

Long-Term Executive Compensation as a Remedy for Corporate Short-Termism

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INTRODUCTION

It is often argued that corporations are too focused on the short term (i.e., they are “short-termist”). For example, during the 2016 U.S. presidential campaign, candidate Hillary Clinton urged companies to escape the tyranny of short-termism.¹ Similarly, in the recent policy debate in the United Kingdom on the need to reform corporate governance and executive compensation, Bank of England’s Chief Economist Andy Haldane stated that “[e]xecutive pay is a matter of profound and legitimate public interest. Pay practices can encourage short-term behaviour in ways which harm both firms and the economy.”²

In this context, a recent article by Flammer and Bansal (FB) published in the *Strategic Management Journal* argues that long-term executive compensation can help mitigate short-termism.³ More precisely, FB show that the (quasi-random) adoption of long-term executive compensation leads to an increase in firm value, an increase in long-term profits, and is conducive to long-term investments such as investments in innovation and stakeholder relationships. In this Article, I briefly review the core arguments and main results of FB.

I. A “TIME-BASED” AGENCY CONFLICT

In the economics literature, the relationship between shareholders and managers is often conceptualized as a *principal–agent relationship*,

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1. Jennifer Epstein, *Hillary Clinton Calls for Investors to Escape ‘Tyranny’ of ‘Short Termism,’* BLOOMBERG (July 23, 2015), <https://www.bloomberg.com/news/articles/2015-07-24/hillary-clinton-calls-for-investors-to-escape-tyranny-of-short-termism->.

2. David Oakley & Jim Pickard, *Theresa May Suffers Backlash over Flagship Business Reforms*, FIN. TIMES (Nov. 24, 2016), <https://www.ft.com/content/1e804da2-b19b-11e6-a37c-f4a01f1b0fa1>.

3. Caroline Flammer & Pratima Bansal, *Does a Long-Term Orientation Create Value? Evidence from a Regression Discontinuity*, 38 STRATEGIC MGMT. J. 1827 (2017).

where the principal (the shareholders) hires the agent (the management) such that the agent will act in the principal's best interest. However, if the agent's preferences are misaligned with those of the principal, the agent can take actions that are not in the principal's best interest—that is, in the context of corporations, managers can take actions that hurt shareholders and reduce the value of the firm. Such agency conflicts come in many flavors. For example, in Jensen's model, managers have preferences for "empire building"—i.e., managers derive utility from being in charge of a large empire—and hence tend to engage in value-destroying acquisitions.⁴ Other traditional agency conflicts include, for example, managers' preferences for shirking⁵ or managers' tendencies to engage in too little risk-taking.⁶ In all these models, managers act in a way that is not in the shareholders' best interests, which in turn decreases the value of the firm.

FB propose a new form of agency conflict, which they coin a "time-based" agency conflict.⁷ This "time-based" agency conflict arises if managers' time preferences are misaligned with those of the shareholders. FB argue that managers are likely to be more myopic compared to shareholders. In particular, career concerns, short-term compensation, and pressure to meet analysts' earnings forecasts are all considerations that may induce managers to invest in (inferior) short-term projects at the expense of (superior) long-term projects, thus hurting the value of the firm.⁸

To the extent that FB's "time-based" agency conflict has bearing in the data, one would expect the provision of long-term incentives—such as the use of long-term executive compensation—to alleviate managers' tendencies to overinvest in short-term projects and ultimately increase firm value.

II. THE CAUSAL IMPACT OF LONG-TERM EXECUTIVE COMPENSATION

There are three main tools of long-term compensation: 1) restricted stocks (i.e., stocks that cannot be sold in the short run), 2) restricted stock

4. See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

5. See Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979).

6. See Bengt Holmström, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUDIES 169 (1999).

7. See Flammer & Bansal, *supra* note 3, at 1827.

8. See François Degeorge et al., *Earnings Management to Exceed Thresholds*, 72 J. BUS. 1 (1999); Robert Gibbons & Kevin J. Murphy, *Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence*, 100 J. POL. ECON. 468 (1992); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).

options (i.e., stock options that cannot be sold or exercised in the short run), and 3) the so-called long-term incentive plans (LTIP). In practice, LTIPs are implemented in a variety of ways, but typically feature the award of stocks or options contingent on the achievement of some pre-established, long-term targets.

