

A R T I C L E S

Complementarity in Monitoring and Bonding: More Intense Monitoring Leads to Higher Executive Compensation

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Executive Overview

Agency theory addresses problems created from the separation of principals and agents in modern corporations. Some agency theorists have investigated the exact relationship between control mechanisms (monitoring and bonding) and suggested that they work as substitutes. We posit that, although monitoring and bonding may be concurrent substitutes in a system of governance, monitoring intensity is positively related to bonding (i.e., compensation) so that *over time*, they are complements rather than substitutes. In particular, we suggest that increased monitoring intensity shifts risk to managers, who then require greater compensation to offset their increased employment and career risk. Accordingly, they reinforce each other in a negative cycle such that monitoring leads to increased pay, which in turn leads to increased monitoring due to complaints of excessive pay. The result is that in today's economic environment society often criticizes executive pay without realizing that, in part, higher compensation is an outcome of prior increased monitoring intensity. These findings are particularly important as elected officials are increasingly under pressure to monitor and limit executive compensation. An understanding of this relationship also has implications for executive risk taking and entrepreneurial activities.

Agency theory has provided the foundation for theoretical research and day-to-day implementation of corporate governance devices that have been used to oversee the management of publicly traded corporations. Agency theory focuses on reducing agency problems that derive from the separation of principals (owners) and agents (managers) in modern corporations. Two of the fundamental mechanisms agency theory proposes to address the agency problem are monitoring and bonding (compensation¹). However,

controversy remains over two fundamental issues: how well these mechanisms work to curb the agency problem (Kaplan, 2008a; Locke, 2008; Walsh, 2008) and what the exact relationship is between the two mechanisms.

Relative to the first debate, some have sug-

conceptualize bonding as total compensation, although generally a substantial portion of compensation is in the form of stock-based compensation. Stock-based compensation is inherently more risky than salary and annual bonus. As such, the risk associated with incentive compensation is also a "cost" the CEO and other top executives bear because it can fluctuate based on firm performance. Therefore, in this paper we use the terms "incentive compensation" or just "compensation" to refer to the implementation or practical application of bonding. We use "bonding" when referring to the theoretical construct as posited by agency theory.

¹ Bonding refers to costs the owners (principals) incur to provide incentives that the agent will act in the owners' interest. In this paper, we

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gested that monitoring and compensation have been ineffective in reducing and controlling CEO self-serving behavior, citing as evidence that executive compensation is unreasonably high and has increased much more dramatically than firm performance (Bebchuk & Fried, 2006). Others have argued that Bebchuk and Fried's conclusion is inappropriate (Canyon, 2006). Monitoring is not broken, but rather monitoring has become increasingly intense due to the greater numbers of independent outsiders on boards and on key board committees. This trend has come, as explained more fully later, due to listing requirements on exchanges and other regulatory changes such as the Sarbanes-Oxley Act of 2002 that required more outsiders to head key board committees such as the auditing committee.

Relative to the second debate, some have pondered the exact relationship between these mechanisms and have suggested that they may work as substitutes (Rediker & Seth, 1995). They argued that when executives are given appropriate incentives that align executive behavior to shareholder interests, monitoring activities are needed to a lesser extent. Accordingly, this line of research suggests that there is a systematic balance between these governance devices (monitoring and compensation).

In this paper we provide an alternative perspective on the controversies surrounding the efficacy of and the relationship between monitoring and compensation as a means to control agency costs. We posit that, although monitoring and compensation may be concurrent substitutes in a system of governance, over time increases in monitoring intensity are related to increases in compensation so that they are complements rather than substitutes in the longer term. In particular, we suggest that increased monitoring intensity shifts risks to managers, who require higher pay to compensate them for the increasingly intense employment risk they must undertake as key executives.

Similar to Canyon's position, we posit that control mechanisms are not broken down but rather that they continue to intensify, as noted above. We build on this insight by connecting this increased intensity to a risk-shifting phenomenon where managers are required to take on more risk

and thus require increased compensation. Consistent with Zajac and Westphal (1994) and Rediker and Seth (1995), we believe that these control mechanisms (monitoring and compensation) are interrelated. However, we argue that they are long-run complements and not short-term substitutes. Recognition of this relationship seems critical as society and its elected representatives examine executive compensation and means to control it.

In this paper we show that over time, escalating executive compensation is a predictable effect of more intense monitoring. First, we provide evidence of trends in monitoring intensity. Next, we examine how increased monitoring intensity has created a risk-shifting phenomenon. Subsequently, we examine trends in compensation and other outcomes resulting from risk shifting to managers. Finally, we discuss implications of this perspective. We conclude with a discussion of other theoretical perspectives that may balance the agency theory perspective, explore future research, and propose possible solutions to the controversy surrounding the efficacy of and relationship between monitoring and compensation.

Trends in Monitoring

Agency theory suggests that it is important to allocate risks and responsibilities for decision control to parties who are best able to perform them (Fama & Jensen, 1983). To preserve this specialization, boards must manage shareholder-manager relations in a way that does not unduly shift residual risks onto managers. Maintaining an appropriate risk-reward balance for both parties is an important function of the board of directors (Fama & Jensen, 1983). Although boards are viewed as an entity to protect shareholder wealth, an additional important role of the board is to manage the contract with managers so that managers are adequately compensated relative to the market. As monitoring intensity increases, managers' job security is less certain, and they may view it as having to take on extra risk. Because of this extra risk, over time they demand and are able to receive more pay. In this section, we examine trends in board monitoring and changes in ownership that provide the background necessary to

Figure 1
Increase in Percentage of Institutional Investor Ownership in the U.S. Stock Market



Source: Gillan and Starks (2007).

understand the trend toward increased monitoring intensity. In addition to examining internal monitoring mechanisms (i.e., ownership concentration, boards of directors, and board leadership structure), we also examine external monitoring mechanisms (i.e., macro institution policy change and the market for corporate control).

