Setting the CEO’s pay:  
It’s more than simple economics

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Abstract

Underlying the contentious debate on CEO pay is a view of the Board of Directors based on an economic theory in which the shareholders and CEO are seen to have conflicting goals— with the CEO attempting to garner more compensation at the expense of the shareholders. Principal-agent theory, the dominant economic perspective, argues that the role of the board is to closely monitor the CEO and to design incentive schemes that align the conflicting interests of the shareholders and management. While superficially reasonable, the empirical evidence for this theory and its effects on corporate governance have been disappointing. We offer here a social psychological perspective on Board functioning in which the CEO and the Board are jointly responsible for firm performance—and subject to the inevitable effects of reciprocity and social influence. Empirical evidence supports this. Implications for board functioning are discussed.
The fascination with CEO compensation is not recent. Articles on the topic date back as far as 1925, and Forbes Magazine’s annual review and tabulation of CEO pay was already a regular feature by the early 1970s. Interest in the topic, however, has seen a marked upturn in recent years – an upturn almost as vigorous as the rise in CEO pay itself. In large part, this increase in interest can be attributed to two things. First, there is the staggering amounts paid to CEOs. Second, and less obvious to casual observers, there is an underlying economic rationale for this based on the development of what is called principal-agent theory—a view of behavior that has come to dominate economic thinking on motivation and incentives. The ready availability of detailed pay awards for CEO’s, in combination with the equally visible measures of CEO productivity (in as much as it can be measured by corporate performance), and an elegant theoretical rationale has presented an irresistible data set on which to test this new theory. Its attractive logic has also allowed it to insinuate its way into most standard explanations of CEO pay.

At its heart, principal-agent theory boils down to a superficially reasonable justification for CEO compensation—pay-for-performance. This, of course, is a comforting perspective when viewing the significant levels of pay commanded by modern CEOs and has led to rewarding CEOs with equity (either in options or in restricted shares) as a way of linking increased compensation to increased performance. Who can object to paying a CEO well if he or she delivers returns to the shareholders, especially if the pay package doesn’t deliver if performance is poor? However, because the equity vehicles used as pay devices correlate only imperfectly with CEO performance, a large proportion of CEO
compensation can be regarded as ‘pay-at-risk’. This in itself is taken by many as a justification under principal-agent theory for higher overall levels of CEO pay.

The trouble is that study after study has failed to find anything that passes as a significant pay-for-performance arrangement among CEOs. When confronted by the data, the dominant paradigm for explaining CEO pay simply fails to produce consistent or plausible estimates of the strength of the relationship. Recently, some researchers have begun to argue that the whole pursuit of a CEO pay-for-performance has resulted in what has been labeled “pay without performance.”

This has opened the way for a counter view that takes the intuitive, if unpalatable, position that CEO pay is really nothing more than theft. Usually couched in more diplomatic terms such as ‘rent appropriation’, ‘stealth wealth’, or pay ‘under the radar’, this argument suggests that, in the absence of a vigilant and responsible board, the CEO and other top management team members enrich themselves at the expense of the shareholder, whose rightful company profits are diverted into ever larger executive compensation packages. This picture of the modern CEO getting up and looking in the bathroom mirror every morning thinking ‘what can I get away with today?’ may be disquieting but, for many, sits better with the empirical reality than the market-led explanations of principal-agent theory.

In this paper, we summarize the evidence for principal-agent predictions of CEO pay and contrast it with a more social psychological view of the CEO pay setting process that
emphasizes the psychological dynamics that occur in the board room that can influence CEO compensation decisions. Unlike the excessively negative view of human behavior posited by economic theories that invoke opportunism and self-dealing, we show how the corporate governance process is subject to the common social psychological effects of reciprocity and social influence that may lead the board of directors to increase CEO pay simply because of identification with the company. In the next section, we review in some detail the basic ideas of principal–agent theory. We then turn to considerations of corporate governance and the social psychological effects that we believe deserve greater attention in the boardroom context than they are usually accorded. We describe some empirical results illustrating these effects and end the paper with a discussion of the implications of our work.

