# UNIVERSITY OF SOUTHERN CALIFORNIA
## MARSHALL SCHOOL OF BUSINESS

FBE 533
Spring 2011

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# COMPENSATION, INCENTIVES, AND GOVERNANCE

## COURSE DESCRIPTION

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The current financial crisis has focused attention on executive compensation amid accusations that the "Wall Street bonus culture" is a root cause of excessive risk taking that led to the crisis. This course investigates the role of compensation in the crisis, and develops a framework to analyze more broadly how organizational value is created (or destroyed) through compensation, incentive and governance systems. Particular attention is paid to problems with top-executive compensation, including defective bonus plans and equity plans, the complacency of the board and compensation committee, misguided government policies, and a general ignorance, confusion or indifference about how value is created and destroyed. Given their increasing importance, the course also focuses on the cost, value, incentives, and expensing of executive and employee stock options. Additional topics covered include the design of incentive contracts for managers and lower-level employees, performance measurement (including EVA), and performance standards. Applications include incentive arrangements in companies going private (leveraged buyouts and private equity), going public (IPOs, spin-offs, carve-outs), as well as companies merging, downsizing and restructuring.

FBE 533 draws heavily (but implicitly) from microeconomics and introductory finance. The course makes extensive use of cases, and assumes some background in number-crunching and financial-statement analysis. The material in FBE 533 is not technical in the mathematical or quantitative sense, but it involves a great deal of theory. In particular, the course develops a conceptual framework useful in understanding a wide variety of real-world incentive problems in organizations.

### PREREQUISITES AND CONCENTRATION CREDIT

This course requires only introductory finance and is open (and accessible) to both finance and non-finance majors.

### EDUCATIONAL OBJECTIVE

The objective of this course is to provide a general framework for analyzing compensation, incentives, and governance in organizations. All organizations have explicit or implicit incentive systems. The educational objective is to stress the importance of these systems in predicting organizational behavior, with particular focus on understanding (and correcting) systems that generate dysfunctional or unintended incentives or results. More broadly, the course will help develop your ability to continue to expand your knowledge of organization theory from the evidence acquired throughout your career. You should not expect to leave the course with a "cookbook" set of solutions or with an encyclopedia of soon-forgotten institutional facts, but rather with a general way of thinking about organizational incentive problems and their solutions.

### CAREER FOCUS

FBE 533 is particularly relevant for students pursuing careers in consulting, corporate finance, accounting, and general management, as well as for prospective owners and entrepreneurs.

### REQUIRED AND RECOMMENDED READINGS

The required readings and cases for the course are available in a "Reading Packet" from the USC Bookstore. In addition to the required readings, there are several "recommended readings" available for you to download from the class "Blackboard" website. These readings are indicated with an asterisk in the syllabus.

### TEACHING PHILOSOPHY

My approach to teaching is to emphasize open classroom discussion and de-emphasize lectures. Cases will comprise about one third of the required readings. Additional assignments include notes, articles from the academic and business press, and computer exercises. Also, I will be distributing additional material such as problems, notes, relevant articles and examples when appropriate.

Because the course is discussion-oriented, it is critical for you to keep up with the readings, and to come prepared to each class. To assist in your preparation, discussion questions for each class session will be distributed weekly and posted on the class website. In the event that preparation levels sag, I reserve the right to resort to other "preparation facilitators" such as cold-calling. The first several sessions develop the basic theoretical "building blocks" used throughout the course. The material in the course is cumulative, so it is important to attend class, keep up with the readings, and take careful notes.

After the first class session I would like you to sit in the same seat each day. This helps me keep track of participation, and makes it easier for you to interact with each other during class discussions. I will create a seating chart on the second day.

An environment for effective learning is one in which people are free to discuss energetically all relevant issues and ideas. As the instructor, I take responsibility for helping guide the discussion and, in particular, for limiting discussion of topics that will take us too far off track. Productive discussions often involve emotional commitment, energy, and disagreements with the ideas of others (including the instructor's). There is a clear distinction between disagreeing with another person's ideas and criticizing him or her as a person. We all have responsibility for preventing the latter; it blocks learning and is therefore inappropriate for the classroom.

