



Stock grants as a commitment device

Gian Luca Clementi^{a,*}, Thomas F. Cooley^b, Cheng Wang^c

^a*Department of Economics, Stern School of Business, New York University, USA*

^b*Department of Economics, Stern School of Business, New York University, USA*

^c*Department of Economics, Iowa State University, USA*

Received 21 November 2003; accepted 16 April 2005

Available online 28 September 2005

Abstract

A large and increasing fraction of the value of executives' compensation is accounted for by security grants. However, in most models of executive compensation, the optimal allocation can be implemented through a sequence of state-contingent cash payments. Security awards are redundant. In this paper we develop a dynamic model of managerial compensation where neither the firm nor the manager can commit to long-term contracts. We show that, in this environment, if stock grants are not used, then the optimal contract collapses to a series of short term contracts. When stock grants are used, however, nonlinear intertemporal schemes can be implemented to achieve better risk-sharing and higher firm value.

© 2005 Elsevier B.V. All rights reserved.

JEL classification: D21; D82; G32

Keywords: Moral hazard; Optimal contracts; CEO compensation; Stock grants

1. Introduction

The theoretical literature on optimal managerial compensation with moral hazard has long established that current and deferred compensation should be made

*Corresponding author.

E-mail addresses: gclement@stern.nyu.edu (G.L. Clementi), tcooley@stern.nyu.edu (T.F. Cooley), chewang@iastate.edu (C. Wang).

URL: <http://pages.stern.nyu.edu/~gclement>, <http://www.stern.nyu.edu/~tcooley>, <http://www.econ.iastate.edu/faculty/wang/>.

contingent on the value of the firm. Managers should be paid more when shareholder value is higher, both in the current period and in the future. The compensation schemes that we observe in use typically consist of current cash compensation, stock and option grants, and promises of future cash compensation. It is often argued that stock and option grants are natural means to implement state-contingent deferred compensation. However, in the case of most models the optimal allocation can be implemented simply by a sequence of contingent cash payments.¹ Security awards are redundant instruments, in the sense that they do not offer any advantage over a contingent sequence of cash outlays.

In this paper we show that an exclusive role for securities grants arises in environments where the enforcement of contracts is limited, so that firms cannot commit to follow up on promises of cash compensation. Under limited enforcement, firms can motivate their employees with promises of deferred cash compensation only to the extent that such promises are self-enforcing. Securities grants can provide a partial solution to this inefficiency by acting as a commitment device, as it is harder for firms to renege on payments to shareholders than on cash payments to employees. If we abstract from enforcement, the schedule of contingent cash-flows provided by a given security grant can be awarded to an executive by means of a contract that explicitly specifies the cash payment corresponding to each state of nature. However, as we argue below, companies' (shareholders') ability to renege on the latter form of compensation is much greater. For this reason, an executive will value a security grant more than the promise of a stream of cash payments that replicates the payoffs of the grant in all states of nature. It follows that using stock and/or options to provide management with a given expected utility is less expensive, and thus increases shareholder value.

A *vested*² stock grant is a sure claim to a risky cash flow, as it can be easily exchanged for cash once the eventual selling restrictions have expired. The same can be said of a vested option grant, as it can be exchanged for a non-negative cash flow at the exercise date. This is not the case for deferred cash payments, even when they are part of an explicit contract. While systematic studies have not been conducted yet, there is ample anecdotal evidence that firms do default on promises of cash payments to employees, let them be wages, or medical and insurance benefits, or pensions, or severance pay. Shleifer and Summers (1988) have argued that, in the case of many corporate acquisitions, a large fraction of the increase in the target's shareholder value is due the acquirer's ability to renege on employees' long-term compensation contracts. The US Airways reorganization of 2002 indicated that Chapter 11 of the Bankruptcy Code allows corporations to default on their long-term obligations towards current and former employees. The judge in charge of the case allowed US Airways to terminate the pilots' pension plan as a step to avoid liquidation. The recent boom in executive compensation litigation provides further

¹This is the case for both static models such as Haubrich (1994), Holmstrom (1979), and Garen (1994), and dynamic models such as Wang (1997) and Clementi and Cooley (2000).

²A stock or option grant vests when the grantee acquires ownership of the securities. Further restrictions, however, may hinder from selling the stock or exercising the option.

support for our hypothesis that the enforcement of certain provisions of compensation contracts is imperfect. Utz (2001a,b) gives an account of the most frequent causes of litigation and illustrates them with a short series of cases. Among the most common disputes are those that concern the degree to which an employer may amend or terminate a severance pay plan, therefore undermining the employee's ability to cash on the employer's promise.³ A severance pay plan is a typical example of what we refer to as an explicit promise of deferred cash compensation. We interpret the large volume of severance pay litigation documented by Utz as a sign that enforcement of such promises is imperfect and that employers successfully attempt to renege on them.⁴

We argue that, because of the documented ability to renege on a variety of contractual provisions, effectively firms cannot use deferred cash compensation as an incentive device for their managers. The main idea of this paper is that security grants provide a solution to this problem. By granting stock to its executives, for example, a firm assigns them claims which are equal in nature to those of all other shareholders. This means that renegeing (even partially) on these claims would entail defaulting on the payments to all shareholders. This obviously is not very likely to happen.

We build a simple two-period model of hidden action in which neither the firm (principal) nor the manager (agent) can commit to long-term compensation contracts. By this we mean that at the beginning of the second period the two agents will act as mandated by the continuation of the long-term contract only if it provides each of them with payoffs greater than their outside options. The remaining assumptions are standard. The probability distribution of the firm's profits depends in a natural way on the (unobservable) effort exerted by the manager. The principal is risk-neutral, while the agent is risk-averse and suffers disutility from effort.

If the compensation consists of cash payments only, then it is easy to show that the optimal long-term contract collapses to a sequence of two independent static contracts. This occurs because regardless of the profit realization, the firm will not deliver to the manager a payoff greater than his outside value. In fact any larger payoff would result in the firm breaching the contract and hiring a new executive.⁵ On the other hand, the manager will choose to quit whenever the continuation of the long-term contract promises less than his outside value.

³According to Utz (2001b), vesting standards dictated by the Employee Retirement Income Security Act do not apply to the typical severance plan. For this reason, an employer's ability to terminate or amend the plan is largely unrestricted, except to the extent that the terms of the plan itself restrict that right.

⁴One could argue that establishing an escrow account would allow firms to commit to deliver on at least some of the promises of deferred cash compensation. After all, this is similar to what happens in some European countries, where firms face tight restrictions on the use of funds accumulated to cover pension benefits and severance pay. However, as long as external finance is more expensive than internally generated funds, immobilizing funds in an escrow account is inefficient. This is the reason why in the same European countries there is pressure towards relaxing the restrictions mentioned above.

⁵Throughout the paper we assume that breaching the compensation contract is costless. This assumption is made for the sake of simplicity and can be dispensed with. Our results still hold when we relax it, as long as the cost of breaching is not too large.

Things are different if at the end of the first period the firm can grant stock to the manager, because, by assumption, the firm cannot renege on the stock. Suppose that the owners breach the contract and fire the manager. The cost of replacing him is now higher. In fact it equals the cost of hiring the substitute plus the dilution of shareholder value induced by the increase in the number of shares outstanding. For this reason, when a properly designed stock grant is included in the compensation contract, the firm can credibly commit to deliver to the manager in period 2 a payoff higher than his outside value. In equilibrium the firm will take up this opportunity, as it allows for better risk-sharing, and thus for a decrease in the cost of delivering a given expected utility to the manager. Under our assumptions on the market for CEOs, this lower cost translates one to one into higher shareholder value.

The evidence gathered by [Utz \(2001b\)](#) shows that in reality enforcement problems also arise when security are used, if the vesting of a stock or option grant is conditional on the cause of the employee's termination. The reason is that courts have a hard time verifying the actual reason of the termination.⁶ In our model shareholder value is larger when vesting can be made contingent on the type of separation (i.e. when the courts can verify the reason of the termination). In particular, shareholder value is maximal if vesting is denied when the manager quits. However, we show that the introduction of securities grants increases shareholder value even when enforcement problems do not allow for vesting to be contingent.

There is very little (if any) theoretical work investigating the conditions under which including securities in compensation packages is actually optimal. Since the current US tax code and FASB⁷ standards discriminate across different means of compensation, it is likely that tax and accounting considerations play an important role in shaping employees' compensation packages.⁸ In this paper we abstract completely from such considerations, with the purpose of isolating the role of limited enforcement.

The research on the optimal design of securities grants is also in its infancy. [Aseff and Santos \(2005\)](#) characterize the optimal stock option grant in a otherwise standard hidden action model. [Acharya et al. \(2000\)](#) investigate the optimality of resetting strike prices on previously-awarded option grants. In contrast to our work,

⁶For example, [Utz \(2001b\)](#) argues that courts are often called to determine whether an employee's termination of employment was of a type causing the employee's options to vest. In the case of *Tredway v. Merck & Co.* the plaintiff refused to transfer to a 50/50 joint venture of Merck with another organization, and took instead a job with an unrelated employer. The employee had received stock options, which were not vested when he terminated his contract. The court determined that this particular type of separation was not among the ones contemplated in the stock option plan, and therefore ruled in favor of the employer, denying vesting of the option grant.