Ownership Concentration

Ownership of firms has become increasingly concentrated. Empirically, ownership concentration is generally defined to include both the number of large-block shareholders (i.e., those who own 5% of the firm) and the total percentage of shares that they own. Theoretically, as ownership concentration increases (i.e., as the number of large-block holders increases), monitoring is expected to become more effective (Shleifer & Vishny, 1986), and it is more likely that managers' decisions will increase shareholder value.

In practice, institutional owners have become the dominant ownership group in the United States and the United Kingdom (Monks & Minow, 2004). Institutional owners (agent owners) are financial institutions such as stock mutual

funds and pension funds that manage the assets of the general public. Over the years, some have become very large, and because of their size constitute large-block shareholder positions. In fact, large-block shareholders such as institutional owners have been increasing in number and size and have thereby increased the average concentration of shares held in large U.S. corporations. As Figure 1 shows, institutional ownership in the U.S. stock market has steadily increased over more than 50 years, with ownership increasing from less than 10% in 1952 to more than 70% in 2006 (Gillan & Starks, 2007).

When organizations such as pension and mutual funds have large ownership positions, it is difficult to exit via simply selling the stock. As an alternative to "voting with their feet," these owners often become active in regard to governance initiatives that try to hold managers accountable for their strategic actions. Often, when top managers exhibit excessive opportunism (or incompetence), institutions with large shareholdings pressure the board to change the management team. If the board is reluctant to change managers, blockholders sometimes attempt to change the compo-

Table 1
CEO Duality and Lead Independent Directors

CEO Duality	2002	2006	2007	
Companies separating chair/CEO role	25%	32%	35%	
Companies with truly independent chair	n/a	10%	13%	
Lead Independent Directors	2004	2005	2006	2007
Lead directors	114	144	165	178
Presiding directors	300	303	298	270
Total	414	447	463	448

Source: Spencer Stuart (2007).

sition of the board through proxy votes. During the early 1990s, for example, institutional owners began to shift their attention away from CEOs to focus more on the board's responsibility to preempt these problems by providing independent oversight and vigilance (Monks & Minow, 2004). As CalPERS CEO Dale Hanson suggested, "We are no longer into CEO bashing. We are now into director bashing" (Monks & Minow, 2004, p. 197). The focus on boards has led to greater board independence from the firm's CEO and upper management, and increased the board's ability to monitor managers more intensely.

Board Leadership Structure

There have been substantial calls for firms to give less power to a single CEO, and thus we are seeing the chairmanship of the board and the chief executive officer role being divided. Theoretically, the separation of chairman and CEO should facilitate monitoring. However, in the vast majority of firms in the United States, the CEO also holds the chair role. This dual-position structure is less pervasive in firms outside of the United States. For example, very few firms in the United Kingdom operate under the dual-position structure (Boyd, 1995; Dalton & Kesner, 1987; Monks & Minow, 2004).

Research suggests that the dual-position structure (CEO duality) has persisted because it has strategic leadership benefits: It increases decision-making speed and creates unity in the command structure of a firm (Finkelstein & D'Aveni, 1994). Although the unification of power associated with CEO duality might be useful when a firm is in crisis and needs to have a consistent message, in regard to monitoring CEO behavior and perfor-

mance it's "rather like the fox guarding the hen house" (Dalton & Dalton, 2005). In other words, the chair of the board has effective control of the oversight of corporate management and could potentially use that control to inhibit appropriate oversight of him or herself. As noted in Table 1, the trend toward board independence has manifested itself in a higher percentage of S&P 500 firms separating chairman and CEO roles. In 2007, 35% of firms in the S&P 500 separated the two roles, compared to 25% in 2002. There has also been a slight increase in the percentage of firms with truly independent chairpersons, from 10% in 2006 to 13% in 2007.

An alternative and intriguing practice to separating CEO and chairperson positions is to have a lead independent (outside) director (LID) (Lipton & Lorsch, 1992). The LID is chosen from the ranks of the outside independent board members and allows the CEO to maintain his positional status. The LID serves as a liaison between corporate management and the outside board members (Dalton & Dalton, 2005). Thus, the outside directors no longer have direct contact with the CEO if an evaluation of the CEO's performance is required. This enables a more independent evaluation of the CEO but also protects the CEO from being unnecessarily distracted, especially when the board is dealing with routine matters. The LID alternative seems to satisfy the need to unify the strategic leadership of the firm but also enables increased monitoring. The dramatic increase in LIDs in S&P 500 firms generally supports this assertion. (See Table 1). Since 2004, the number of LIDs has increased by 56%, compared to a drop of 10% in presiding directors

Table 2
Prevalence and Independence of Standing Committees

	2002	2007	2002	2007
	% With This Committee		% Composed Entirely of Independent Directors	
Audit	100%	100%	97%	100%
Compensation/HR	100%	100%	94%	100%
Nominating/governance	77%	99%	75%	100%
Executive	50%	39%	2%	4%
Finance	32%	33%	57%	71%
Public policy/social & corporate responsibility	15%	11%	77%	77%
Legal/compliance	n/a	5%	n/a	92%
Science & technology	4%	5%	71%	67%
Environment, health & safety	5%	5%	63%	91%
Investment/pension	16%	4%	36%	65%
Risk	n/a	3%	n/a	44%
Acquisitions/corporate development	n/a	3%	n/a	39%
Strategy & planning	3%	3%	58%	54%

Source: Spencer Stuart (2007).

over the same time period. Taken together 90% of all S&P 500 firms have either an LID or a presiding director. In summary, either of these approaches, splitting the roles of CEO and chair or creating the role of the LID, increases the scrutiny of the CEO and the strategic decisions the CEO will make. Thus, either approach intensifies the governance associated with board of director monitoring.