PRINCIPAL-AGENT THEORY AND CEO COMPENSATION – what do we know?
Agency problems occur when the interests of a principal (e.g., the shareholders) and their agent (e.g., the CEO) diverge in ways that may allow the agent to take advantage of his greater knowledge to indulge himself at the principal’s expense (for instance by diverting profits from the shareholders to his own pay, or by failing to take actions that might benefit the shareholders because of a personal loss). Problems of agency in business are most commonly found in the corporate form of business organization where the shareholders cannot closely monitor the CEO. While public ownership of companies allows more ambitious commercial enterprises to be launched than would otherwise be easily arranged, the downside of such large ventures is the well-known separation of ownership from control, as first identified by Berle and Means almost 70 years ago. In
these circumstances the interests of the owners of capital (the principals) will not necessarily coincide with those of the managers of that capital (the agents). At its basest, this can be characterized as the problem that investors face in ensuring that they get their money back. Management or governance that ensures close monitoring of the CEO by the board is clearly one possible remedy, but principal-agent theory points to a wider class of solutions that also include compensation arrangements that linking managers’ reward to investment (or company) performance and, hence, aligning the interests of all parties.

The problem is most acute at the very top of the corporation, where it falls to the board, especially members of the compensation committee, to craft the incentives of the CEO. In this view, the board is assumed to faithfully represent the interests of the shareholders by designing a contract that aligns the firm’s and CEO’s interests. Directors are assumed to resist influence by the CEO and to conduct any explicit or implicit contract negotiation at arm’s length, setting in place incentives that come as close as possible to reflecting what a market-based arrangement would achieve (as if the employee-CEO was actually the owner of the business). Principal-agent theory assumes that deviation from this optimal type of behavior on the part of the directors will be ruled out by the directors’ fear of shareholder law suits or concern over the consequential reputational damage that directors would suffer from failure to impose the appropriate pay-for-performance contract.
Examining individual cases reported in the business press allows one to find ample evidence, either supporting or undermining this view of CEO pay. In fact, Michael Eisner in his early years at Disney Co and Eisner in his later years at the same company (where he received $575 million in a single year—1998) provides strong support both for and against this view. Other examples include John Rigas, CEO of Adelphia, using the corporate jet to transport his daughter’s Christmas tree or Ronald Allen, former Chairman of Delta Airlines, receiving a contract for $500,000 a year in consulting—even if he weren’t alive. But, of course, this is not a reliable way in which to test a theory. More worrying, however, is that the ever growing number of statistically controlled studies in this area do seem to be similarly equivocal on the empirical evidence whether anything like a pay-for-performance regime describes CEO compensation.

On the one hand, supporting principal-agent theory, it has been shown that more independent boards are associated with lower CEO pay. Similarly, higher concentrations of institutional share ownership and a separation of the CEO and board chairman roles have both been associated with higher pay-for-performance sensitivity. On the other hand, these supportive results are countered by studies that show either an insignificant or extremely modest connection between CEO pay and performance. Still other studies directly contradict principal-agent theory by presenting evidence showing that allowing the CEO more control over the board (for example, either through also being board chairman or through having more insiders on the board) can lead to superior performance. Even those experts in the field seen as the most enthusiastic supporters of
this principal-agent view have admitted that it has delivered disappointingly few insights into the actual structure of CEO contracts.

**BOARD GOVERNANCE – is this the problem?**

While principal-agent theory is most commonly associated with pay-for-performance arrangements, it is a much wider concept - encompassing notions of reputation, promotions, career concerns and, at its most basic, being fired. In order to craft the appropriate reward incentives, the board must enjoy a certain degree of independence. Recent corporate failures such as Adelphia, Enron, Tyco and Worldcom have been ascribed to an absence of this independence. The Sarbanes-Oxley Act 2002 can be seen as an attempt to reduce the ‘control rights’ of managers in favor of the shareholders. Thus, vigorous audit and remuneration committees, the elimination of staggered boards, and increased boardroom diversity are all seen as instruments in the battle to free up directors to enable them to establish the appropriate incentives for the CEO and the top management team.