⁷FASB stands for Financial Accounting Standards Board, whose main task is to establish and improve standards of financial accounting and reporting in the United States.

⁸See [Lipman \(2001\)](#) for a readable but comprehensive account of the tax and accounting treatment of the different components of managerial compensation. As an example of differential tax treatment, the compensation originated by option grants that qualify as Incentive Stock Options according to IRS guidelines is taxed at the long-term capital gain tax rate, which is lower than the marginal income tax rate that applies to cash compensation. On the accounting side, it is well known that, differently from cash compensation, the award of stock options does not generate any charge in the income statement.

in both of these papers compensating the manager by means of securities is suboptimal, in the sense that the use of contingent cash compensation would increase shareholder value.

The remainder of the paper is organized as follows. The model is introduced in Section 2. In Section 3 we show how to solve for the optimal long-term compensation contract with stock. In Section 4 we briefly consider the case of full commitment and we show that in that case stock grants are redundant. In Section 5 we characterize the optimal contract under limited commitment and we show that the inclusion of stock grants in the compensation package increases shareholder value. In Section 6 we consider the case in which the commitment problems generated by imperfect enforcement are so severe so as to make state-contingent stock grants unavailable. We show that firms can still improve over cash-only compensation, by awarding state-contingent securities (options, for example) at the signing of the contract. Section 7 concludes.

2. The model

There are two periods: $t = 1, 2$. We consider the problem of a firm that needs a manager to operate in each period. There are many equally skilled individuals, each of whom can be the firm's manager. The firm is risk neutral and maximizes expected discounted dividends. The manager's preferences are described by the utility function

$$H(c_t, e_t) = u(c_t) - e_t,$$

where c_t and e_t denote time t consumption and effort, respectively. We assume that $u : \mathfrak{R}^+ \rightarrow \mathfrak{R}$ and that $u(\cdot)$ is twice continuously differentiable, strictly increasing, and strictly concave. All agents discount future utility with the same factor δ , $\delta \in (0, 1)$.

We assume that for all t , $e_t \in \{0, a\}$, with $a > 0$. Further, let π_t denote the firm's profit at time t (gross of manager's cash compensation). We assume that for all t , $\pi_t \in \{\pi_H, \pi_L\}$, where $0 < \pi_L < \pi_H$, and that $prob(\pi_t = \pi_H | e = a) = \bar{p}$, $prob(\pi_t = \pi_H | e = 0) = \underline{p}$, with $\bar{p} > \underline{p} > 0$.

The manager's effort is not observable to the firm and thus constitutes private information for the manager. We assume that if a manager does not work in a given period, then he receives a constant consumption c^* . This implies that his per-period reservation utility is $\omega = u(c^*)$.

At the beginning of period 1, the firm makes a take-it-or-leave-it offer to the manager (i.e. to one of the many identical candidates for the job). The offer consists of a long-term compensation contract. It is long-term, in the sense that period-2 compensation is allowed to depend on both periods' profit realizations.

Definition 1. A long-term compensation contract consists of period-1 contingent cash payments $\{w_{1i}\}_{i=H,L}$, period-1 contingent stock grants $\{s_i\}_{i=H,L}$, and period-2 contingent cash payments $\{w_{2ij}\}_{i,j=H,L}$.⁹

⁹When clarity of exposition is not at stake, time indices will be suppressed.

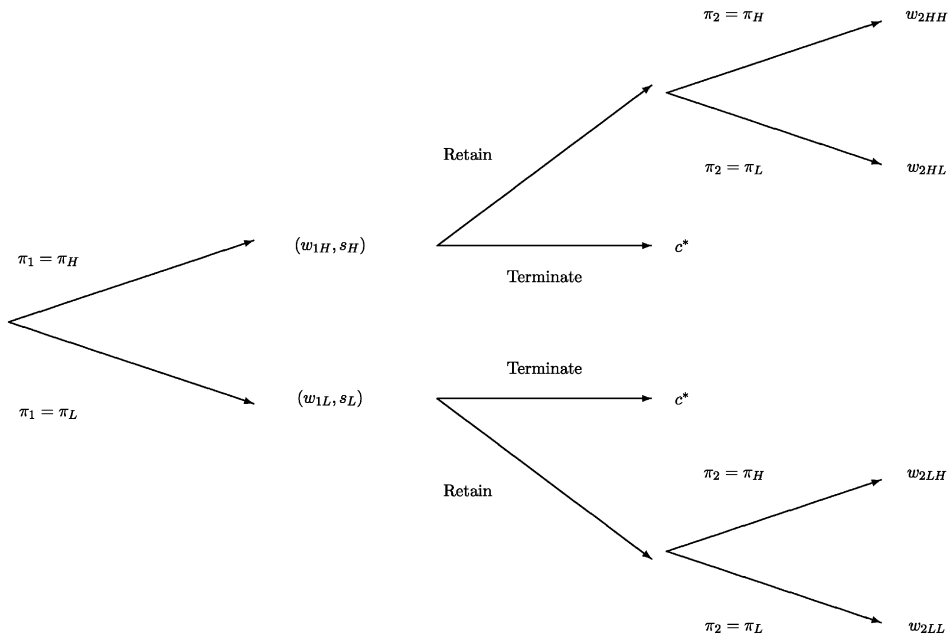


Fig. 1. The timing.

The scalar s_i ($s_i \in [0, 1]$) denotes the fraction of equity that is granted to the manager at the end of period 1, contingent on the realization of state i .

We assume that both parties have limited commitment to the contract, in the following sense. At the beginning of period 2, both the firm and the manager can unilaterally decide to breach the contract at no pecuniary cost. They will do so if and only if the continuation values implied by the contract are lower than the values of their outside opportunities. If the contract is breached, neither party will fulfill his period-2 contractual obligations. The manager will become unemployed and the firm will have to hire a substitute.

Notice that we do require period-by-period commitment. In other words, the beginning of period 2 is the only time in which the contract can be breached.¹⁰ We say that the manager is fired whenever it is the firm that breaches the contract. Alternatively, if the contract terminates because of the manager’s decision, we say that he quit. The timing of the model is described in Fig. 1.

¹⁰Our assumption of limited commitment is similar to those used by Thomas and Worrall (1988), Phelan (1995), and Kocherlakota (1996) among others in the dynamic contracting literature. Thomas and Worrall (1988) characterize the long term compensation contract between a risk-neutral firm and a risk-averse worker when both can renege and revert to the spot market. Phelan (1995) studies a model of moral hazard where commitment is one-sided. Kocherlakota (1996) considers two-sided limited commitment in a model of hidden endowment.

2.1. Vesting and sale restrictions

In this sub-section we specify the vesting and sale restrictions that apply to the stock grant. We consider three different cases.

Neither party reneges. This is the case in which the firm does not fire the manager and the manager does not quit the firm in period 2. We assume that vesting occurs at the beginning of period 2. However, the manager is restricted from selling the stock until all uncertainties are resolved (i.e., until the end of period 2).

The firm reneges. This is the case in which the firm fires the manager at the beginning of period 2. The assumptions on vesting and sale restrictions made in the case where neither party reneges also apply here. This means that upon firing the manager, the firm cannot cancel his stock grant.

The manager reneges. This is the case in which the manager quits the firm at the beginning of period 2. We consider three scenarios, identified as A, B, and C, respectively. In scenario A, the stock grant vests at the beginning of period 2, and the manager can sell the stock immediately upon vesting or hold it until the end of period 2. Since the manager is risk averse, he will always choose to sell the stock immediately. In scenario B, the stock grant vests at the beginning of period 2, but the manager cannot sell it until all uncertainties are resolved (i.e. until the end of period 2). In scenario C, the manager loses the grant. Vesting is denied. To summarize, there are no restrictions either on vesting or selling in scenario A; there's only a restriction on selling in scenario B; and the stock grant is canceled in scenario C.

3. Optimal contracting

We solve for the optimal contract by backward induction. At the beginning of period 2, a stock holding s and a period-2 contingent cash payment (w_H, w_L) imply a level of expected utility U for the manager. For every utility level U , we determine the pair $(w_H(U, s), w_L(U, s))$ that delivers that utility efficiently (i.e. at the minimum cost to the firm). Then we turn to period 1 and we solve for the optimal period-1 cash compensation, stock grants (s_H, s_L) , and promised future utility levels (U_H, U_L) .

3.1. Period 2

First, consider the problem of a firm that retained its manager at the end of period 1. The state variables of this problem are the manager's promised utility U and equity stake s . The manager's consumption will be the sum of cash compensation and dividends, that is $c = w + s(\pi - w) = s\pi + (1 - s)w$. The value of the firm at this stage is given by $V_2(s, U)$, where

$$V_2(s, U) = \max_{w_H, w_L} \bar{p}[\pi_H - w_H] + (1 - \bar{p})[\pi_L - w_L] \tag{P2}$$

subject to

$$\bar{p}u[(1 - s)w_H + s\pi_H] + (1 - \bar{p})u[(1 - s)w_L + s\pi_L] - a = U, \tag{1}$$

$$\begin{aligned} & \bar{\rho}u[(1-s)w_H + s\pi_H] + (1-\bar{\rho})u[(1-s)w_L + s\pi_L] - a \\ & \geq \underline{\rho}u[(1-s)w_H + s\pi_H] + (1-\underline{\rho})u[(1-s)w_L + s\pi_L]. \end{aligned} \tag{2}$$

Condition (1) is the promise-keeping constraint. It requires that the contract delivers exactly the promised utility U . Condition (2) is the incentive compatibility constraint. Throughout the paper we restrict our attention to scenarios in which it is always optimal for the firm to induce the manager to exert the high level of effort.