## GRADING

The course grade will be based on homework assignments, class participation, a midterm examination, and a final examination. The weights for the final grade are:

| | |
|---|---|
| Homework Assignments | 25% |
| Class Participation | 10% |
| Midterm Exam (March 9) | 25% |
| Final Exam (May 4) | 40% |

*Homework Assignments*. Written responses to homework questions will be due at the beginning of most class sessions. These questions generally involve calculations or issues related to the course discussion for that day, and are used to facilitate your preparation. If you cannot attend class, you may e-mail the homework assignment to receive credit. Homework will be graded and returned within two weeks of the due date. I will consider accepting late homework under special circumstances, but cannot promise to grade and return late homework on a timely basis.

I will drop the lowest six homework scores (out of approximately 24 assignments) with the following exception: assignments for Sessions 22 and 23 are mandatory and cannot be dropped. Also, although you are welcome to compare ideas and results with classmates, I expect students to hand in their own assignments.

*Class participation*. Because this is a discussion-oriented class, I expect all students to prepare and actively participate in classroom discussions. Participation scores will be based on both the quantity and quality of your classroom contributions. The "quantity" of participation will be determined objectively based on my (imperfect) recollection following each class. The "quality" dimension is based on both my subjective assessment and peer assessments of how your participation contributed to classroom learning. High quality participation does not necessary mean providing the right answer or "cracking" the case, but rather presenting views or analyses that provoke debate and stimulate additional discussion.

*Examinations*. The midterm and final examination will consist of short essay questions. Sample "practice questions" will be available on the course website.

## OFFICE HOURS

I will be generally available after class on Mondays and Wednesdays; additional office hours will be announced preceding exams. I will also attempt to answer questions via e-mail (kjmurphy@usc.edu) on a timely basis; this is usually the best way to get in touch with me.

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# COMPENSATION, INCENTIVES, AND GOVERNANCE

# SYLLABUS

**Session 1**
*January 10*

## BANKING BONUSES AND THE FINANCIAL CRISIS

Kevin J. Murphy, "Compensation Structure and Systematic Risk," Testimony to the U.S. House of Representatives (June 11, 2009). **(RP)**

*Fahlenbrach, Rudiger and Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," Ohio State University working paper (January 13, 2010).

**Session 2**
*January 12*

## THE FINANCIAL CRISIS AND EXCESSIVE RISK TAKING

Liebowitz, Stan J. 2009. Anatomy of a Train Wreck: Causes of the Mortgage Meltdown. Chapter in Benjamin Powell and Randall Holcomb (eds.) *Housing America: Building Out of a Crisis*. Transaction Publishers. **(RP)**

Boyd, John H., Ravi Jagannathan and Sungkyu Kwak. 2009. What Caused the Current Financial Mess and What Can We Do About It? Journal of Investment Management 7(4), 1-17 **(RP)**

*Taylor, John B. 2009. The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong. Stanford University, Rock Center Working Paper No. 30.

**Session 3**
*January 19*

## REGULATING PAY IN BAILED-OUT BANKS

Kenneth R. Feinberg, Testimony to the Congressional Oversight Panel (October 21, 2010). **(RP)**

Kevin J. Murphy, "Executive Pay Restrictions for TARP Recipients: An Assessment," Testimony to the Congressional Oversight Panel (October 21, 2010). **(RP)**

**RP**-required reading from Readings Packet.

*-recommended (not required) reading, available on the class website.

**Session 4**
*January 24*

## CEO PAY: 80 YEARS OF GOVERNMENT INTERVENTION

Kevin J. Murphy and Michael C. Jensen, "A Brief History of Executive Compensation: 80 Years of Government Intervention." Working Paper, December 2010
*(To be distributed in class)*

Kevin J. Murphy, "Measuring Executive Compensation" (December 2010) **(RP)**

*Frydman, Carola, and Dirk Jenter, "CEO Compensation," (MIT Working Paper, November 2010).

*Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, Vol. 3b, Elsevier Science North Holland (1999), Chapter 38: 2485-2563.