Once again, while intuitively appealing, these notions often flounder when confronted by rigorous statistical studies of changes in corporate governance and their impact on performance. The existence of compensation committees, increases in the proportion of outsiders on compensation committees, and a wide range of other measures of corporate governance integrity have not proven as valid predictors of corporate performance and as explanations of CEO pay.
MANAGEMENT INFLUENCE

The managerial power school of thought takes the position that the CEO contract cannot
be viewed as if it had been drawn up by the board at arm’s length because to some extent
or other the board will have been ‘captured’ by the CEO. The more power the CEO can
exert over the board, the more generous will be the CEO’s pay – both in level and in the
extent to which it is independent of firm performance. This argument has a long pedigree.
One of the best publicized cases of a powerful CEO, portrayed in *Barbarians at the Gate*
(both a book and movie), is found in Ross Johnson’s tenure as CEO at RJR Nabisco.
More recent examples have emerged in the post-Enron investigations, including not only
Enron but also Adelphia, Home Depot, Tyson Foods and many others. The renewed
interest in this view is promoted under the ‘pay without performance’ banner. There is
strong empirical to support the conclusion that the more directors who have been
appointed by the CEO, the greater the protection from threat of hostile takeover, and the
greater the control the CEO commands over board business (through the dual holding of
the board chairmanship) then the less the CEO remuneration contract will resemble
something that might have been negotiated at arm’s length.

There is a tension inherent in this view, however. In terms of effective functioning, the
board of directors is, regardless of its exalted role, a social group. If the board were a
group of strangers, it might do an effective job of crafting a CEO compensation contract
that conforms to the pay-for-performance strictures of principal agent theory (and even
this outcome is questionable). This arrangement would most certainly fail in that all
important aspect of providing advice and counsel to the CEO. There is a fundamental
tension between conformance/compliance and effective corporate performance. The latter depends on an open interchange of ideas and a healthy social interaction. Clearly, the outside directors are likely to perform better in providing advice and counsel if they feel a sense of psychological ownership and identification with the firm. Board members, therefore, find themselves facing a conundrum. On the one hand, they have a fiduciary responsibility to the shareholders but, on the other, they have a strong tacit obligation to help the CEO. And in terms of face-to-face interactions and general social contact, it is the CEO with whom board members are closest.

Contracts, in such circumstances, are likely to lack hard edges, be more implicit than explicit, and be interpreted in a forgiving rather than literal manner. From an economic perspective, the boardroom is seen largely as a ‘black box’ in which the optimal terms of the CEO compensation contract are determined. This theory seems to fall far short of reality. In order to understand more accurately what actually happens in terms of defining and administering CEO pay, it is necessary to look more closely inside this black box. To do this, we turn to some basic considerations drawn from social psychology.

**PSYCHOLOGICAL PERSPECTIVES ON CEO COMPENSATION**

The board is foremost a small group of people making important decisions. The stakes may be unusually high but, at its root, we should not be surprised to find that the process is subject to all the usual social psychological effects that beset group decision making everywhere. And, when dealing with the ambiguous decision of CEO compensation, two of these social psychological effects seem to be particularly important: reciprocity under
which the board may feel obligated to the CEO, and social influence in which the CEO can shape the judgments of the board.

Reciprocity is such a fundamental norm in society that its influence is often overlooked or underestimated. The basic notion is that when one party benefits another then an obligation is generated. As with any norm, there is a strong social expectation about how one ought to behave in certain contexts. Failure to comply with such a norm is usually accompanied by a social sanction. The obligation is more general and less limited than that emerging in the instrumental type exchange, so familiar to economists, as in ‘you give me that and I will give you this’. Reciprocity occurs when an individual is responding to actions even if no material gain is anticipated. Being a corporate director brings both financial and status-related benefits. To the extent that the serving CEO is identified with the bestowing of such office then it is easy to see how board members might feel some reciprocal obligation.

The continued close group interaction of the board over time furthers this effect. In the continuing round of sharing the benefits of these high positions, there is a cycle of reciprocal giving. This serves to cement social relations among the directors and may be a key component in facilitating the giving and taking of advice and counsel between the board and the CEO. On the downside, however, these same effects can have a tendency to blind the board to disappointing corporate performance and to incline them to generosity in terms of compensation arrangements.
A second psychological process of group dynamics that has important implications for boardroom behavior is social influence. In many ways, the world that we inhabit is a socially constructed reality; that is, in uncertain situations we rely on the judgments and behavior of others to determine our actions. Faced with a decision and lacking other salient indicators of the correct response, individuals have a marked propensity to fall back on social cues as to what is or is not appropriate. Thus, the power of deference to authority was famously illustrated in the Milgram experiments which showed that otherwise normal mature individuals were prepared to administer apparently lethal electrical shocks to another person when the situation was arranged to be one of obedience to authority. In a similar way, social comparison is frequently used when we lack another way of determining what is right – for example confronted as to how much we should spend on a new automobile many find it easy to use as a referent how much a neighbor or colleague spends.