Next, consider a firm that fired its manager at the end of period 1 and hence needs to hire a new one at the beginning of period 2. Given that there is an unlimited supply of potential managers, the firm will offer to the new hire exactly his reservation utility ω . Therefore, the firm’s outside value equals $V_2(0, \omega)$, i.e. the value of the firm when the manager in charge in period 2 does not hold stock and he is promised an expected utility equal to his outside value. The new manager’s compensation contract will consist of a schedule of contingent cash payments only.

At the beginning of period 2, the outside value for the manager consists of the utility he expects to receive conditional on quitting the firm. This value will depend on the vesting and sale restrictions that apply to the stock grant.

Risk aversion implies that in scenario A a manager that quits will liquidate his position at the beginning of period 2. Therefore, his expected utility is given by

$$\underline{U}(s) = \underline{U}_A(s) = u(c^* + sV_2(0, \omega)). \tag{3}$$

In scenario B, the sale restriction will not allow him to dispose of the stock before the end of the period. This implies that the payoff to quitting is

$$\underline{U}(s) = \underline{U}_B(s) = \bar{\rho}u[c^* + s(\pi_H - w_H^*)] + (1-\bar{\rho})u[c^* + s(\pi_L - w_L^*)], \tag{4}$$

where (w_H^*, w_L^*) are the cash compensations awarded to the newly-hired manager, i.e. the solution to (P2) when $s = 0$ and $U = \omega$. Finally, in scenario C, since the manager loses his stock grant upon quitting, his expected utility is simply

$$\underline{U}(s) = \underline{U}_C(s) = \omega \quad \forall s. \tag{5}$$

3.2. Period 1

At the beginning of period 1, the manager’s reservation utility is $u(c^*) + \delta u(c^*) = (1 + \delta)\omega$. From our earlier discussion, the firm’s task at the beginning of period 1 is to choose the contract $\{(w_i, s_i, U_i), i = H, L\}$ that maximizes the value of current shareholders. We recall that here w_i denotes cash compensation in period 1, s_i is the stock grant that the manager will receive at the end of period 1, and U_i defines the manager’s expected utility in period 2. All three components of the contract are contingent on the realization of state i in period 1. Therefore, the firm value at the beginning of period 1 is

$$\begin{aligned} V_1 = & \max_{\{w_i, s_i \in [0, 1], U_i\}_{i=H,L}} \bar{\rho}[\pi_H - w_H + \delta(1 - s_H)V_2(s_H, U_H)] \\ & + (1 - \bar{\rho})[\pi_L - w_L + \delta(1 - s_L)V_2(s_L, U_L)] \end{aligned} \tag{P1}$$

subject to

$$\bar{\rho}[u(w_H) + \delta U_H] + (1 - \bar{\rho})[u(w_L) + \delta U_L] - a \geq (1 + \delta)\omega, \tag{6}$$

$$\begin{aligned} &\bar{\rho}[u(w_H) + \delta U_H] + (1 - \bar{\rho})[u(w_L) + \delta U_L] - a \\ &\geq \underline{\rho}[u(w_H) + \delta U_H] + (1 - \underline{\rho})[u(w_L) + \delta U_L], \end{aligned} \tag{7}$$

$$U_i \geq \underline{U}(s_i), \quad i = H, L, \tag{8}$$

$$(1 - s_i)V_2(s_i, U_i) \geq (1 - s_i)V_2(0, \omega), \quad i = H, L. \tag{9}$$

Conditions (6) and (7) are the individual rationality and incentive compatibility constraints, respectively. Condition (8) imposes that the manager must be offered a continuation utility larger than his period-2 outside value. Condition (9) imposes that the continuation value for the shareholders be greater than their value if they fire the current manager and hire a new one in period 2. Following Thomas and Worrall (1988), we call conditions (8) and (9) self-enforcing constraints.

Note that the self-enforcing constraints require that the firm’s strategy of not firing the manager and the manager’s strategy of not quitting the firm constitute a Nash equilibrium. Specifically, (8) requires that, conditional on the firm not firing him, the manager is better off staying with the firm and obtain U_i rather than quitting and get $\underline{U}(s_i)$. Similarly, (9) states that, conditional on the worker not quitting, the firm is better off retaining him (obtaining $(1 - s_i)V_2(s_i, U_i)$) rather than dismissing him and get $(1 - s_i)V_2(0, \omega)$. Note that, upon hiring a new manager, total firm value equals $V_2(0, \omega)$. However, since a fraction s_i goes to the manager in charge in period 1, the value of the original shareholders is only $(1 - s_i)V_2(0, \omega)$.¹¹

3.3. Self-enforceability

For a given stock grant s , the only period-2 compensation schedules that the firm can credibly commit to deliver are those that imply expected utility levels U that satisfy conditions (8) and (9). Such couples (s, U) are said to be *self-enforcing*. Formally,

Definition 2. A pair (s, U) is said to be self-enforcing if $U \geq \underline{U}(s)$ and $V_2(s, U) \geq V_2(0, \omega)$.

We also define the self-enforceability correspondence Φ by

$$\Phi(s) \equiv \{U : U \geq \underline{U}(s), V_2(s, U) \geq V_2(0, \omega)\}, \quad s \in [0, 1].$$

$\Phi(s)$ defines the set of continuation utility values that the firm can credibly promise to its manager, conditional on awarding him an equity stake s . Alternatively, when

¹¹Note also that it would not make sense to consider a dominant strategy equilibrium here, simply because the firm cannot keep the manager if the manager decides to quit, and the manager cannot decide to stay if he is fired.

$V_2(s, U)$ is strictly decreasing in U , we can write

$$\Phi(s) = \begin{cases} \emptyset & \text{if } \underline{U}(s) > \overline{U}(s), \\ [\underline{U}(s), \overline{U}(s)] & \text{otherwise,} \end{cases}$$

where $\forall s$, $\overline{U}(s)$ solves

$$V_2(s, \overline{U}(s)) = V_2(0, \omega). \quad (10)$$

Clearly, when $V_2(s, U)$ is strictly decreasing in U , then for all level of stock holding s , $\overline{U}(s)$ is the highest expected utility the long-term contract can credibly promise to the manager. It is immediate that, regardless of the vesting clause and sale restrictions, $\overline{U}(0) = \underline{U}(0) = \omega$. Further, for all $s \in (0, 1]$, $\underline{U}_A(s) > \underline{U}_B(s) > \underline{U}_C(s)$. In turn, these facts directly imply two properties of the self-enforceability correspondence, that are stated in the following lemma.

Lemma 3.

1. $\Phi(0) = \{\omega\}$.
2. $\forall s \in [0, 1], \Phi_A(s) \subseteq \Phi_B(s) \subset \Phi_C(s)$.

The first result of Lemma 3 says that if no stock is awarded to the manager at the end of period 1, then the only self-enforceable expected utility promise is ω , the manager reservation utility. The reason is that any value higher than ω will give the firm the incentive to deviate, while anything below ω will give the manager the incentive to deviate.

The second result says that tighter vesting and sale restrictions, by lowering the manager's outside value, imply a larger set of self-enforceable promised utilities. This result provides a rationale for why restrictions on stock grants are widely used in practice. In fact, they imply a weak ordering over the firm values in the three vesting scenarios. In Scenario B, firm value will be weakly higher than in Scenario A and weakly lower than in Scenario C. Therefore, a first prescription of our model is that firms are always weakly better off by denying vesting in the event the employee quits his job. In spite of this conclusion, it is still relevant to consider scenarios A and B. These are the only available alternatives if courts are unable to establish which party was responsible for the termination of the contract, so that vesting cannot be made contingent on this event.¹²

4. The optimal contract under full commitment

We now briefly consider the case of full commitment. That is, the case in which both the manager and the firm can commit to abide by the provisions of the long-term contract, no matter the continuation values that those provisions imply. Under

¹²In Section 5.2.2 we characterize the self-enforceability correspondence in the three scenarios and we provide sufficient conditions for non-emptiness.

these assumptions, the self-enforcing constraints (8) and (9) need not be imposed in the optimization (P1). It is easy to show that in this case it is always optimal to set $s_i = 0$, $i = H, L$. That is, optimality is achieved without recourse to stock grants.

Proposition 1. *Under full commitment, it is always optimal to set $s_i = 0$, $i = H, L$.*

Proof. Let $\{w_{1i}, s_i, w_{2ij}\}_{i,j=H,L}$ denote the optimal contract under full commitment. Here the letters i and j denote the nature of the outcome (high or low profit) in period 1 and 2, respectively. Now define a new contract by setting

$$\begin{aligned} \hat{w}_{1i} &= w_{1i}, \quad \hat{s}_i = 0, \quad i = H, L, \\ \hat{w}_{2ij} &= (1 - s_i)w_{2ij} + s_i\pi_j, \quad i, j = H, L. \end{aligned}$$

Obviously, this contract is feasible and incentive compatible (i.e., it satisfies the constraints in (P1) and (P2)) and it specifies the same state contingent consumption plan for the manager. It is straightforward to show that the new contract also gives the firm the same expected utility as the optimal contract. \square

5. Analysis

In this section we characterize the optimal compensation contract. We begin by analyzing the benchmark scenario in which stock grants are not allowed (i.e. the case of $s \equiv 0$). Then we proceed to consider the more interesting case in which stock grants are used.