To examine whether the provision of long-term compensation is value-enhancing, one approach would be to regress firm value (e.g., Tobin's Q) on long-term compensation (e.g., the ratio of long-term to total compensation).⁹ However, as FB emphasize, such a regression might be misleading given the potential endogeneity of long-term compensation with respect to firm value.¹⁰ In other words, unobservable characteristics may drive a spurious relationship between the two. For example, it could be that companies with better long-term prospects are both (1) more valuable and (2) more inclined to reward their management through long-term compensation. In this case, one would observe a positive correlation between firm value and long-term compensation, yet it would not be indicative of a causal impact of long-term compensation on firm value.

Admittedly, it is difficult to establish causality. In the ideal experiment, one would randomly assign long-term compensation to some companies and short-term compensation to others—similar to the approach used in randomized controlled trials. One would then compare the differential in firm value between the two groups. Naturally, such an experiment is difficult to conduct in the real world. Instead, FB use an empirical setup that is very close in spirit to this ideal experiment.¹¹ Specifically, they focus on shareholder proposals advocating the use of long-term executive compensation that pass or fail by a small margin of votes. Intuitively, whether a proposal passes with 50.1% of the votes or is rejected with 49.9% of the votes is as good as random. Hence, such “close call” proposals provide (quasi-)randomized variation in the use of long-term executive compensation.

FB consider all shareholder proposals on long-term executive compensation that came to a vote between 1997 and 2012 and are compiled in the SharkRepellent and RiskMetrics databases.¹² There are 808 such shareholder proposals, out of which sixty-five have a vote outcome within $\pm 5\%$ of the majority threshold, and 152 have a vote outcome within $\pm 10\%$ of the majority threshold; intuitively, these

9. “Tobin's Q is the ratio of the market value of total assets (computed as the book value of total assets plus the market value of equity minus the sum of the book value of equity plus deferred taxes and investment tax credit) to the book value of total assets.” Flammer & Bansal, *supra* note 3, at 1835.

10. *See id.* at 1828.

11. *See id.* at 1835–37.

12. *See id.* at 1833.

proposals can be seen as being “close calls.” FB then use a regression discontinuity design to estimate how the adoption of close call proposals affects several outcome variables.¹³

FB’s main result is that the stock market reacts positively to the adoption of close call, long-term compensation proposals.¹⁴ Specifically, FB find that a proposal that is marginally accepted yields an abnormal return of 1.14% compared to a proposal that is marginally rejected; intuitively, shareholder value increases by 1.14%. This finding suggests that long-term compensation is value-enhancing and hence supports FB’s “time-based” agency conflict: by adopting long-term executive compensation—and hence by switching towards a longer-term orientation—companies can alleviate the misalignment of time preferences between managers and shareholders, which ultimately translates into value creation.

FB also explore the impact of long-term executive compensation on operating performance.¹⁵ They examine three measures of operating performance: the return on assets, net profit margin, and sales growth. They find that all three measures increase significantly in the long run (i.e., as of two years after the vote). Interestingly, they find that operating performance decreases slightly in the short run, suggesting that the adoption of a longer-term orientation might require some sacrifices in the short run (e.g., by investing in ambitious research and development (R&D) projects that are costly in the short run). Nevertheless, the net effect is positive since value increases overall.