In the context of the compensation committee, when confronted by the question of what is a reasonable amount of remuneration there is a strong tendency for individuals to benchmark that judgment on what they themselves earn—or what others in comparable positions make. These influences have been empirically demonstrated for CEO pay awards. Furthermore, these social influence effects are amplified by considerations of social status and similarity. Research has shown that the more similar is the CEO to the other board members (for example, in age, social class, graduate school) then the stronger are these social influence effects. In essence, board members come to view the situation (whether CEO pay or company performance) through the eyes of the CEO with whom
they increasingly identify and sympathize – not because of any corruption but because of the strong and in many other dimensions positive effects of social influence.

**RESEARCH**

In this section we summarize the results of a series of empirical tests that investigate principal-agent theory versus the managerial power predictions for CEO pay, as interpreted through the lens of reciprocity and social influence. We examine firms in two contrasting industries – retailing (129 firms) and semi-conductors (137 firms). Thanks to the assistance of an executive compensation firm, we have a wide range of data on firm size (revenues, employees), performance (total shareholder return), the CEO (age, sex, tenure), the board (number of directors, insider-outsider status, number of meetings, number of committees), individual directors (sex, fees, status, age, tenure) and executive compensation (base, bonus, options granted, long-term incentives, restricted stock grants, etc.).

To test out the ideas sketched previously, we needed to identify and measure some concrete variables to represent the underlying ideas such as principal-agent design, good governance, and so on. For example, in explaining CEO compensation, there are certain fundamental considerations one would expect to find in any explanation of pay. We include under this heading controls for industry, firm size (revenues and number of employees), performance (average shareholder return over the previous three years), CEO tenure, CEO age and CEO gender. In addition, to test the principal-agent view, we utilized the presence of large shareholders (the number of block holders of at least 5%), whether the CEO also served as chairman, the total size of the board (number of directors), and the
number of independent directors on the board. Governance quality is measured by diversity (the number of female directors), the presence of a staggered board, the annual number of board meetings, and the number of committees of the board.

Since the main argument of this paper is that the effects of board decisions on CEO pay can only sensibly be interpreted through the lens of reciprocity and social influence, it is necessary to identify variables by which these effects can be measured at board room level. Reciprocity is assessed by the presence of the CEO on the nominating committee (reflecting the discretion of CEO to ‘give’ directorships), the fees paid to the head of the compensation committee, and the extent to which the CEO was on the board before the chair of the compensation committee (reflecting that the serving CEO ‘gave’ this directorship). The social influence of the CEO over board members is assessed by whether the CEO also serves as chairman (this duality of role facilitating control), the total committees of the board on which the CEO serves, whether the CEO sits on the compensation committee (an increasingly rare event), and the extent to which the CEO was older than the chair of the compensation committee.

Consistent with other investigators, we find that size is relatively more important than firm performance in explaining the various measures of pay – measured in any of six ways: base salary, bonus, total cash compensation, value of stock options, value of restricted stock awarded, and pay-for-performance sensitivity (PPS). This is a common result; one researcher has identified more than 100 studies showing that size explained some 40% of the variation in CEO pay, while performance accounted for a mere 5% of pay. In our study, the variables describing the agency relationship and the structure of corporate governance do not improve
explanatory power greatly and produce the occasional unexpected result – such as a higher number of female directors being associated with higher CEO pay.

Entering the variables that capture social influence and reciprocity effects, further increases explanatory power. On the average, for every $1,000 more in fees that is given to the chair of the compensation committee, the cash compensation of the CEO is $1,746 higher. Also, an increase in the involvement of the CEO on board committees (by one standard deviation) results in an extra $310,000 in restricted stock grants.