5.1. When stock grants are not allowed

Here we show that if the compensation contract does not include stock grants, then the long-term contract collapses to a sequence of static contracts. That is, the cash compensation awarded in period 2 does not depend on period-1 profits.¹³

Proposition 2. *If stock grants are not allowed, the optimal dynamic contract collapses to a sequence of static contracts.*

Proof. Consider Problem (P1). Set $s_H = s_L = 0$. Since $\Phi(0) = \{\omega\}$, it must be the case that $U_H = U_L = \omega$. This means that the manager’s utility in period 2 does not depend on the first-period outcome. The value of the firm at the beginning of period 1 is then given by

$$V_1^{\text{cash}} = \max_{w_H, w_L} \bar{\rho}[\pi_H - w_H] + (1 - \bar{\rho})[\pi_L - w_L] + \delta V_2(0, \omega)$$

subject to

$$\begin{aligned} \bar{\rho}u(w_H) + (1 - \bar{\rho})u(w_L) - a &= \omega, \\ \bar{\rho}u(w_H) + (1 - \bar{\rho})u(w_L) - a &\geq \underline{\rho}u(w_H) + (1 - \underline{\rho})u(w_L). \end{aligned}$$

¹³This result holds in more general setups than ours. For example, see Kocherlakota (1996).

We conclude that, in the case of $s \equiv 0$, the feasibility sets of the programs (P1) and (P2) are the same and the objective functions differ by an additive constant. Therefore, the maximizers must be the same. The contingent cash compensations are equal across periods. \square

5.2. When stock grants are allowed ($s \geq 0$)

Here we consider the case in which the firm is allowed to include stock grants in the manager’s compensation contract. We find it useful to introduce the variable u_i , $i = H, L$. The value u_i denotes the period-2 utility from consumption that the manager receives in state i . We also denote the inverse of the utility function as $v(\cdot)$. That is, we write $v(u) \equiv u^{-1}(u)$.

5.2.1. Optimal period-2 compensation

Contingent on continuation of the contract, firm value $V_2(s, U)$ is given by

$$V_2(s, U) = \max_{u_H, u_L} \bar{\rho}[\pi_H - w_H] + (1 - \bar{\rho})[\pi_L - w_L],$$

subject to

$$\bar{\rho}u_H + (1 - \bar{\rho})u_L - a = U, \tag{11}$$

$$\bar{\rho}u_H + (1 - \bar{\rho})u_L - a \geq \underline{\rho}u_H + (1 - \underline{\rho})u_L, \tag{12}$$

$$w_H = v(u_H) \frac{1}{1 - s} - \frac{s}{1 - s} \pi_H, \tag{13}$$

$$w_L = v(u_L) \frac{1}{1 - s} - \frac{s}{1 - s} \pi_L. \tag{14}$$

Conditions (13) and (14) are derived from the definition of the newly-introduced variable u_i . In fact, we have that $u_i = u(s\pi_i + (1 - s)w_i) \forall i$.¹⁴

Lemma 4. *The incentive compatibility constraint (12) is binding at the optimum.*

Proof. Rewrite condition (12) as $(\bar{\rho} - \underline{\rho})(u_H - u_L) \geq a$. Suppose that at the optimum this constraint holds with strict inequality. Then, it is possible to decrease u_H and increase u_L in such a way that both conditions (11) and (12) are satisfied. However, since the inverse of the utility function is strictly convex, the value of the firm is now strictly higher. Obviously, this contradicts the assumption that the starting pair (u_H, u_L) is optimal. \square

¹⁴Notice that the high effort level $e = a$ is not always implementable. In fact condition (12) implies that $u_H \geq u_L + a/(\bar{\rho} - \underline{\rho})$. The latter, together with condition (11), requires that $U \geq u_L + a\underline{\rho}/(\bar{\rho} - \underline{\rho})$. Finally, since $w_L \geq 0$, it must hold that $U \geq u(s\pi_L) + a\underline{\rho}/(\bar{\rho} - \underline{\rho})$. Therefore a sufficient, albeit not necessary condition for $e = a$ to be implementable for every pair (s, U) such that $U \geq \omega$, is that $\omega \geq u(\pi_L) + a\underline{\rho}/(\bar{\rho} - \underline{\rho})$.

In light of Lemma 4, we can use (11) and (12) to solve for the optimal pair (u_H, u_L) . We obtain

$$u_H = U + \frac{1 - \rho}{\bar{\rho} - \underline{\rho}} a, \tag{15}$$

$$u_L = U - \frac{\rho}{\bar{\rho} - \underline{\rho}} a. \tag{16}$$

Substituting (15) and (16) in the objective function, we get that

$$V_2(s, U) = \frac{1}{1 - s} [\bar{\pi} - f(U; a)], \tag{17}$$

where, for every x , the function $f(x; a)$ is defined as

$$f(x; a) \equiv \bar{\rho}v \left(x + \frac{1 - \rho}{\bar{\rho} - \underline{\rho}} a \right) + (1 - \bar{\rho})v \left(x - \frac{\rho}{\bar{\rho} - \underline{\rho}} a \right).$$

Notice that $f(x; a)$ defines the expected cost to the firm of delivering to the manager the period-2 utility level x , conditional on the recommended effort level being a . It is easy to show that the function f is strictly increasing and strictly convex in x , for any given a .

5.2.2. *The self-enforceability correspondence Φ*

By (17), the firm’s outside value at the beginning of period 2 is given by

$$V_2(0, \omega) = \bar{\pi} - f(\omega; a).$$

Therefore, it follows that

$$\bar{U}(s) = f^{-1}[f(\omega; a) + s(\bar{\pi} - f(\omega; a))].$$

Given the properties of f , if $\bar{\pi} > f(\omega; a)$, then

$$\bar{U}'(s) > 0 \quad \forall s.$$

This simply says that the maximum expected utility the firm can commit to deliver to its manager increases monotonically in the size of the stock grant. It is the formal statement of the idea that motivated our work: the use of stock grants enables the firm to commit to levels of promised utility that otherwise would not be self-enforceable. From now on we will maintain the following assumption:

Assumption 5. $\bar{\pi} > f(\omega; a)$.

Showing that granting stock increases the firm’s ability to reward its manager in the future is not enough. We need to provide conditions under which the correspondence Φ is nonempty. In scenario C, it is clear that this is always the case for all s , since $\underline{U}_C(s) = \omega \quad \forall s \in [0, 1]$. In scenarios A and B, non-emptiness of Φ is not a general property.

Since the value function $V_2(s, U)$ is strictly decreasing in U , $\Phi(s)$ is not empty if and only if

$$V_2(s, \underline{U}(s)) \geq V_2(0, \omega). \tag{18}$$

In turn, condition (17) implies that the latter holds if and only if

$$f(\underline{U}(s); a) - s[\bar{\pi} - f(\omega; a)] \leq f(\omega; a). \tag{19}$$

Proposition 3 provides a condition under which, in both scenarios A and B, the set $\Phi(s)$ is non-empty in an interval that includes $\{0\}$.

Proposition 3. *If*

$$\bar{\rho}v' \left(\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) + (1 - \bar{\rho})v' \left(\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) < v'(\omega), \tag{20}$$

then there exist values $s_A, s_B, 0 < s_A < s_B \leq 1$, such that $\Phi_A(s)$ is non-empty over $[0, s_A]$ and $\Phi_B(s)$ is non-empty over $[0, s_B]$.

Proof. Consider scenario A first. For $s = 0$, condition (19) holds with equality. Therefore, we just need to show that

$$L(s) \equiv f(\underline{U}_A(s); a) - s[\bar{\pi} - f(\omega; a)] \tag{21}$$

is decreasing in s at $s = 0$, i.e.

$$L'(0) = V_2(0, \omega) \left\{ u'(c^*) \left[\bar{\rho}v' \left(\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) + (1 - \bar{\rho})v' \left(\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) \right] - 1 \right\} < 0. \tag{22}$$

Given our assumptions on the utility function, $L'(s)$ is a continuous function. Therefore, if $L'(0) < 0$ is negative, there must exist $s_A > 0$ such that $\Phi_A(s)$ is non-empty over $[0, s_A]$. But $L'(0) < 0$ is equivalent to

$$\bar{\rho}v' \left(\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) + (1 - \bar{\rho})v' \left(\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a \right) < v'(\omega).$$

Since f is a strictly increasing function and $\underline{U}_B(s) < \underline{U}_A(s) \forall s$, it follows that for all $s > 0$ such that $\Phi_A(s)$ is non-empty, $\Phi_A(s) \subset \Phi_B(s)$, and so $\Phi_B(s)$ must be non-empty, too. Further, there is a non-empty interval $(s_A, s_B]$ such that $\Phi_A(s) = \emptyset$ and $\Phi_B(s) \neq \emptyset \forall s \in (s_A, s_B]$. \square

When condition (20) does not hold, it can be the case that the self-enforceability correspondence is empty on an interval immediately to the right of $s = 0$, but it is non-empty for larger values of s . We consider this case in Appendix A.¹⁵

¹⁵By the same argument used in the proof of Proposition 3, it is easy to show that when $v'(\cdot)$ is strictly convex, the self-enforceability correspondence is empty for s close enough to 0, in both scenario A and B. Lemma 7 in Appendix B shows that in scenario A strict concavity of $v'(\cdot)$ is actually necessary for non emptiness, for all s . This implies, for example, that if $u(c) = \log(c)$, then $\Phi_A(s) = \emptyset$ for all $s \in (0, 1]$. In Lemma 8 we give a necessary condition under which $\Phi_B(s) \neq \emptyset$ for any fixed $s > 0$ for a class of utility functions including $u(c) = \log(c)$.