Macro Institutions and Boards of Directors

Policies at the macro institution level (i.e., recent legislative and stock exchange policies) have been enacted to increase board independence and, in turn, increase monitoring intensity. The Sarbanes-Oxley Act established standards for board independence but focused exclusively on audit committee member independence (Green, 2005). As section 301(m)(3)(A) of the act provides, "In general—each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent." In response to this requirement, 100% of firms in the S&P 500 have audit committees composed solely of independent directors. However, as Table 2 illustrates, both compensa-

tion and nominating committees are also now completely composed of independent directors, and other committees, such as those focused on legal/compliance and environment/health/safety issues, have steadily increased in percentage of independent committee members.

Additionally, stock exchanges have increased listing requirements for director independence. For example, both the New York Stock Exchange and the NASDAQ have implemented more rigorous listing guidelines for firms and have developed more comprehensive definitions of director independence. Both exchanges require that a majority of a listing firm's board be composed of independent directors.

The movement toward greater levels of director independence is reflected in the changes of board composition on the S&P 500. A study by Spencer Stuart (Spencer Stuart, 2007), a consulting and executive search firm, indicates that boards of S&P 500 firms have become more independent in recent years, with 81% of directors classified as independent. Compare this number to a study by Patton and Baker (1987) indicating that in 1985 and 1969, 68% and 52% of directors (respectively) were classified as outsiders. The

trend toward greater independence has continued and is also reflected in the fact that in 2007, nearly 43% of S&P 500 firms had the CEO as the only nonindependent director on the board, up from 31% in 2002 and 23% in 1998 (Spencer Stuart, 2007). Thus, following more stringent legislation and exchange requirements, boards are being composed of more independent directors, which increases the likelihood of more intense monitoring.

The Market for Corporate Control

Beyond internal governance mechanisms, there also exist external governance mechanisms to monitor management and further ensure the alignment of interests between management and shareholders. The market for corporate control is an external governance mechanism that, according to some scholars, disciplines underperforming firms and managers. The market for corporate control is often viewed as a “court of last resort” (Kini, Kracaw, & Mian, 2004). This suggests that the takeover market as an external source of discipline may be used only when internal governance mechanisms have been relatively weak and proven to be ineffective (O’Sullivan & Wong, 1999).

Research, however, has shown that takeovers are often less about disciplining poorly performing firms and more about gaining control of firms (whether high or low performers) that will yield a high return relative to the investment made by the purchaser (Sinha, 2004). For example, a study of active corporate raiders in the 1980s showed that takeover attempts often were focused on firms that were performing above average in an industry (Walsh & Kosnik, 1993). Similarly, Weir and Wright (2006) found that intensified internal governance and nondisciplinary takeovers may actually work as complements. However, the distinction between disciplinary and nondisciplinary takeovers remains empirically difficult to verify (Schwert, 2000). Taken together, this research suggests that takeover targets are not always low performers with weak governance. Thus the market for corporate control may not be as efficient a governance device as theory suggests. Nevertheless, CEO turnover is likely to increase with a takeover, regardless of whether the takeover is a disciplining mech-

anism or is pursued as an appropriate investment. As such, an active market for corporate control effectively increases CEO employment risk.

Although the market for corporate control may be a blunt instrument as far as corporate governance is concerned, the takeover market has continued to be very active. In fact, 2007 was a record year for acquisitions, with a value of \$4.5 trillion. Acquisition activity in 2007 was an extension of previous records set in 2006 and 2005, with roughly 33% of these deals being funded by private equity firms (Karnitsching, 2008). Although the value of deals in 2008 was down about 30% from the prior year (\$3.1 trillion) (Karnitsching & Cimilluca, 2009), the market for corporate control is still very active relative to historical levels. A recent flurry of transactions in the financial sector (e.g., Merrill Lynch, Lehman Brothers, Countrywide, and Wachovia) is a prime example. In fact, research suggests that the more intense governance environment may have fostered an increasingly active takeover market (Kumar & Ramchand, 2008).

The trends noted above strongly suggest that CEOs and top management teams are facing increasingly intense monitoring in all forms and from all sources. To summarize, increased concentration of ownership, less power associated with the CEO position due to board leadership sharing, more regulatory influence and requirements in regard to board structure focused on more independent boards, and continued threat from the market for corporate control have resulted in increased monitoring intensity. In the next section we suggest that this creates a risk-shifting phenomenon for managers. We explore further how this risk shifting is connected to compensation.

Intense Monitoring and Shifting Risk to Managers

In this subsection we explore first how increased monitoring has led to higher CEO turnover and shorter average CEO tenure. Employment risk is a central tenet of agency theory (Eisenhardt, 1989) and a major driver of CEO behavior. CEO turnover and shorter average CEO tenure are primary indicators of the level of employment risk, so we will initially review the trends in CEO tenure

and risk. If managers bear more employment risk they would be expected to ask for more pay to compensate for this risk. As a result, we will next examine the trends in executive compensation. Finally, we review how risk shift affects strategic decision making in large firms by examining product diversification. From these three constructive steps we will illustrate that over time monitoring intensity and compensation are cyclically related.

Outcomes of Intense Monitoring: CEO Tenure and Dismissal

A logical consequence of increased monitoring is an associated increase in CEO turnover and shorter average CEO tenure. Indeed, there is evidence that today's CEOs spend fewer years in office and are dismissed with increasing frequency than their predecessors. This is illustrated in an annual study of CEO succession by Booz and Company that found that global CEO turnover rates increased 59% between 1995 and 2006. Additionally, instances in which the departing CEO was dismissed or forced out increased by an astounding 318% during this same period, with one in eight forced out in 1995 compared to one in three forced out in 2006 (Lucier, Wheeler, & Habbel, 2007). As we have suggested, these higher turnover rates have been attributed "to the legislative and regulatory reaction to corporate scandals, the rise of the corporate governance movement, and the increasing activism of institutional shareholders" (Karlsson et al., 2008, p. 80).