One, hitherto overlooked, possibility is that the impact of these social processes is more marked under certain circumstances than others. For, example, social influence is likely to be more effective the more opportunity available to the CEO to exercise it. There are three particular circumstances where this might occur. First, the more frequently a board meets, the more monitoring it can do (in a principal-agent sense). However, this interaction propinquity also affords the CEO to influence more decisions. Second, the more board committees the company has then, again, the greater the opportunity of the CEO to influence affairs. Finally, the greater is the number of independent directors then the more influence opportunities exist for the CEO to influence them – a prediction that runs counter to the standard principal-agent interpretation that more independent directors will improve the monitoring of performance.

Using the entire set of variables, ranging across those that capture principal-agent effects to those that describe good governance and including the basic reciprocity and social influence measures, we examine the extent to which each of the opportunity variables mentioned above moderates the impact social influence. Specifically, we examine the moderating effect of the
fees paid to the chair of the compensation committee and the number of meetings of the board. Figure 1 shows that the impact on total cash compensation to the CEO increases with the level of fees paid to the chair of the compensation committee (a reciprocity effect), but that this effect is moderated by the number of board meetings. The effect is more marked in boards with fewer meetings. It appears that the influence effect is moderated by the number of board meetings to the extent that the impact on CEO pay is most marked with the combination of generous fees and not so many board meetings—more reward for less effort. Increasing fees paid to directors by one standard deviation ($148,000) increases TCC by $185,000 when there are 11 board meetings but by $386,000 with only four board meetings.

In a similar vein, Figure 2 illustrates that the impact on CEO pay of the number of committees on which the CEO serves (a measure of social influence) is more marked the greater number of board committees that exist (because more opportunity exists to exercise influence). Whereas increasing committee participation from zero to two committees adds $272,000 to Total Cash Compensation in the presence of five committees, it can actually reduce TCC by $358,000 when only three committees exist.

Finally, Figure 3 shows that CEO duality (also serving as chairman) can outweigh the impact of extra independent directors on CEO pay. When boards have relatively few independent directors (four in this example), allowing the CEO to chair the board makes little difference to CEO pay. TCC rises by some $24,000. But, when there are seven independent directors, the social influence effect of allowing the CEO to chair the board raises TCC by $469,000,
essentially wiping out any restraining effect on pay that such large number of independent
directors was having. The impact of independent directors on pay is contingent on CEO
influence. This is a key lesson that we take away from this investigation. Governance and
principal-agent effects do not work in isolation from social influence. Social influence has
the effect of moderating such effects.

MANAGERIAL RECOMMENDATIONS
Based solely on the sheer volume of empirical research, principal-agent theory remains the
dominant approach to the study of executive compensation. However, as the results and
discussion presented illustrate, its success in explaining CEO compensation have been
decidedly mixed. A more psychologically nuanced view of how the CEO pay is set helps
explain some of the inconsistent results observed over the years. Our results also present a
fuller picture of boardroom relations in general and the determination of CEO pay in
particular.

Our main message is that within any employment relationship, and certainly within the
boardroom, the universal effects of reciprocity and social influence should be taken into
account. As we have shown, not only do they have a direct bearing on board decision making
but they have the potential to moderate (and dull) the impact of current governance
mechanisms. Thus, we find that the monitoring effects suggested by principal-agent theory
and corporate governance (large boards, diverse boards, and so on) have unexpected effects
on CEO pay. We find that reciprocity and social influence moderate the impact of the
standard principal-agent prescriptions for good governance. Social influence is seen to interact with the effect of the number of board meetings (Figure 1), the number of board committees (Figure 2) and the number of independent directors (Figure 3) in ways that increase CEO pay independent of firm performance.

Much recent research on corporate governance policy innovations has been based on principal-agent theory and emphasized increasing the monitoring efficacy of the board or creating compensation packages that leave the CEO with a strong equity interest in the corporation and, hence, aligned with the shareholders. However, this perspective begins with a strong implicit assumption that the board’s role is that of a policeman protecting the shareholders from theft by the CEO. The operating assumption is that executives are likely to make decisions that are not in the shareholders interests.