5.2.3. The firm’s problem in period 1

Let now V_1^{stock} denote the value of the firm at the beginning of period 1. That is,

$$V_1^{\text{stock}} = \max_{\{u_i, s_i, U_i\}_{i=H,L}} \bar{\rho}[\pi_H - v(u_H) + \delta(1 - s_H)V_2(s_H, U_H)] + (1 - \bar{\rho})[\pi_L - v(u_L) + \delta(1 - s_L)V_2(s_L, U_L)],$$

subject to

$$\bar{\rho}[u_H + \delta U_H] + (1 - \bar{\rho})[u_L + \delta U_L] - a = (1 + \delta)\omega, \tag{23}$$

$$\bar{\rho}[u_H + \delta U_H] + (1 - \bar{\rho})[u_L + \delta U_L] - a \geq \underline{\rho}[u_H + \delta U_H] + (1 - \underline{\rho})[u_L + \delta U_L], \tag{24}$$

$$U_i \in \Phi(s_i), \quad i = H, L. \tag{25}$$

Using (17), it is easy to show that

$$V_1^{\text{stock}} = - \min_{\{u_i, s_i, U_i\}_{i=H,L}} \bar{\rho}[v(u_H) + \delta f(U_H; a)] + (1 - \bar{\rho})[v(u_L) + \delta f(U_L; a)] - (1 + \delta)\bar{\pi}$$

subject to (23), (24), (25).

The above program implies unique optimal values for the contingent utility compensations, but not for their implementation by means of cash and stock. In fact, as we illustrate below, a given promised utility can be implemented by a continuum of combinations of stock and contingent period-2 wages.

Proposition 4 is our main result. It shows that the ability to award stock grants allows the firm to partially overcome its lack of commitment. Including stock grants in the compensation package allows the contract to make period-2 compensation contingent on first-period outcomes, thereby increasing shareholder value.

Proposition 4 applies to all cases in which $\Phi(s)$ is nonempty on an interval $[0, s^*]$, for some $s^* \in (0, 1]$. In scenario C, this is always true. By Proposition 3, we know that, when condition (20) holds, it is true regardless of the vesting clause. Fig. 2 depicts such a case. The analysis of the optimal contract in the case in which $\Phi(s) = \emptyset$ in an interval immediately to the right of $s = 0$ is included in Appendix A. It turns out that the results stated in Proposition 4 hold true also in that case, provided that a further condition is imposed.

Proposition 4. *If $\Phi(s)$ is non-empty over $[0, s^*]$ for $s^* \in (0, 1]$, then the following conditions are necessary for optimality:*

1. $U_L = \omega$,
2. $U_H > \omega$,
3. $s_H > 0$.

Proof. Since the function $f(x; a)$ is strictly convex in x , one can use the argument used in the proof of Lemma 4 to show that, in solution, (24) holds with equality.

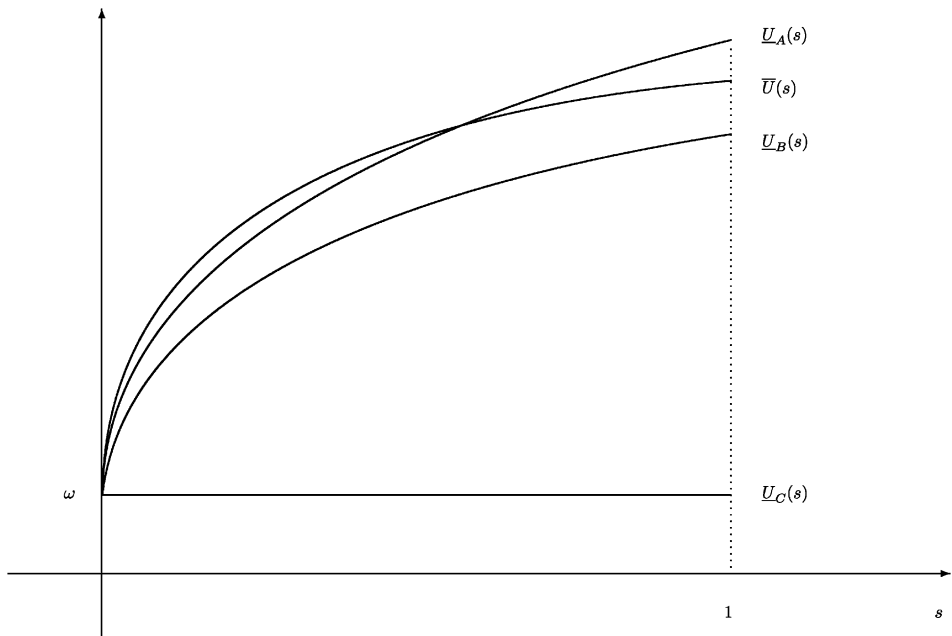


Fig. 2. Self-enforceability correspondence.

Therefore, using (23) and (24), we get that

$$u_H + \delta U_H = \omega(1 + \delta) + \frac{1 - \rho}{\bar{\rho} - \rho} a,$$

$$u_L + \delta U_L = \omega(1 + \delta) - \frac{\rho}{\bar{\rho} - \rho} a.$$

Then, necessary and sufficient conditions for a maximum are

$$v' \left[\omega(1 + \delta) + \frac{1 - \rho}{\bar{\rho} - \rho} a - \delta U_H \right] - \frac{\partial f(U_H; a)}{\partial U_H} \leq 0, \tag{26}$$

$$v' \left[\omega(1 + \delta) - \frac{\rho}{\bar{\rho} - \rho} a - \delta U_L \right] - \frac{\partial f(U_L; a)}{\partial U_L} \leq 0. \tag{27}$$

Notice that the left-hand side of (27) is a monotone decreasing function of U_L . It is straightforward to show that for $U_L = \omega$ such function assumes a strictly negative value. This implies that it is optimal to choose $U_L = \omega$. The left-hand side of (26) is also strictly decreasing in U_H and it is immediate to show that for $U_H = \omega$, it assumes a strictly positive value. Therefore in solution $U_H > \omega$. Then, self-enforceability also implies that $s_H > 0$. In fact, $\bar{U}(0) = \omega$. \square

A corollary of Proposition 4 is that the value of the firm is now higher than in the case of cash-only compensation considered in Section 5.1. The reason is that the possibility of awarding stock grants enables the firm to use both current and deferred compensation as incentive devices in period 1. For given outside value ω , a positive spread between U_H and U_L implies a lower spread between u_H and u_L . By strict concavity of the utility function, this implies a lower expected compensation, and thus higher firm value.

Corollary 6. $V_1^{\text{stock}} > V_1^{\text{cash}}$.

Proof. The value V_1^{cash} is the value of Problem (P1) under the restriction that $s_H \equiv s_L \equiv 0$. This proves that $V_1^{\text{cash}} \leq V_1^{\text{stock}}$. The fact that the inequality is strict follows from the observation that Problem (P1) defines the maximization of a strictly concave function over a strictly convex set, and therefore admits only one maximizer. \square

By Lemma 3, we also know that firm value in Scenario B will be weakly higher than in scenario A and weakly lower than in Scenario C. Notice, however, that if in scenario A the upper bound for the size of the stock grant s^* is so large that the constraint $U_H \leq \bar{U}(s^*)$ does not bind, then the optimal compensation contract (and therefore firm value) is the same across the three vesting scenarios.

5.3. A numerical example

Our model is too parsimonious to lend itself to a proper calibration. The numerical exercise that follows is to be considered simply as an illustrative example. The utility function is assumed to be $u(c) = c^{3/5}$. The remaining parameters are $\bar{\rho} = 0.7$, $\underline{\rho} = 0.4$, $\pi_H = 70$, $\pi_L = 60$, $\delta = 0.96$, and $\omega = 10$. We have solved for the optimal contract in the cases of full commitment, absence of commitment without stock, and absence of commitment with stock, for a large set of effort levels a in the interval $[0, 0.35]$. For the contract with stock, we have selected scenario C.