FB further study the mechanism through which the adoption of long-term executive compensation benefits shareholders. They find that long-term compensation is conducive to long-term investments such as investments in innovation and stakeholder relationships.¹⁶ First, FB document a significant increase in R&D expenditures and the number of patents following the adoption of close call, long-term compensation proposals. What is more, FB observe an increase in the number of highly-cited patents—i.e., not only the *quantity* of innovation increases but also the *quality* of innovation. Also, FB document an increase in the number of explorative patents (i.e., patents in fields that are “new to the firm”), suggesting that companies pursue riskier (and arguably more ambitious) innovation. Second, FB observe that companies significantly increase their stakeholder engagement following the adoption of close call, long-term compensation proposals, as measured by the Kinder, Lydenberg, and

13. *See id.* at 1835–37.

14. *See id.* at 1838–40.

15. *See id.* at 1840.

16. *See id.* at 1840–42.

Domini (KLD) index of social performance from the KLD database. Among the different types of stakeholders, they find that the increase is especially pronounced with respect to employees and the environment. The result pertaining to employees is in line with previous studies showing that employee satisfaction is a significant driver of value creation.¹⁷

FB's findings that companies increase their long-term investments following the adoption of close call, long-term compensation proposals yield further support for the presence of a "time-based" agency conflict. To the extent that myopic managers (i.e., managers whose time horizons are too short-sighted compared to shareholders' time horizons) tend to underinvest in valuable long-term projects, one would indeed expect a shift towards more long-term investments (such as innovation and stakeholder relationships) once managers are incentivized to adopt a longer-term horizon through the award of long-term compensation.

CONCLUSION

FB's results indicate that long-term compensation is effective in mitigating managerial myopia. Their results have been highlighted in the recent policy debate in the United Kingdom on the need to reform executive pay.¹⁸ In his blog post featuring FB's study, Alex Edmans highlights where FB's study fits in the current policy debate:

Executive compensation is fixed and needs reform. But, most of the calls for reform focus on the wrong dimensions. They focus on the *level* of pay . . . [whereas] the most important dimension is the *horizon* of pay—whether it depends on the short-term or long-term.

We certainly want executives to act in the interest of society, and for a more equal society. But, the way to increase equality is not to bring CEOs down, but to induce them to bring others up. Treating stakeholders (workers, customers, suppliers, the environment) well is costly in the short-term, but the evidence shows that it pays off in the long-term. So the best way to

17. See, e.g., Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621 (2011); Alex Edmans, *The Link Between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility*, 26 ACAD. MGMT. PERSP. 1 (2012); Caroline Flammer, *Does Corporate Social Responsibility Lead to Superior Financial Performance? A Regression Discontinuity Approach*, 61 MGMT. SCI. 2549 (2015).

18. See Alex Edmans, BUS., ENERGY & INDUSTRIAL STRATEGY COMM., SUBMISSION TO CORPORATE GOVERNANCE INQUIRY, 2016-17, HC CGV006 (UK), <http://alexedmans.com/wp-content/uploads/2015/02/Corporate-Governance-Inquiry-Short.pdf> [https://perma.cc/9SQY-RG53].

encourage purposeful behavior is not to scrap equity incentives (thus decoupling pay from performance), but extend the horizon to the long-term.¹⁹

While FB's results provide a first step in understanding the benefits of long-term compensation and how it helps mitigate managerial myopia, further research is needed to fully understand the usefulness of this tool. In particular, more work is needed to understand the conditions under which long-term executive compensation is most effective and how it can be best integrated with other governance mechanisms (e.g., the linking of executive compensation to social and environmental performance criteria—a novel governance practice documented by Flammer, Hong, and Minor).²⁰ Making ground on these questions is an exciting avenue for future research.

19. Alex Edmans, *Long-Term Executive Incentives Improve Innovation and Corporate Responsibility*, ALEXEDMANS.COM: ACCESS TO FIN. (Sept. 17, 2016), <http://alexedmans.com/long-term-executive-incentives-improve-innovation-and-corporate-responsibility/> [<https://perma.cc/9C5Z-7MZA>].

20. See Caroline Flammer et al., *Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes* (Sept. 11, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2831694 [<https://perma.cc/9R97-6L2W>].