Further evidence of the impact of more intense monitoring can be seen in the fact that when firms separate CEO and chairperson positions, CEO dismissal rates are higher than dismissal rates for CEOs who are also chairs. In the United States, where CEOs generally are also chairs, the dismissal rate of CEOs who never held the chairperson position was 57%, compared to 28% for CEOs who had held the position since the beginning of their tenure and 33% for CEOs who were granted the position later in their tenure (Karlsson et al., 2008).

Additionally, CEO tenure has also been affected by the increase in more intense monitoring. In a recent study conducted in conjunction with the National Bureau of Economic Research,

Steven Kaplan and Bernadette Minton found that average CEO tenure has fallen to as low as six years. "[T]his is substantially shorter than the average tenures reported in previous work for the 1970s, 1980s, and 1990s" (Kaplan & Minton, 2006, p. 3). This research suggests that as other forms of monitoring have intensified, boards too have become more sensitive to firm performance and as such have begun to act more quickly to remedy poor performance through CEO dismissal. This emphasis on performance or outcome controls has increased employment risk for managers (Eisenhardt, 1989). Not only do dismissed CEOs lose their jobs, but often they lose their human and social capital, become stigmatized, or suffer other reputational losses that damage their market value and make it difficult to find a new job (Wiesenfeld, Wurthmann, & Hambrick, 2008). As a new CEO takes the reins of a firm and becomes cognizant of the more intense monitoring environment and the associated increase in employment risk, it is very likely that he or she will seek ways to manage and/or be compensated for this risk.

The Relationship Between Monitoring and Compensation

We argue that a risk-shifting phenomenon is taking place such that more intense monitoring shifts risks to managers, requiring them to take on more risk and therefore receive more pay. Interestingly, there is a significant amount of research in both management (e.g., Rediker & Seth, 1995) and finance literature (e.g., Lippert & Moore, 1995) that suggests there is a substitution effect between monitoring (for example, measured by the number of outside independent directors) and executive compensation (long-term incentive compensation or stock options). Although these associations suggest that in the *current period* one governance device might be balanced out by another in a system of governance, our argument proposes that the level of monitoring intensity results in increased compensation in the *next period* of time rather than the current period. Furthermore, although research has found that risk shifting is related to higher executive pay (Miller, Wiseman, & Gomez-Mejia, 2002), our arguments connect

monitoring intensity to the risk-shifting phenomenon. Additionally, our argument is an *over time* argument. For example, if a CEO is dismissed by a board due to an increased sensitivity to monitoring firm performance for other purposes (e.g., failed strategy), the new CEO would enter either a failed situation or a situation in which the strategy needs to be revamped—both of which are risky undertakings vis-à-vis the new CEO. Accordingly, the new CEO (whether chosen from inside or outside the firm) would seek protection by negotiating a higher salary, improved incentive compensation to encourage risk taking, and a golden parachute (compensation for early termination as a result of a change in ownership) to take on the greater risk associated with the increasingly intensive monitoring environment (see arguments by Hermalin and Weisbach, 2003).

Trends in Executive Compensation Magnitude

Executive compensation, as noted above, is another control mechanism used by boards of directors to influence executive behavior. Boards set compensation to ensure that executives have the appropriate incentives to create shareholder wealth. An abundance of evidence indicates that executive compensation has and continues to increase dramatically. In and of itself this increase is not problematic; however, the evidence suggests that shareholder wealth has increased at a much slower rate.

Over the last 20 years, there has been a dramatic increase of CEO pay. *Forbes* reports that for the period 1989 through 2008, total compensation for CEOs of Fortune 500 firms increased at 9.5% per year. Over the same period, the S&P 500 index increased at a rate of 8.2%, and the average wages for workers increased by only 4.3% (Popken, 2007). By comparison, in 2007, CEOs made 344 times (Anderson, Cavanagh, Collins, Pizzigati, & Lapham, 2008) what the average worker made, up from 71 times in 1989 (Mishel, 2006).

A closer look at the components of average CEO pay helps to explain the increase in pay and what is likely fueling the increased scrutiny. Salary and bonus, which made up 65% of total CEO pay

in 1989, increased at roughly the same rate (4.2%) as workers' pay. However, forms of pay labeled "other compensation" (about 8.6% of pay in 1989) increased annually at 15.7%, while gains from stock (26.1% of total pay in 1989) increased 13.2% per year. Stock gains are the main driver of the increase in CEO pay. These increases are significant, yet the increases for the highest paid CEOs are even more dramatic. While average pay for Fortune 500 CEOs reached nearly \$13 million for 2007, compensation for the top 50 CEOs, those most likely to be covered in the popular press, averaged \$57.5 million, with the average pay for the top five CEOs reaching \$142.7 million.

For all CEOs, compensation growth is driven by gains in stock valuations that CEOs were given as an incentive to increase shareholder wealth. In 1993, S&P 500 firms granted CEOs options and grants worth a total of \$857 million. For 2007, options and grants given to CEOs by S&P 500 firms had increased to \$5.8 billion. The main argument for the use of stocks as compensation is that they create a tight link between stock price performance and the executive. Increases in stock price, which are driven by the information investors have about firms' future earnings, translate directly into wealth for the CEO. The CEO, in theory, is therefore more likely to engage the firm in activities that will increase the firm's future earnings, as they result in increased personal wealth through stock price appreciation. This is the bonding argument put forward in agency theory. The research suggests that when large direct owners are in place, compensation does not become excessive because such owners have an incentive to monitor compensation (Zajac & Westphal, 1994). However, when institutional owners dominate as the largest owners, they prefer to rely more on stock-based incentive compensation because their large portfolios do not allow them to use more costly direct monitoring of managerial effort (Black, 1992).