Fig. 3 illustrates how the three contracts change when we vary the level of managerial effort. The top left panel displays the levels of period-1 state-contingent utility u_H (upward sloping curves) and u_L (downward sloping curves). The top right panel displays the levels of promised utility U_H and U_L . Notice that in the case of no commitment and no stock, promised utility is not contingent on the first-period outcome, therefore current compensation is the only way to provide the manager with incentives to exert the high effort. When we allow for stock, promised utility becomes contingent. Differently from the full commitment case, however, promised utility contingent on a good outcome is bounded below by ω . In turn, this implies that the period-1 compensation contingent on the adverse outcome is lower than in the case of full commitment. The left bottom panel shows that, as predicted by Lemma 3, firm value is higher when stock is included in the compensation contract.

As noted above, the model does not pin down the sizes of the contingent stock grants. Promised utility contingent on a low period-1 outcome, being equal to ω , can always be delivered to the manager without making recourse to stock. This obviously

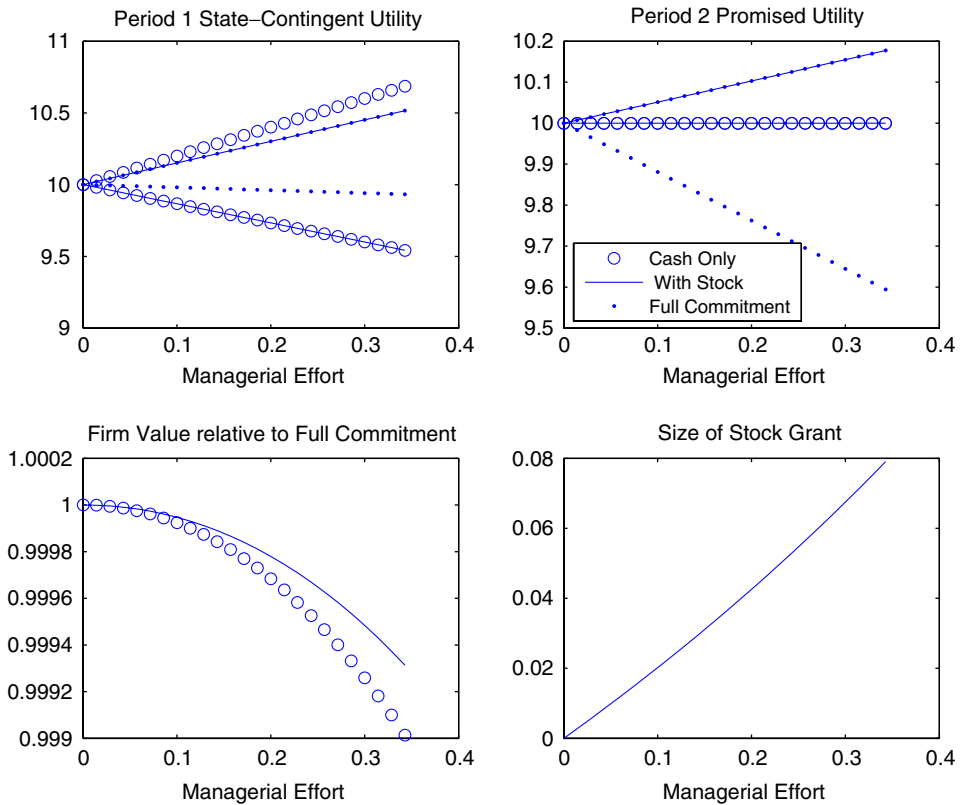


Fig. 3. Comparing contracts.

is not true for the promised utility contingent on a high period-1 outcome. The right bottom panel displays the size of the smallest grant s that insures self-enforceability of the optimal promised utility. The contingent period-2 cash compensations implied by $s_L = 0$ and by this minimal grant are depicted in the left panel of Fig. 4. The spread between w_H and w_L is greater conditional on low period-1 outcome, because in that case cash is the only means of period-2 compensation. The right panel depicts the cash compensations implied by one of the (infinitely) many other implementations of the optimal contract. We have chosen the case in which $s_L = s_H = 0.04$. In this case, when the required effort level is low, the cash flows generated by the stock grant provide the manager with ‘too much’ incentive. If the grant was not integrated by cash compensation, the difference between the levels of period-2 contingent utility would be higher than required by the incentive compatibility constraint. This is the reason why, contingent on a low profit realization, cash compensation must be higher than in the case of a high realization. Finally, notice that, according to the right bottom panel of Fig. 4, a compensation contract with $s_H = 0.04$ cannot implement the optimal allocation for values of the effort level a larger than approximately 0.2.

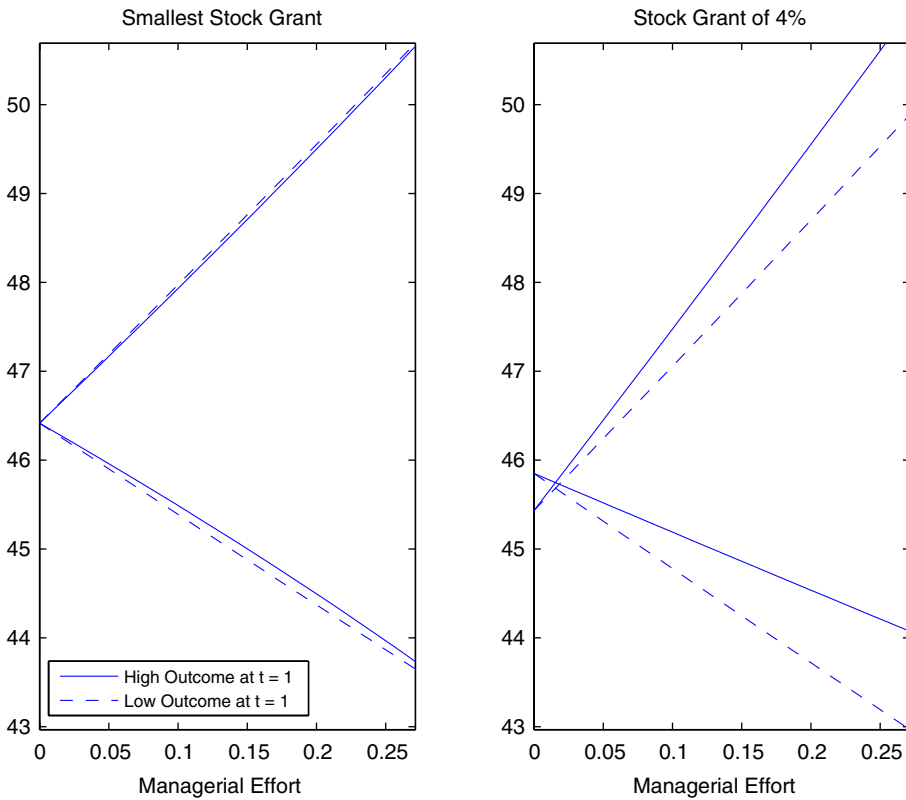


Fig. 4. Contingent wage compensation at $t = 2$.

6. Stock option grants

In the previous section we have established that in an environment characterized by imperfect contractual enforcement, including stock grants in the compensation contract has the potential to increase shareholder value.

This result depends crucially on the assumption that the firm can commit to actually grant stock at the end of period 1. In this section we investigate how the optimal contract changes once we dispense with this hypothesis. That is, we study the scenario in which firms cannot credibly commit to award stock at the end of period 1. We consider the case in which the firm replaces the contingent stock grant with options awarded at the beginning of time (i.e. when the contract is signed). In this new circumstance, the amount of stock obtained by the manager at the end of the first period is still contingent on the firm’s performance at $t = 1$, but cannot be chosen optimally by the owners.

We assume that the compensation contract consists of cash compensation and a stock option grant (z, P) , to be awarded at the beginning of time and exercisable at the end of period 1. With z we denote the largest fraction of the firm that the

manager can acquire, should he decide to exercise. In other words, z is the size of the option grant, measured as a percentage of total equity. We denote the exercise price (or, rather, the exercise total value) of the option, as P . Notice that once the manager has decided how many options to exercise, the firm's problem is the same as in the previous sections. This means that we can focus on period-1 problem. The value of the firm is given by

$$V_1^{\text{opt}} = \max_{z, P, \{w_i, s_i \in [0, z], U_i(s)\}_{i=H,L}} \bar{\rho}[\pi_H - w_H + \delta(1 - s_H)V_2(s_H, U_H)] + (1 - \bar{\rho})[\pi_L - w_L + \delta(1 - s_L)V_2(s_L, U_L)], \tag{P3}$$

subject to

$$\bar{\rho}[u(w_H - s_H P) + \delta U_H(s_H)] + (1 - \bar{\rho})[u(w_L - s_L P) + \delta U_L(s_L)] - a = (1 + \delta)\omega, \tag{28}$$

$$\bar{\rho}[u(w_H - s_H P) + \delta U_H(s_H)] + (1 - \bar{\rho})[u(w_L - s_L P) + \delta U_L(s_L)] - a \geq \underline{\rho}[u(w_H - s_H P) + \delta U_H(s_H)] + (1 - \underline{\rho})[u(w_L - s_L P) + \delta U_L(s_L)], \tag{29}$$

$$s_H = \arg \max_{s \in [0, z]} u(w_H - sP) + \delta U_H(s), \tag{30}$$

$$s_L = \arg \max_{s \in [0, z]} u(w_L - sP) + \delta U_L(s), \tag{31}$$

$$U_i(s) \geq \underline{U}(s), \quad i = H, L, \quad s \in [0, z], \tag{32}$$

$$V_2(s, U_i(s)) \geq V_2(0, \omega), \quad i = H, L, \quad s \in [0, z]. \tag{33}$$

The firm chooses the option grant (z, P) and the amount of options $s_i \in [0, z]$ that it wishes the manager to exercise, should state i occur. Constraints (30) and (31) impose that it is optimal for the manager to exercise s_i . The variable $U_i(s)$ is the expected continuation utility awarded to the manager, should state i occur, and should the manager exercise exactly s options. Conditions (32) and (33) impose that all promised utilities are self-enforceable, both *on* and *off* the equilibrium path.