**Session 5**
*January 26*

## (THERE'S NO) ACCOUNTING FOR CEO PAY

Kevin J. Murphy and Michael C. Jensen, "A Brief History of Executive Compensation: 80 Years of Government Intervention." Working Paper, December 2010
*(To be distributed in class)*

**Session 6**
*January 31*

## WHAT COLOR IS YOUR PARACHUTE?

Kate Kelly, Susanne Craig, and Ianthe Jeanne Dugan, "Closing Bell: Grasso Quits NYSE Amid Pay Furor," *Wall Street Journal*, September 18, 2003. **(RP)**

**Session 7**
*February 2*

## (WHY) ARE CEOS PAID TOO MUCH?

Lucian Arye Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*. 17(3) (Summer 2003): 71–92 (**RP**)

Waxman, Henry A. (et al.). 2007. "Executive Pay: Conflicts of Interest Among Compensation Consultants," United States House of Representatives Committee on Oversight and Government Reform (December) (**RP**)

*Kevin J. Murphy and Tatiana Sandino, 2010. "Executive Pay and "Independent" Compensation Consultants," *Journal of Accounting and Economics* 49 (2010) 247-262

**Session 8** *February 7*

## (WHY) HAS CEO PAY INCREASED?

Bengt Holmstrom and Steven N. Kaplan, "The State of Corporate Governance: What's Right and What's Wrong?" *NBER Working Paper 9613*, April 2003. **(RP)**

Kevin J. Murphy and Ján Zábojník, "CEO pay and turnover: A market-based explanation for recent trends." *American Economic Review* (May 2004). **(RP)**

Kevin J. Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options The University of Chicago Law Review, Vol. 69, No. 3 (Summer, 2002), pp. 847-869. **(RP)**

*Bebchuk, Lucian A., Jesse M. Fried and David I. Walker, 2002. Managerial Power and Rent Extraction in the Design of Executive Compensation, University of Chicago Law Review, 69(3), 751-846. Available from the Social Science Research Network eLibrary at: http://papers.ssrn.com/abstract=316590.

*Gabaix, Xavier, and Augustin Landier, 2007, Why Has CEO Pay Increased so Much? Quarterly Journal of Economics.

**Session 9** *February 9*

## (WHY) ARE US CEOS PAID MORE?

Nuno Fernandes, Miguel A. Ferreira, Pedro Matos, and Kevin J. Murphy, "The Pay Divide: (Why) Are U.S. Executives Paid More?" University of Southern California (December 2010)
*(To be distributed in class)*

**Session 10** *February 14*

## THE GOVERNING OBJECTIVE

James M. McTaggart, Peter W. Kontes, and Michael C. Mankins, "The Governing Objective," Chapter 1 from *The Value Imperative: Managing for Superior Shareholder Returns*, The Free Press, New York, 1994. **(RP)**

Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (October 2001). **(RP)**

**Session 11** *February 16*

## INCENTIVES AND BEHAVIOR

Carlton, Jim, "Commission Clash: A Real-Estate Chain Riles Competitors By Breaking the Rules," *Wall Street Journal* September 10, 1991. **(RP)**

Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay Them, But How" *Harvard Business Review*, May/June 1990, reprint #90308. **(RP)**

**Session 12** *February 23*

## PAYING FOR PERFORMANCE

Kevin J. Murphy, "H.J. Foods Management Incentive Plan," Marshall School Case Study. **(RP)**

Jensen-Murphy-Wruck. Chapter 7: "Problems with Non-Equity Incentive Plans." **(RP)**

**Session 13** *February 28*

## SETTING THE PERFORMANCE STANDARD

Kevin J. Murphy, "Tengo Tequila, LLC," Marshall School Case Study **(RP)**

Jensen-Murphy-Wruck. Chapter 7: "Problems with Non-Equity Incentive Plans." **(RP)**

*Michael C. Jensen, "Paying People to Lie: the Truth about the Budgeting Process," *European Financial Management*, Vol. 9(3), 2003. **(RP)**

*Kevin J. Murphy, "Performance Standards in Incentive Contracts" *Journal of Accounting and Economics* (2000) **(RP)**

*Robert Gibbons and Kevin J. Murphy, "Relative Performance for Chief Executive Officers," Industrial and Labor Relations Review, Vol. 43 No. 3 (February, 1990), pp. 30-51.