Trends in Executive Compensation Beyond Salary and Stock Option Incentives

As stated above, compensation is used as a mechanism to align manager incentives with the cre-

ation of shareholder wealth. Although we have focused our arguments on central forms of compensation, stock-based incentive and cash-based salary and bonus, these are not the only forms of pay CEOs receive. CEOs often receive other forms of compensation such as perquisites, golden hellos (signing bonuses), golden parachutes, and pensions, which also can be related to risk shifting.

Allowance of perquisites can be very valuable for executives, and is often less easily measured and/or less likely to be disclosed in accessible records. As noted in *Forbes*, perquisites are “executive personal benefits, such as premiums for supplemental life insurance, annual medical examinations, tax preparation and financial counseling fees, club memberships, security services and the use of corporate aircraft” (DeCarlo, 2008). Like other forms of pay, perquisites and other compensation are on the rise. In 2007, Fortune 500 CEOs reported \$365,000 in other compensation, up from \$112,000 in 1992, an annual increase of 8.2% per year.

Golden hellos, golden parachutes, and pensions can also be valuable. Golden hellos and golden parachutes are large lump sum payments paid, respectively, upon hire or termination. Pension plans, such as supplemental executive retirement plans (SERPs), are paid out over several years (Kalyta, 2009). These additional types of compensation serve as a type of insurance policy. The golden hello may be viewed as compensating the CEO for leaving an environment where the task set and benefits are known and certain for an environment where responsibilities and benefits are unknown. “Such golden hello payments are intended to make the executive ‘whole’—in essence to treat the executive as if his career were one smooth ascent with no costly interruptions” (Cresswell, 2006). Mark Hurd received a \$20 million golden hello upon being appointed CEO of Hewlett-Packard, which, as one researcher noted, was “absolutely unrelated to his performance” (White, 2005).

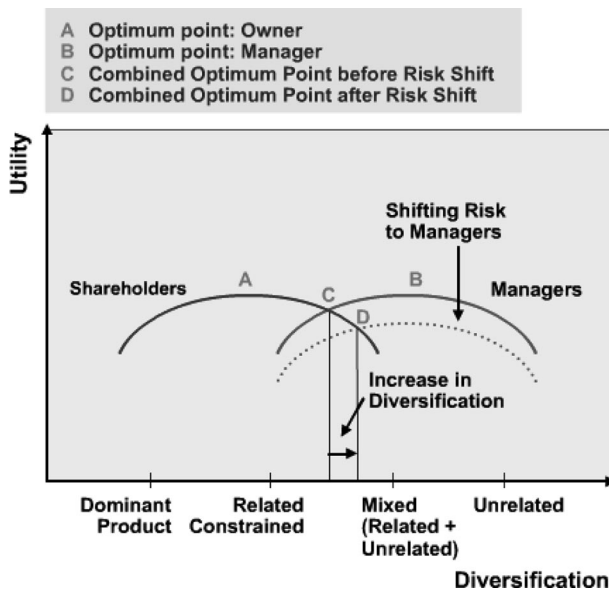
Severance payments in the form of golden parachutes and pensions may also be negotiated at the point of hire. The literature generally views golden parachutes as a takeover defense. How-

ever, they are usually put in place as part of the negotiations when a new CEO or management team is put in place—not in reaction to or in anticipation of an imminent takeover. Thus, in practice, golden parachutes (as well as golden hellos) now appear to be part of the contracting process for new executive leaders and the standard package negotiated between new CEOs and the board’s compensation committee. Nevertheless, some recent severance agreements have led to an increase of criticism of severance payments. CEOs at several high-profile firms have received enormous payments upon departure, including Bob Nardelli at Home Depot (\$210 million), Angelo Mozilo at Countrywide Financial (\$110 million), Michael Ovitz at Disney (\$140 million), and Stan O’Neill at Merrill Lynch (\$161 million). The 2007 Fortune 500 firms reported \$10.2 billion of reserves on the books for severance payments for their current CEOs.

The causes and effects of huge severance payouts have been studied from a number of theoretical perspectives. According to Lys, Rusticus, and Sletten (2007), severance agreements serve to protect CEOs from factors affecting firm performance that are beyond their control. Firms in industries with inherently volatile stock returns may result in early termination for low performance. Likewise, young CEOs are more likely to have severance agreements than older CEOs, perhaps to compensate them for greater future losses if they are terminated. If key managers feel that they may be stigmatized for firm failure they may ask, as we have argued, for higher severance packages upon becoming key managers. “Thus, some portion of the high pay that executives and directors receive can be thought of as compensation for bearing extreme career risk” (Wiesenfeld, Wurthmann, & Hambrick, 2008, p. 247). As such, these additional payments generally protect managers from the increased employment risks they may experience in taking a new position.

As noted above, while the literature on the relationship between monitoring and compensation has argued that these two mechanisms are substitutes (which suggests a negative relationship), we argue that the opposite is in fact true. Monitoring and compensation are positively re-

Figure 2
Intense Governance Shifts Risk to Managers



lated such that increased monitoring leads to increased executive compensation due to risk shifting. In essence, we suggest that they are complementary in a negative way; increased monitoring leads to increased risk for managers, which leads to increased demand for pay for the increased risk. In turn, complaints about excessive pay lead to increased monitoring, suggesting a negative cycle. Next, we discuss how indirect effects related to strategies (in particular diversification strategy) might also contribute to the connection between monitoring and compensation.

Diversification and Risk Shifting

To illustrate risk shifting more fully we use firm diversification strategy as an example. Research suggests that product diversification is a common way for managers to reduce their employment risk (Amit & Livnat, 1998). Shareholders view optimal diversification to be less than what managers would prefer. This is illustrated in Figure 2, which shows optimal utility (or welfare) level firm diversification for managers compared to shareholders. Because shareholders can diversify their risk through other means such as the diversification of their stock portfolio, they do not want firms to diversify extensively. Thus shareholders' optimal point A on the shareholders curve depicts an

optimal position for shareholders, which is less than what managers would prefer (point B).

