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Massive Kinked Bonuses

While most people are paid by the hour or with a yearly salary, some are also paid bonuses. And, some are paid very large, all-or-nothing bonuses.

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My favorite recent example is from last summer when golfer Darren Clarke earned a $3-million bonus from his sponsor. But it was how the payout was structured more than the amount that so intrigued me — his sponsor's payout was all or nothing.

All or Nothing?

For some time, Clarke wore the logo of sporting goods company Dunlop on his golf shirt and was paid nothing unless something extraordinary happened. The golfer from Northern Ireland agreed with Dunlop that he would wear the logo in all tournaments and would be paid only if he won a major tournament. There are four major tournaments in golf: the Masters, the U.S. Open, the British Open and the PGA Championship. Going into the British Open tournament, the 42-year old Clarke was ranked 111th in the world and had never won a major championship. When he won the British Open, he collected the $1.45-million winner's check and the win-and-take-all $3-million bonus from Dunlop (Larry Dorman, *The New York Times*, July 18, 2011).

How (or against what work-related objective) people are paid is fascinating. It is particularly interesting in this case of very, very large bonuses. The sports odds that Darren Clarke would win the tournament going into it were roughly 200 to 1. Winning $3 million at odds of 200 to 1 calculates to an expected payment of $3 million divided by 200, or $15,000.

But did this all-or-nothing bonus motivate him differently than paying him $15,000 flat out for just wearing the logo

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in a single tournament? And if so, motivate him to do what? Show more methodical and conservative conduct? Doubtful, since one could argue that the payout structure could have created incentives to the contrary. Be a better golfer by making him hungrier for the win? (Would he really have been less hungry without the all-or-nothing bonus?) Be a better billboard for the sponsor? Certainly the sports world was buzzing about the Dunlop deal last summer getting the company more publicity than normal for sponsoring an athlete, and folks (like me) are still talking and writing about it. Clarke did win a major, after all.

What Research Says

Many people are paid bonuses, many more are paid for their time and some are paid for piece work. An important research paper in the area is Edward Lazear's "Salaries versus Piece Rates" (*Journal of Business*, July 1986) that nicely outlines the costs and benefits of paying in different forms while considering issues like incentives, risk, and relative and absolute values of output. The issues are obviously complicated and many people are paid small bonuses very frequently (think for a moment about tips and sales contracts and all of the people who are compensated this way).

Many economists believe that folks are paid such bonuses because it is efficient and mutually beneficial, especially given the constraints mentioned by Lazear. Others feel that many who receive large bonuses do so in ways that are not entirely open or appropriate. This lack of transparency combined with an all-or-nothing high-stakes payout increases the likelihood of adverse behavior — such as short-termism, unethical actions or undermining the productivity of colleagues (and therefore the company) in trade for increasing one's own pay. Massive kinked bonuses, like Darren Clarke's $3-million all-or-nothing in golf are very rare, but worth discussing, as generalizable lessons can be learned from extreme events.

Should Boards Pay Massive Bonuses to Themselves?

A few years ago a major international company had an arrangement where it essentially paid its directors a bonus if earnings hit a certain target and nothing otherwise (this wasn't precisely the arrangement but it's accurate enough for our discussion). Does this system, where a board director was paid roughly $500,000 if the firm hits a certain target of earnings per share and absolutely nothing if the firm does not, get the directors to care about the bottom line and be aligned with shareholders? Yes. But, in the event that the company has earnings that are close to the target but aren't quite there, hasn't this compensation contract created an environment where inappropriate accounting methods or short-sighted manipulations are more tempting than ever? Absolutely! Paying massive kinked bonuses may work in some circumstances where the adverse incentives created are low-harm, but directors' pay is not one of them.

Other Sports Examples

One can argue whether in sports the adverse incentives created by kinked or all-or-nothing bonuses are low-harm. But these kinds of arrangements are increasing in popularity. It was revealed in January that Tim Tebow, the young quarterback for the NFL's Denver Broncos, was to earn a $250,000 bonus for each playoff win his team had (so long as he played 70 percent of the time during the season). Tebow played in more than 70 percent of the games and the Broncos won one playoff game.

Also in January it was revealed that if Louisiana State University (LSU) won the Bowl Championship Series (BCS) against Alabama and became BCS National Champions, LSU's coach Les Miles would have his salary raised by $980,000 for each of the six years left on his contract. Does this seem like an odd number? Maybe. But Alabama coach Nick Saban is contracted to earn $4.73 million in 2012 and Miles (who now earns $3.751) had a clause in his contract with LSU to pay him $1,000 more per year than the highest paid coach in his league (who just happens to be Alabama's Saban). (Brad Wolverton, *The Chronicle of Higher Education*, Jan. 5, 2012). Alabama won the game (21-0) with crushing defense so Coach Miles' pay is $980,000 less this coming year than it would have been otherwise. As I have noted previously (May 2011 in this column), relative pay matters a lot.

Some consider the true value of sports is that the games teach lessons for life. In addition to that, and just being interesting, sports also teach lessons for compensation. ws

got a ? question

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