," according to Grace director Robert Macaulay. Kenneth Gilpin, *W.R. Grace Discloses Benefits Package Given Retiring Chief*, N.Y. TIMES, Apr. 11, 1995, at C24.

HeinOnline -- 3 Stan. J.L. Bus. & Fin. 2 1997

compensation will be advanced by those, such as the contributors to this symposium, whose scholarly efforts will alert policy makers and courts to the significant problems in this area and to the most helpful approaches to restrain the acquisitive instincts of insufficiently inhibited corporate executives.

HeinOnline -- 3 Stan. J.L. Bus. & Fin. 3 1997