Managers, on the other hand, can receive more utility from more extensive diversification. Diversification can reduce employment risk; if one business fails, the whole organization survives due to diversification and the CEO is likely to retain his position. Furthermore, because firm size and executive compensation are related and because diversification is related to firm size, diversification can provide an avenue of increased compensation for managers.

As the intensity of governance increases, managers are less able to reduce their employment risk by diversifying corporate assets. For instance, research has shown that, all other things being equal, firms with large-block shareholders tend to have lower levels of diversification. This is because these shareholders tend to be vigilant monitors of managers, making sure that managers do not overdiversify the firm (Hoskisson, Johnson, & Moesel, 1994). Without the ability to diversify the firm as highly, managers face higher employment risk (i.e., risk is shifted to managers), as represented by the lower dashed line under the Managers curve in the lower right quadrant of Figure 2 (Anderson & Reeb, 2003). If increased diversification is not a possibility (see Point D of Figure 2), given the added risk they have incurred managers are likely to require higher compensation.

Discussion

In this paper we argue that the intensity of internal and external monitoring influences the amount of pay that executives receive in overall compensation, not only salary and bonus but also contingent compensation and additional compensation such as golden parachutes. Thus, more intense monitoring shifts risk to managers and, over time, leads them to demand more pay to compensate for the increased risk created by the more intense monitoring environment. We argue that this correlation is due in part to an overreliance on agency explanations. Because monitoring and bonding are the two main governance devices suggested by agency theory, it appears to us that the *over time* connection between monitoring and

compensation leads firms into a position where a governance dilemma is created. Intense monitoring leads managers to demand more pay and more pay leads to increased governance intensity, often forced by regulatory agencies. As such, an overreliance on agency theory and the instruments it suggests actually becomes part of the problem.

In the rest of this section, we address alternative explanations for increased compensation besides increased monitoring intensity. We then discuss future research from the perspective that we have put forward. Finally, we propose some issues derived from our proposal that might be considered to improve the practice of corporate governance.

Alternative Explanations for Increased Executive Compensation

Besides the perspective presented in this paper, increases in executive compensation can be explained in at least three additional ways. In general, the following explanations probably all contribute to the trend to some degree, although we suggest why they may be less salient than our argument regarding monitoring intensity.

The first explanation deals with CEO human capital (Combs & Skill, 2003). CEOs must be able to process and make sense of enormous volumes of information under conditions of great uncertainty, and often in very short time frames. Contemplate a typical Fortune 500 firm: It operates on multiple continents, has several major business lines and myriad products and services, and faces fierce product competition; it must constantly develop new technologies to remain competitive, remain attractive financially, comply with changing legal standards and reporting requirements, and remain socially legitimate. CEOs must be able to identify and capture strategic opportunities and respond to the often conflicting needs of multiple stakeholders.

If one believes that the business environment is becoming more complex, then compensation is increasing because CEOs deserve it. They are compensated for their talent and skill at leading complex organizations in hypercompetitive markets (Kaplan, 2008a, 2008b). However, it is difficult to see that managerial talent has increased as

dramatically over these last few decades as has compensation. As noted earlier, CEOs made 344 times in 2007 what the average worker made, up from 71 times in 1989. It is hard to believe that their human capital has increased this dramatically in less than 20 years (Walsh, 2008). Furthermore, as noted above, the evidence suggests that their pay exceeds the value they are supposed to be producing in these key managerial positions. If their human capital is highly valued in the market, logic suggests that they would be producing improved stock valuations in the firms they manage, especially given the dramatic increase in pay they have been receiving. However, this has not been the case.

A second explanation is referred to as the managerialist perspective (Bebchuk & Fried, 2006). From agency theory, we learn that managers and owners have different risk preferences. Managers seek to reduce risk associated with their employment (Fama, 1980). Proponents of this explanation claim that managers gain power over their environments and therefore are able to influence their pay to their advantage. CEOs have significant influence on the activities of the firm. For example, the relationship between firm size and CEO compensation has been documented for almost a century (Taussig & Barker, 1925). Thus CEOs can increase their pay by growing the firm's revenues, irrespective of firm profits (Barkema & Gomez-Mejia, 1998). However, above-mentioned trends indicating (a) increased power of owners, (b) increased board vigilance over CEO alignment with owner interests, and (c) shorter average CEO tenure are not consistent with the notion that CEO power over CEO pay has increased.

A third explanation deals with social capital and network ties. Some argue that CEOs are hired at "arm's length" such that compensation reflects the outcome of negotiations between two unrelated parties, the CEO and the board of directors. Research has shown, however, that corporate elites are highly connected both professionally and socially (Bebchuk & Fried, 2006). CEOs often serve on the boards of other firms. They frequent the same social clubs and events, and may have attended the same schools. The network has a vested interest in the success of one of its own.

Social comparison theory suggests that board members may compensate highly a CEO who is part of their network as a means of reaffirming their own value (O'Reilly, Main, & Crystal, 1988).

Although this notion has been shown to have merit through empirical studies, the tenets of this explanation have become less salient as more recently CEOs have tended to serve on fewer boards. Burr (2007) reported that CEOs in 2006 "fill 53% fewer corporate directorships outside their own companies than they did in 1990." The main explanation for this is that CEOs are reducing their commitments to other boards because they "face mounting pressure . . . to focus virtually all of their attention on running their own companies" (Burr, 2007). The rationale for this is that CEOs are facing an "over-managed, over-inspected environment" (Burr, 2007) that may be hobbling talented CEOs from serving on other boards. Moreover, the report suggests that "the growing structure of governance policies, procedures, reviews and approvals is believed (by many CEOs) to be lowering the level of risk that boards and CEOs seem willing to embrace in the interest of progress" (Burr, 2007). This analysis suggests that the trend is due to more intense monitoring and scrutiny that CEOs are facing. In fact, the quality of outside director networks with critical executive experience is decreasing as the current financial crisis takes its toll. The *Wall Street Journal* reported a "growing number of directors with demanding day jobs who are quitting or planning to quit corporate boards just when those companies need them most. In recent months, directors have cited time commitments in leaving the boards of Ford Motor Co., Sprint Nextel Corp. and American International Group Inc. [AIG]" (Lublin, 2008). Thus, the network perspective seems to have less salience as fewer networked partners staff key board committees such as the compensation committee. In fact, several of these alternative explanations, including this one based on social comparison theory, seem less salient due to the increased intensity of monitoring itself.