A relevant feature of this contract is that period-2 wages are conditional on the exercise decision of the manager. That is, conditional on a given realization (high or low), two managers that exercise different quantities of their options may end up receiving different cash wages in period 2. Optimality requires the cash payments to be adjusted according to the realizations of the states. This may seem a little unusual but we would argue that it is not. It is not uncommon for managers whose options end up out of the money to have compensation adjusted in subsequent periods (see Acharya et al. (2000)).

6.1. Analysis

For simplicity, we limit our analysis to scenario A. Notice first that the continuation utilities off the equilibrium path do not enter the objective function or

any of the constraints, except for conditions (30) and (31). Therefore, off the equilibrium path we can set $U_i(s) = \underline{U}(s)$, $\forall s$, without loss of generality. That is, if the manager deviates from the suggested exercise policy, he will get his outside value. For any i , let also

$$s(w_i, P) \equiv \arg \max_{s \in [0, z]} u(w_i - sP) + \delta \underline{U}(s).$$

The quantity $s(w_i, P)$ is the fraction of options that the manager exercises if faced with a first-period wage w_i , exercise price P , and continuation utility $\underline{U}(s)$. In other words, $s(w_i, P)$ is the manager's optimal deviation. As in the previous sections, let $u_i \equiv u(w_i - s_i P)$. Since the incentive compatibility constraint (29) binds, we can use (28) and (29) to obtain

$$u_H + \delta U_H(s_H) = (1 + \delta)\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a,$$

$$u_L + \delta U_L(s_L) = (1 + \delta)\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a.$$

Finally, again without loss of generality, let $z = \max\{s_H, s_L\}$. Then, the problem of the firm can be rewritten as follows:

$$V_1^{\text{opt}} = - \min_{P, \{s_i \in [0, z], U_i\}_{i=H,L}} \bar{\rho}[v(u_H) + \delta f(U_H; a)] + (1 - \bar{\rho})[v(u_L) + \delta f(U_L; a)] - (1 + \delta)\bar{\pi},$$

subject to

$$U_i \in \Phi(s_i), \quad i = H, L,$$

$$u(w_H - s(w_H, P)P) + \delta \underline{U}(s(w_H, P)) \leq (1 + \delta)\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a, \tag{34}$$

$$u(w_L - s(w_L, P)P) + \delta \underline{U}(s(w_L, P)) \leq (1 + \delta)\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a, \tag{35}$$

$$u_H = (1 + \delta)\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a - \delta U_H,$$

$$u_L = (1 + \delta)\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a - \delta U_L,$$

$$w_H = s_H P + v \left[(1 + \delta)\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a - \delta U_H \right],$$

$$w_L = s_L P + v \left[(1 + \delta)\omega - \frac{\underline{\rho}}{\bar{\rho} - \underline{\rho}} a - \delta U_L \right].$$

Notice that conditions (34) and (35) are the reformulation of conditions (30) and (31).

Proposition 5 states that the contract with stock options implies a firm value that is lower than that implied by the contract with stock grants characterized in Section 5.2. The intuition is simple. In order to replicate the allocation achieved with stock grants, the compensation contract with options must be such that in the high state the manager exercises a quantity of options equal to the stock grant. In the low state, instead, he must find it convenient not to exercise any option. Such a contract may not exist. Proposition 5 states also that the contract with options performs strictly better than the contract with cash compensation only. The reason is that, contrary to the contract with cash only, the contract with options allows continuation utilities U_H and U_L to differ.

Proposition 5. *The values V_1^{cash} , V_1^{stock} , V_1^{opt} satisfy $V_1^{\text{cash}} < V_1^{\text{opt}} \leq V_1^{\text{stock}}$.*

Proof. The fact that $V_1^{\text{opt}} \leq V_1^{\text{stock}}$ follows directly from the observation that V_1^{opt} maximizes the same function as V_1^{stock} , but on a smaller feasibility set. To prove that $V_1^{\text{cash}} < V_1^{\text{opt}}$, we will show that there exists a feasible, and possibly sub-optimal contract with options, that delivers a firm value strictly larger than V_1^{cash} . Let $s_L = 0$ and $U_L = \omega$, so that $w_L = v(\omega + [\underline{\rho}/(\bar{\rho} - \underline{\rho})]a)$. Such choices imply that, conditional on the low state occurring, the manager will receive the same utility awarded by the optimal contract with cash. Further, let $P = \delta[(V_2(0, \omega)u'(c^*)) / (u'(w_L))]$. At such exercise price, it is optimal for the manager to exercise zero options in the low state. Finally, whatever s_H , set $U_H = \underline{U}(s_H)$. Now we just need to show that there exists a couple (w_H, s_H) , with $s_H > 0$, such that the two following conditions hold:

$$u(w_H - s_H P) + \delta \underline{U}(s_H) = (1 + \delta)\omega + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a, \tag{36}$$

$$-Pu'(w_H - s_H P) + \delta V_2(0, \omega)u'(c^* + s_H V_2(0, \omega)) \geq 0. \tag{37}$$

Condition (37) requires that it is optimal for the manager to exercise s_H options in the high state. Recall that $u(w_L) + \delta \underline{U}(0) = (1 + \delta)\omega - [\underline{\rho}/(\bar{\rho} - \underline{\rho})]a$. Therefore, there exists a value w_H , with $w_H > w_L$, such that $u(w_H) + \delta \underline{U}(0) = (1 + \delta)\omega + (1 - \underline{\rho})/(\bar{\rho} - \underline{\rho})a$. Given that $u' > 0, u'' < 0$, it follows that $-Pu'(w_H) + \delta V_2(0, \omega)u'(c^*) > 0$. Then, by continuity of u' , there exist strictly positive values s_H , and wages $w_H(s_H)$ implied by (36), such that the pairs $(s_H, w_H(s_H))$ satisfy (37). \square

The main lesson of Proposition 5 is that, when enforcement problems are so severe to make contingent grants of stock unavailable, awarding call options at the signing of the contract has the potential to increase shareholder value with respect to the case of cash-only compensation. We conjecture that, under this further restriction on the firm's commitment ability, the award of securities other than options at the signing of the contract would also imply higher shareholder value than in the case of cash-only compensation. What is crucial is that these securities pay state-contingent cash-flows.

7. Conclusion

In this paper we have presented a simple model of the relationship between a firm and its manager. We have shown that if the enforcement of compensation contracts is imperfect, cash compensation and stock grants are no longer perfectly substitutable means to compensate managers. By awarding stock, a company is able to overcome (at least partially) its lack of commitment and can credibly promise to deliver continuation utility levels that are higher than the manager's reservation utility. As a consequence, deferred compensation can be made contingent on current performance. By using both current and deferred compensation for incentive purposes, a firm can provide its manager with a given utility level at a lower cost, therefore increasing shareholder value. Our analysis also shows that if the commitment problems generated by imperfect enforcement are so severe so as to make contingent stock grants unavailable, firms can still improve over cash-only compensation, by awarding state-contingent securities (options, in our analysis) at the signing of the contract.

In the introduction we have argued that the literature on the design of optimal compensation contracts is still in its infancy. Further work in the area is warranted, as it could be useful to both companies' compensation committees and regulators. In particular, we think it would be worth extending our analysis in two dimensions. First, it would of interest to allow the manager to select the riskiness of his projects. [Carpenter \(2000\)](#) studies the decision problem of a risk-averse manager compensated with stock options, under the assumption that he can determine the riskiness of the projects he undertakes, but the compensation scheme she considers is not optimal. The second idea is to consider correlated shocks. Essentially, this amounts to assume limited commitment and introduce stock compensation in the environment studied by [Mukoyama and Sahin \(2005\)](#).

Acknowledgements

Our work has benefited greatly from the comments of Wouter Den Haan (the editor), two anonymous referees, Rui Albuquerque, Cevdet Aydemir, Jennifer Carpenter, Christine Parlour, Vincenzo Quadrini, and Duane Seppi. We are also grateful to attendants at the GSIA Financial Economics Lunch Seminar, the 2002 North American Summer Meeting of the Econometric Society, and the CFS Conference on Contracts and Institutions in Models with Heterogeneous Agents for their comments and suggestions. All remaining errors are our own responsibility.

Appendix A. Optimal contract with stock: complete analysis

In this appendix, we generalize our result in Proposition 4 to the cases where $\Phi(s)$ is not necessarily non-empty over $[0, s^*]$ for some $s^* \in (0, 1)$. One such case is depicted in [Fig. 5](#).