But is this a reasonable assumption to make about the relationship between executives and shareholder interests? An increased emphasis on monitoring and effecting incentive alignment makes it more difficult for the advice and counsel, so important to a board’s operation, to be both offered and received. For example, there is evidence that the more institutional pressure there is to make boards structurally independent, then the more CEOs work at reaching out to their board in a personal way. This need not be in self-seeking pursuit of higher compensation, as we documented, but in order to better tune the board into an effective operating institution. Thus, while the optimal contract recommended by principal-agent theory may diminish agency costs, it may also inhibit the board from offering the expert advice that the CEO needs to receive.
Recently, Bengt Holmstron, one of the developers of principal-agent theory who has also served on a board of directors, noted that as a board member “we want to avoid arm’s length bargaining” since this inevitably leads to contentious negotiations between the CEO and the Board. Holmstrom notes that a crucial function of the board is to help the CEO make decisions that are in the shareholders’ interests. The exigencies of these decisions requires that there be trust between the parties. He observes that “Powerful boards can be disastrous for a company” if they result in a lack of trust between senior executives and the directors. For this reason, Holmstrom describes how, in his role as a board member, it is important for the board to be generous in setting CEO compensation, less the CEO feel unappreciated.

In our results, looking at the sample average CEO Total Cash Compensation (base plus bonus) of $1,242,933, some $676,001 (54%) could be attributed to standard economic variables, while the remaining 46% is due to the influence and interaction effects discussed in our research. Looking at the bonus component alone leaves social influence and interaction effects with the major share of the explanatory power (65%). There are clearly important explanations of CEO pay that are not captured in the standard economic model. Managerial influence does matter when it comes to setting CEO pay.

Consistent with Holmstrom’s experience, excess cash compensation on the order of $500,000 may be a small price to pay for social cohesion in the boardroom. Of course, this level of cash pay may also be mirrored in higher stock options and other long term compensation. The average firm in the sample had $5 billion in annual revenues. But, however we calculate any notion of ‘over payment’ costs, these must be offset against the positive benefits of a cooperative CEO-Board relationship. In some sense reciprocity and social influence can be seen as the glue that holds together the incomplete contracts that are required at this level. It
is one thing to achieve incentive alignment by specifying a payment-by-results contract for the typical first-line worker, but it is quite a different matter to design its equivalent for a CEO. Incompleteness abounds. The boardroom operates within a socially constructed reality. Without reciprocity there would be none of the cooperative relationships necessary for incomplete labor contracts to survive.

So when commentators cry out for more robust and independent boards, they miss the point that, important as independent directors may be, they still have to operate in an environment in which the psychological pressures identified here abound. The interaction effects we found are clear proof of the existence and strength of the social micro-underpinnings of board operations. Structural aspects of boardroom governance such as the number of board committees or independent directors can result in higher, not lower, cash compensation because of the interaction with social influence. Failure to allow for the social psychology of the board will lead to inevitable disappointment and confusion over outcomes.

Separation of ownership from control presents some serious incentive issues. Opportunism will undoubtedly be a problem. However, at least at the level of the board and in all probability at many other levels of the corporation, failure to involve the social psychology of group behavior will lead to potentially misleading prescriptions. In order that the board can begin to avoid the problems created by informational asymmetry regarding CEO behavior it needs to draw on a certain level of reciprocity and trust that will simply be absent without social ties.

In a supervisory / dual board system it is possible that the separation of monitoring from advice and assistance can be achieved. Recent European experience with this model has not,
however, been encouraging. There is a balance to be struck between monitoring and advising, and that balance is probably best struck within a single organizational entity - the board. Minimizing agency costs, while striving for the maximum value added available through the effective and holistic application of the board’s expertise to the strategic challenges facing the corporation, requires a recognition of psychological dynamics.
SELECTED BIBLIOGRAPHY


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Figure 1
TCC Interaction Effects between Director Fees and Board Meetings

TCC and Director Fees and Board Meetings

- 4-meetings
- 7-meetings
- 11-meetings

Impact on TCC vs. Influence Variable - Director Fees

Low fees = $17,365; Medium fees = $165,231; High fees = $313,097
TCC and Number of Board Committees and CEO Committee Participation

Figure 2
TCC and Interaction Effects between Number of Board Committees and CEO Committee Participation

Low Committee Participation = 0 committees; Medium = 1 committees; and High = 2 committees.
Figure 3
TCC and Interaction Effects between Duality and Independent Directors

TCC and Duality and Independent Directors

CEO not Chair | CEO is Chair

CEO and Chair

Impact on TCC ($)

- 3-Indp. Dirs
- 5-Indp. Dirs
- 7-Indp. Dirs