From this we conclude that tying more intense monitoring to higher compensation has merit rel-

ative to these alternative perspectives. As such, we present some suggestions for future research, both empirical and theoretical, in subsequent sections.

Future Research: Positive Complementarity and Possible Moderators to the Monitoring and Compensation Relationship

We have suggested that the relationship between monitoring and executive compensation is complementary but in a negative way, with increased monitoring leading to increased risk for managers, who then require higher compensation for the increased risk. However, we believe future research is still needed to examine and clarify this relationship. For example, recent research by Wright and colleagues (Walters, Kroll, & Wright, 2008; Wright & Kroll, 2002; Wright, Kroll, & Elenkov, 2002) suggested that monitoring and CEO compensation may positively complement one another to increase firm performance and increase shareholder returns after acquisitions. We believe this perspective may complement our view in that it suggests that these governance mechanisms may work together *concurrently* when they are in balance. However, when one control mechanism becomes more intense than the other, the relationship may become negatively reinforcing as undue risk is shifted to managers *over time*. This remains an area for future research to examine, given the potential complexity of this relationship.

We also believe there are a number of contingency and intervening variables that may influence the relationship between monitoring and executive compensation. First, firm performance may be a critical variable that influences this relationship. For example, if a firm is performing well it is less likely that monitoring intensity will increase dramatically. Weisbach (1988) found that boards were much more involved, for example in CEO dismissal, when a firm experienced a period of low performance. During times of low performance, monitoring may intensify as the board becomes more active in the management and control of the organization (Lorsch & MacIver, 1989). Thus, future research may examine how firm performance may be a key determinant

of the overall complementarity between monitoring and compensation.

Additionally, further research is needed to examine the many different forms of executive compensation and how they may affect the overall relationship between monitoring and compensation. CEO compensation is not only large, but comes in many different forms, and these different forms can interact to affect the degree to which pay in general can be used to influence CEO behavior. One of the consequences of multiple forms of compensation is that it may reduce the relative proportion and/or salience of stock option pay. For example, the above-mentioned golden hellos may suppress the overall impact of stock option pay on CEO behavior. "The existence of the golden hello undermines the very reason stock options and executive pensions are offered in the first place—to encourage executives to hit performance targets and then to stick around to receive the full value of their compensation package" (Cresswell, 2006). Additionally, some researchers argue that big severance packages, fostered by golden parachutes, lead to an increase of highly risky CEO behavior (Sanders & Hambrick, 2007), especially if the CEOs hold large amounts of stock options. Risky investments will increase stock price volatility. If the investment is successful, the expected value of the stock options increases; if the investment is a failure, the expected value of the severance package increases. Thus, high value severance packages increase the likelihood of CEO risk taking. Either way, the CEO is protected, but the shareholder benefits only if the investment is successful. At the other extreme, the expectation of receiving performance-contingent pensions such as SERPs (Kalyta, 2009) has been shown to cause CEOs nearing retirement to avoid necessary and acceptable levels of risk, which is likely to reduce potential shareholder value. Examining the interaction of multiple forms of executive compensation, such as the mixture of stock options, golden hellos, and golden parachutes, may provide a fruitful area for future research.

Overall, we believe research is still needed to examine the relationship between monitoring and compensation. Extant research has suggested that

monitoring and compensation are concurrent substitutes and positive complements, and conversely, we have suggested that they are negative complements, although we suggest that this later relationship becomes apparent over time. Thus, examining the complexity of the relationship between the many different forms of monitoring and compensation, and how they may work in concert with or opposition to one another to affect firm outcomes, remains a vital area for future research. Additionally, we have suggested a number of intervening and contingency variables that should be considered in examining the relationship between monitoring and compensation.

Implications for Theory

The arguments and explanations contained in this paper have important implications for theory as well. Agency theory has been the dominant foundation for governance practice and policy, and is based on the idea of diffuse ownership. Clearly, diffuse ownership is no longer the dominant situation for large publicly traded firms. As we have suggested, the application of agency theory may create further problems, some of which, like excessive executive compensation, are the exact outcome the application seeks to avoid. Thus, other theories to supplement agency theory and guide governance practice and policy seem warranted. We highlight two theoretical perspectives that may help to highlight and possibly correct the current governance dilemma: multiple agency theory and team production theory.

An emergent theory that examines the conflict owners and managers face is multiple agency theory (Arthurs et al., 2008). This theory is designed to examine the potential conflicts of various agent owners relative to the agent manager of the firm and provide and predict possible outcomes for the firm relative to the conflicts or joint alignment among various agent owners. This theory may be useful in times of agent owner-supported changes such as acquisitions, restructuring divestitures, bankruptcy, IPOs, and other settings wherein there is an increasing number of potential conflicts due to significant principal changes. As owners become concentrated and gain power over critical aspects of the firm, such as the governance

processes, conflicts will inevitably ensue because agent owners represent different ultimate principals. Some research might focus on how managers undertake to manage such “conflicting voices” (Hoskisson et al., 2002). For example, agent owners have a range of activities that focus on governance proposals to direct aggressive tactics for changing the strategy of the firm (private equity firms for example). Managerial agency might have a range of activities in response, from less aggressive cooperative strategies to moderate strategies such as monitoring through an investor relations department (Marcus, 2005) to more aggressive influence strategies such as appeasement.