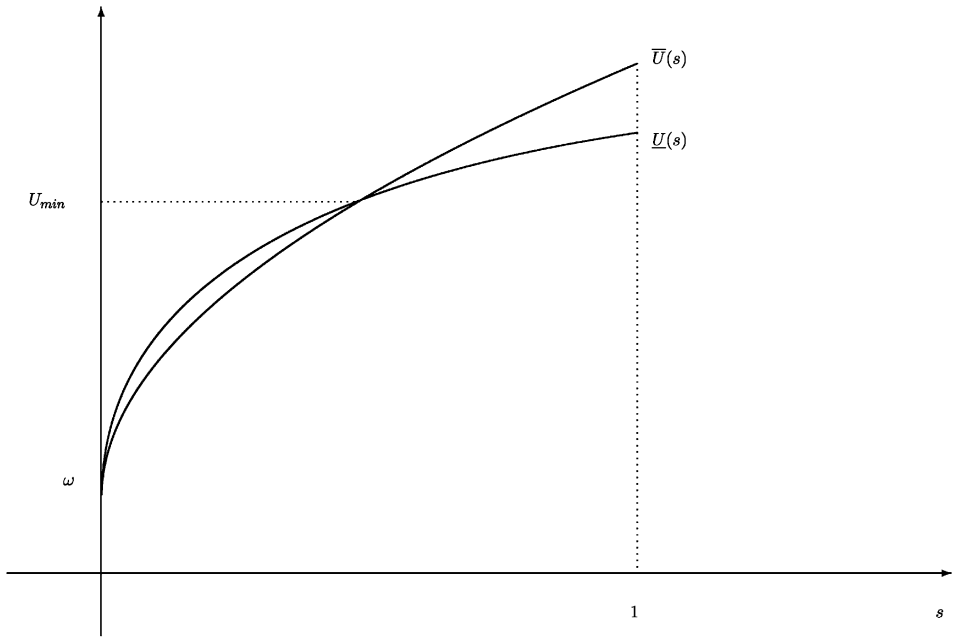


Fig. 5. Self-enforceability correspondence.

Let $\tilde{\Phi}$ denote the graph of the self-enforceability correspondence, i.e. $\tilde{\Phi} \equiv \{U : \exists s \in [0, 1] \text{ such that } U \in \Phi(s)\}$. Let also $U_{\min} \equiv \min\{U : U \in \tilde{\Phi}, U \neq \omega\}$. In other words, except ω , U_{\min} is the smallest self-enforceable utility promise.

Proposition 6. (i) *The optimal contract has $U_L = \omega$.* (ii) *Suppose U_{\min} is sufficiently close to ω (in the sense to be made precise in the proof). Then the optimal contract must also have $s_H > 0$ and $U_H > \omega$.*

Proof. The proof of (i) is the same as in Proposition 4. To prove (ii), notice that

$$U_H = \arg \min_{U_H \in \tilde{\Phi}} F(U_H) \equiv v \left(\omega(1 + \delta) + \frac{1 - \underline{\rho}}{\bar{\rho} - \underline{\rho}} a - \delta U_H \right) + \delta f(U_H; a).$$

Since the function F is strictly convex and strictly decreasing at ω , it follows that $U_H > \omega$ if and only if $F(U_{\min}) \leq F(\omega)$. Finally, the self-enforcing constraint $U_H \in \Phi(s_H)$ implies $s_H > 0$. \square

A parametric example in which $U_{\min} > \omega$ and $s_H > 0$ is for $u(c) = \log(c)$, $\delta = 0.75$, $\pi_L = 0.01$, $\pi_H = 1.0$, $\underline{\rho} = 0.0$, $\bar{\rho} = 0.5$, $a = 1.0$, and $\omega = \log(0.0001)$.

Appendix B. Lemmas

Lemma 7. *If $\forall e \in [0, a]$*

$$\frac{v' \left[\frac{U(s) + \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} e}{\bar{\rho}-\underline{\rho}} \right] - v \left[\omega + \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right]}{v' \left[\frac{U(s) - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} e}{\bar{\rho}-\underline{\rho}} \right] - v' \left[\omega - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right]} > \frac{\underline{\rho}(1-\bar{\rho})}{\bar{\rho}(1-\underline{\rho})},$$

then $\Phi_A(s) = \emptyset$.

Proof. By (17), $\underline{U}(s)$ satisfies

$$v(\underline{U}(s)) = c^* + s[\bar{\pi} - f(\omega; a)]$$

which is equivalent to

$$f(\underline{U}(s); 0) - f(\omega; 0) = s[\bar{\pi} - f(\omega; a)].$$

On the other hand, $\Phi_A(s) = \emptyset$ if and only if

$$f(\underline{U}(s); a) - f(\omega; a) > s[\bar{\pi} - f(\omega; a)].$$

Sufficient condition for this is that

$$\frac{\partial}{\partial e} [f(\underline{U}(s); e) - f(\omega; e)] > 0 \quad \forall e. \tag{38}$$

It turns out that

$$\frac{\partial f(x; e)}{\partial e} = \bar{\rho} \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} v' \left(x + \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right) - (1-\bar{\rho}) \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} v' \left(x - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right).$$

Then, since $\bar{\rho} - \underline{\rho} > 0$ and $v'' > 0$, (38) holds if and only if

$$\frac{v' \left[\frac{U(s) + \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} e}{\bar{\rho}-\underline{\rho}} \right] - v' \left[\omega + \frac{1-\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right]}{v' \left[\frac{U(s) - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} e}{\bar{\rho}-\underline{\rho}} \right] - v' \left[\omega - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} e \right]} > \frac{\underline{\rho}(1-\bar{\rho})}{\bar{\rho}(1-\underline{\rho})}. \quad \square$$

Lemma 8. *Assume $\lim_{c \rightarrow 0} u(c) = -\infty$. Then, for any $s \in (0, 1]$ there exist $c^* > 0$ and $\pi_L > 0$ such that $\Phi_B(s) \neq \emptyset$.*

Proof. Consider any $s \in (0, 1]$. Using (14) and (16), it is easy to obtain

$$\pi_L - w_L^* = \frac{1}{1-s} \left[\pi_L - v \left(\omega - \frac{\underline{\rho}}{\bar{\rho}-\underline{\rho}} a \right) \right].$$

Now recall that by (4),

$$\underline{U}_B(s) = \bar{\rho} u[c^* + s(\pi_H - w_H^*)] + (1-\bar{\rho}) u[c^* + s(\pi_L - w_L^*)].$$

Since $\lim_{u \rightarrow -\infty} v(u) = 0$, for every $\bar{u} > -\infty$ there exist $c^* > 0$ and $\pi_L > 0$ such that $\underline{U}_B(s) < \bar{u}$.

On the other hand, it is also the case that $\lim_{\omega \rightarrow -\infty} f(\omega; a) = 0$. In turn, this implies that, for any couple (ω, π_L) ,

$$\bar{U}(s) = f^{-1}[f(\omega; a) + s(\bar{\pi} - f(\omega; a))] > f^{-1}(s\bar{\rho}\pi_H).$$

Therefore, it is enough to pick values $c^* > 0$ and $\pi_L > 0$ such that $\underline{U}_B(s) < f^{-1}(s\bar{\rho}\pi_H)$. \square

References

- Acharya, V.V., John, K., Sundaram, R.K., 2000. On the optimality of resetting executive stock options. *Journal of Financial Economics* 57, 65–101.
- Aseff, J., Santos, M., 2005. Stock options and managerial optimal contracts. *Economic Theory* 26, 813–837.
- Carpenter, J., 2000. Does option compensation increase managerial risk appetite? *Journal of Finance* 55, 2311–2331.
- Clementi, G.L., Cooley, T., 2000. Sensitivity of CEO pay to shareholder wealth in a dynamic agency model. GSIA, Carnegie Mellon University.
- Garen, J., 1994. Executive compensation and principal-agent theory. *Journal of Political Economy* 102, 1175–1199.
- Haubrich, J., 1994. Risk aversion, performance pay, and the principal-agent problem. *Journal of Political Economy* 102, 258–276.
- Holmstrom, B., 1979. Moral hazard and observability. *Bell Journal of Economics* 10, 74–91.
- Kocherlakota, N.R., 1996. Implications of efficient risk sharing without commitment. *Review of Economic Studies* 63, 595–609.
- Lipman, F.D., 2001. *The Complete Guide to Employee Stock Options*. Roseville, CA, Prima Venture.
- Mukoyama, T., Sahin, A., 2005. Repeated moral hazard with persistence. *Economic Theory* 25, 831–854.
- Phelan, C., 1995. Repeated moral hazard and one-sided commitment. *Journal of Economic Theory* 66, 488–506.
- Shleifer, A., Summers, L., 1988. Breach of trust in hostile takeovers. In: Auerback, A. (Ed.), *Corporate Takeovers: Causes and Consequences*. University of Chicago Press, pp. 33–56.
- Thomas, J., Worrall, T., 1988. Self-enforcing wage contracts. *Review of Economic Studies* 55, 541–554.
- Utz, J.L., 2001a. Executive compensation and severance pay litigation: part I. *Journal of Deferred Compensation* 6 (3), 14–63.
- Utz, J.L., 2001b. Executive compensation and severance pay litigation: part II. *Journal of Deferred Compensation* 6 (4), 57–109.
- Wang, C., 1997. Incentives, CEO compensation, and shareholder wealth in a dynamic agency model. *Journal of Economic Theory* 76, 72–105.