**Session 14** *March 2*

## MEASURING PERFORMANCE

Jensen-Murphy-Wruck. Chapter 7: "Problems with Non-Equity Incentive Plans." ( **(RP)**

**Session 15** *March 7*

## VALUE-BASED COMPENSATION

Kevin J. Murphy, "Hatham Technologies," Marshall School Case Study **(RP)**

Shawn Tully, "The Real Key to Creating Wealth," *Fortune*, September 20, 1993. **(RP)**

**Session 16** *March 9*

## MIDTERM

**Session 17** *March 21*

## HOW MUCH IS TOO MUCH?

Michael C. Jensen and Kevin J. Murphy, "Compensation at Lexerd Systems." HBS Case N2-494-066. **(RP)**

Steve Swartz, "Why Gary Gilligan Stands to Qualify for Guinness Book," *Wall Street Journal*, March 31, 1989. **(RP)**

**Session 18** *March 23*

## INCENTIVES AND LEVERAGE

Karen H. Wruck, "Sealed Air Corporation's Leveraged Recapitalization (A)," HBS Case 9-294-122 (Rev. 12/5/97). **(RP)**

*Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance*, July 1993 (revised April 1997).

**Session 19** *March 28*

## MIMICKING LEVERAGE THROUGH PAY

G. Bennett Stewart, "Remaking the Public Corporation from Within," *Harvard Business Review,* July/August 1990, Reprint #90410. **(RP)**

**Session 20** *March 30*

## GENEROUS DYNAMICS

Kevin J. Murphy and Jay Dial, "Compensation and Strategy at General Dynamics (A)." HBS 9-494-048. **(RP)**

**Session 21** *April 4*

## INCENTIVES TO DOWNSIZE

Kevin J. Murphy, "The Executive Compensation Controversy and the Modern Industrial Revolution," *International Journal of Industrial Organization* (1997). **(RP)**

Kevin J. Murphy, "CEO Pay and Downsizing: The Social Consequences," in *CEO Pay: A Comprehensive Look*, American Compensation Association, 1997. **(RP)**

**Session 22** *April 6*

## STOCK OPTIONS

Kevin J. Murphy, "Primer on Stock Options and the Black-Scholes Formula" **(RP)**

Stock Option Valuation Exercise *(Excel spreadsheet downloadable from class website)*.

*Brian J. Hall, "What You Need to Know About Stock Options," *Harvard Business Review*, March/April 2000.

*Alfred Rappaport, "New Thinking on How to Link Executive Pay with Performance," *Harvard Business Review*, March/April 1999.

**Session 23** *April 11*

## STOCK OPTIONS FOR UNDIVERSIFIED EMPLOYEES

Stock Option Valuation Exercise, Part II. *(Excel spreadsheet downloadable from class website)*.

Peter Coy, "Funny Money, or Real Incentive?" *Business Week* (January 15, 2001), p. 71-72. **(RP)**

Brian J. Hall and Kevin J. Murphy, "Option Value Does Not Equal Option Cost," *WorldatWork Journal*, Second Quarter 2001. **(RP)**

*Hall, Brian J. and Kevin J. Murphy. 2002. Stock Options for Undiversified Executives, Journal of Accounting and Economics, 33(1), 3-42.

**Session 24** *April 13*

## TOO MANY OPTIONS TO TOO MANY PEOPLE

Flanigan, James, "It's Time for All Employees to Get Stock Options," *Los Angeles Times* (April 21, 1996). **(RP)**

Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives,* Vol. 17(3) (Summer 2003), 49-70. **(RP)**

**Session 25** **OPTION OPPORTUNISM**
*April 18*

Fried, Jesse M., 2008. Option Backdating and Its Implications. Washington and Lee Law Review, 853-886. **(RP)**

*Yermack, David, 1997. Good timing: CEO Stock Option Awards and Company News Announcements, Journal of Finance, 52(2), 449-476.

*Aboody, David and Ron Kasznik, 2000. CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, Journal of Accounting and Economics, 29(1), 73-89.

*Lie, Erik, 2005. On the Timing of CEO Stock Options Awards, Management Science, 51(5), 802-812.

**Session 26** **THE EARNINGS MANAGEMENT GAME**
*April 20*

Jensen-Murphy-Wruck. Chapter 9: The Earnings Management Game. *(To be distributed in class)*

**Session 27** **THE POLITICS OF PAY: 2011**
*April 25*

Readings **TBA**

**Session 28** **WRAP-UP AND REVIEW**
*April 27*

**May 4** **FINAL EXAMINATION (11:00AM-1:00PM)**