Team production theory (Blair & Stout, 1999) would complement agency theory in managing these agent owners’ conflicting interests. Team production theory holds that the firm’s board of directors’ key function is to mediate among organizational team members and as such complement agency theory. Team members in this view can be all stakeholders, including a variety of capital stakeholders and bond holders. Agency theory is quite thin in regard to maintaining the contract with key managers, who would be another key constituent in team production theory. Although agency theory prescribes that the board is to hire, fire, and reward the top officers of the firm, team production theory goes much further by suggesting that there needs to be trust in the board in order for key managers and key stakeholders to feel comfortable enough to make firm-specific investments. Such firm-specific investment is critical for firms intent on innovating and establishing competitive resources (Wang & Barney, 2006). However, complete contracting is not possible during the innovation process as well as in much of the complex strategic management process that top managers pursue. As such, it is important for boards to create an atmosphere of trust when such incomplete contracting is required. In this light, the board serves as an impartial mediating body, looking after the interests of all team members (Kaufman & Englander, 2005).

Implications for Practice

Besides theoretical suggestions, we also provide some implications for practice. The main objec-

tive of this paper has been to argue that increased monitoring intensity shifts risk to managers, which then leads managers to seek and obtain greater compensation. We have based our argument on trends in monitoring intensity and executive compensation over the last several decades. If we extrapolate the trends, we would predict that executive compensation will continue to remain high, all else being equal. Below we address implications of our arguments on practitioners and policy makers and make suggestions to improve corporate governance in general.

Given the current regulatory environment, the balance between monitoring and CEO compensation is not solely dependent on the direct stakeholders of the firm. Legislation mandating increased monitoring is likely to have led to increased CEO pay because of an inappropriate amount of risk shifted from shareholders to managers. For example, the implementation of the Sarbanes-Oxley Act has created a situation where monitoring intensity will remain strongly in the hands of outside directors. This and other regulatory requirements suggest that the situation will be difficult to change. Also, given that many failing firms where the CEO has exited with a large severance package have created negative media attention, public interest in the magnitude of CEO pay has led lawmakers to investigate perceived inequities in executive compensation practices. If public outcry over executive compensation leads to efforts to legislate pay limits (such as President Obama’s initiative to limit CEO pay; see Mandel, 2009), CEOs will be forced to bear inappropriate amounts of risk for which they will not be compensated. As such, they will likely reduce their employment risk in indirect ways such as through implementing less risky strategies, for instance, which may lead to lower innovation rates (Kalyta, 2009). Perhaps for this reason among others, the Obama administration has “dialed down” the criticism of executive compensation after the earlier proposals (Langley, 2009). An important implication of our explanation, at a basic level, is that risk shifting is essentially a zero-sum game: Any decrease in shareholder risk will be absorbed by managers, who will, in turn, require compensation for the increased risk or find

other indirect ways to reduce their risk or increase their compensation such as through acquisitions or creative new forms of pay.

Some management researchers do not acknowledge risk as a part of the equation, but suggest that action can and must be taken in order to curb excessive CEO pay (Bogle, 2008; Walsh, 2008). This position seems to assume that the trend of rising compensation is reversible if some appropriate action were to be taken. The primary questions in this line of reasoning are who should take action and what action should be taken. Boards of directors are directly responsible for negotiating compensation contracts with CEOs. Initiatives to increase monitoring intensity are unlikely to be repealed given the current regulatory environment. The choice that boards have is to increase the effectiveness of monitoring such that less risk is shifted inappropriately to managers. Making monitoring practices more effective by incorporating more of a strategic emphasis in the evaluation system would create some balance rather than relying primarily on financial outcomes alone (Thomas, Schrage, Bellin, & Marcote, 2009). Thus, managers would be evaluated not only on financial outcomes but also on the quality of the strategic formulation with agreement of the board about the quality of the strategy undertaken (Baysinger & Hoskisson, 1990). As such, for example, the emphasis on the lead independent directors would be useful if their analysis is also incorporated into the performance appraisal system for the CEO. These suggestions are in line with predictions from team production theory such that there is more trust in the board's monitoring by all parties involved (Kaufman & Englander, 2005). Of course, without appropriate levels of trust in our corporate governance systems, there are significant discounts given to the market in general.

As mentioned above, agency theory has driven the vast majority of legislation governing business practices. If something cannot be done to correct the problem, we would predict the start of a new cycle: Good managers would migrate out of publicly held companies; less qualified CEOs would take their place, and firm performance would de-

cline; large blockholders would seek more attractive investment opportunities in nonpublic (private) companies; private companies would enjoy an increase in funding from blockholders fleeing public companies; and good CEOs would join privately held companies that are not subject to the laws of publicly held companies. Thus, if legislation to limit CEO pay is passed, we expect a flight of capital and talent into privately held companies where an appropriate balance of risk and reward can be achieved. Alternatively, as noted above, managers may reduce their risk taking to compensate for increased risk (Kalyta, 2009). As noted by Locke (2008), over time and in general, the market for executive labor and appropriate levels of pay will find an equilibrium.

Conclusion

In this paper we have described the connection between the increased intensity of monitoring in publicly traded firms and executive compensation through the principle of risk shifting found in agency theory. Intense monitoring has led to overpaying managers to compensate them for the increased risk experienced due to such monitoring. Accordingly, the two principal governance devices founded in agency theory, monitoring and compensation, have created a cycle in which managers are paid excessively, requiring that corporate governance become more stringent, and, as corporate governance becomes more stringent, managers are paid even more. This cycle of governance results in a lack of trust in managers and in the governance devices employed to oversee them. Thus, more research and theoretical development is needed to create a balance in the governance structures of publicly traded corporations. It is hoped that this paper will spur interest in the additional theoretical development and research. Furthermore, we hope that this future research will lead to helping firms to extricate themselves from the current governance dilemma.

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