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REFLECTIONS ON EXECUTIVE COMPENSATION AND A MODEST PROPOSAL FOR (FURTHER) REFORM

*Mark J. Loewenstein**

I. INTRODUCTION

Executive compensation in publicly-held corporations, particularly the compensation of the chief executive officer (“CEO”), is of perennial interest. Like movie stars and sports figures, highly-paid CEOs attract media attention. Each spring, when publicly-held corporations report on executive pay, stories about executive compensation are as predictable as stories about spring flooding. The only question, in each instance, is the extent of the damage.

But the public outcry that accompanies stories on CEO pay has no parallel in sports or cinema, where lavish compensation is hardly unknown. Little controversy follows a disclosure that a movie star will receive \$10 million for his or her next motion picture, but criticism abounds when the media reports that the average compensation for the country’s highest paid CEOs exceeds \$2 million. People feel, instinctively, that if a movie studio pays a star \$10 million for a single motion picture, the star must be worth that much, but the public is skeptical that the studio’s CEO is worth \$10 million for serving in that capacity for the year. And, there is some basis for the public’s cynicism, as representatives of the studio and the star seem to deal at arm’s length when the star’s compensation is fixed, but the CEO and the board at least seem to sit on the same side of the table when the CEO’s compensation is determined.

The current debate over executive compensation revolves around several different questions, not always separately identified: first, are U.S. CEOs overcompensated; second, if CEOs are overcompensated, why is that the case; and third, again assuming that overcompensation is proven, how can the situation best be rectified. Lurking behind the third question are further questions as to whether governmental intervention is either appropriate or likely to be effective in reducing compensation levels, or whether intervention would have the unintended consequence of harming corporate performance. Finally, assuming overcompensation is not proven, we might ask whether the public perception of overcompensation is worth addressing and, if so, how.

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The first two questions are dealt with in the next section, where I suggest that no clear answer emerges from the empirical work as to whether CEOs are overcompensated, but that apparent deficiencies in corporate governance support the popular perception that they are.¹ In reaction to the popular perception, the federal government has seen fit to seek to "correct" this problem. This intervention, together with the judiciary's approach to the problem, should be considered in light of the uncertainty that a problem exists. While one might argue that no governmental intervention is appropriate, the persistent public perception that a problem exists, coupled with the strong possibility that this perception is accurate, justifies an intervention designed to strengthen corporate governance without adversely affecting corporate performance. This Article considers the role of the judiciary, the interventions recently put in place, and other proposed interventions. The Article concludes with a modest proposal designed to provide some assurance that CEO pay is within reasonable limits.

II. A VIEW OF OVERCOMPENSATION AND THE QUICK FIXES

The standard analysis of CEO compensation begins with a recitation of eye-catching statistics. For instance, in the most recent *Wall Street Journal* annual report on executive pay, the median combined salary and bonus for CEOs in 350 of the largest U.S. companies was \$1,432,000 in 1995, an increase of 10.4% from 1994 levels.² Another recent study, which examined CEO pay over the period 1992-1994, used as a sample CEOs who had served for at least three years in one of the 424 largest U.S. publicly-held corporations.³ Due to turnover in the corporations that were included in the sample, there were only 292 CEOs who had served for at least three years.⁴ These individuals earned an average of \$2.7 million (including base salary, performance bonus, and long-term incentives) in 1992.⁵ This average (among the same individuals) increased to \$3.3 million in 1993, and \$3.7 million in 1994, amounting to increases of 20.6% and 12.8%, respectively.⁶ By contrast, the average American worker earned \$18,900 in 1992, \$19,390 in 1993, and \$20,000 in 1994, thus realizing gains of only 2.6% in 1993 and 3% in 1994.⁷ As a result, the pay of CEOs in this sample, as a multiple of the pay of the average American worker, went from 145 times in 1992, to 170 times in 1993, to 187 times in

1. A 1990 Gallup Poll estimated that more than 70% of the American public thinks that corporate executives are paid "too much." Jay Schmiedeskamp, *Majority of Americans Think That Top Officials Are Overpaid*, GALLUP POLL MONTHLY, Dec. 1990, at 21-22.

2. Joann S. Lublin, *The Great Divide*, WALL ST. J., Apr. 11, 1996, at R1 [hereinafter *Great Divide*].

3. Graef Crystal, *In Game of 'I Win, You Lose,' CEOs are Getting Richer Faster Than Workers Can Say 'Logic'*; *Growing the Pay Gap*, L.A. TIMES, July 23, 1995, at D2.

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

1994.⁸

Another favorite yardstick is a comparison of the compensation of U.S. CEOs to the compensation of their European counterparts. On this basis, too, the compensation of U.S. CEOs is impressive, if not excessive. For instance, a recent study conducted by Hewitt Associates, a management consulting firm, compared the average compensation of U.S. and European CEOs at companies with median annual revenues of \$500 million.⁹ Compensation, for these purposes, included base salary, annual bonus, employee benefits, long-term incentives, and perquisites (the one category where European CEOs outpace their American counterparts).¹⁰ The survey showed that CEOs in the U.S. earned, on average, \$1,085,000, compared to \$551,600 for CEOs in Great Britain, \$537,000 for CEOs in Germany, \$485,004 for CEOs in France, and \$318,000 for CEOs in Italy.¹¹

The public perception of overcompensation, which is suggested by such figures, is confirmed, and in part shaped, by critics such as Graef Crystal, who has written extensively on executive compensation.¹² A recent survey conducted by Mr. Crystal, analyzing 1994 pay, suggests, as past studies have, that the link between CEO pay and company performance is slight, at best, and among smaller publicly-held corporations, it is nonexistent.¹³ Crystal and others argue, based largely on statistical comparisons, that U.S. CEOs are overcompensated; they also seek to explain why.¹⁴

In this view, the CEO is an informed seller of his services, but the board is not an informed buyer. Additionally, the negotiations fixing compensation are not at arm's length. The board relies on its compensation committee, which consists of highly paid chief executives from other companies. For this and other reasons, the board is insufficiently motivated to engage in hard bargaining. Moreover, the compensation committee depends on outside consultants who are not wholly objective in their recommendations. These outside consultants are beholden to the CEO for their initial appointment and are anxious to obtain other consulting business from the company, such as consulting on employee benefit plans.

Critics also cite the effect of compensation surveys as an explanation for excessive compensation. When a typical board or compensation com-

8. *Id.*

9. Tara Parker-Pope, *So Far Away*, WALL ST. J., Apr. 11, 1996, at R12.

10. *Id.*

11. *Id.*

12. Mr. Crystal writes regularly on executive compensation for the *Los Angeles Times*, *Fortune*, and other publications. Indeed, Mr. Crystal seems to have made a career of analyzing, reporting, and critiquing executive compensation.

13. Graef Crystal, *CEOs and Incentives: The Myth of 'Pay-For-Performance'*, L.A. TIMES, Jan. 8, 1995, at D1; see also Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It Is Not How Much You Pay Them, But How*, HARV. BUS. REV., May-June 1990, at 138 [hereinafter *Jensen & Murphy*]. But the work of some economists suggests otherwise. See *infra* note 23.

14. See, e.g., DEREK BOK, *THE COST OF TALENT* 95-118 (1993); GRAEF CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 42-50 (1991).

mittee reviews surveys conducted by the compensation consultant, it will seek to pay its CEO the average or higher. Obviously, if enough companies adopt this attitude, CEO pay will rise for that reason alone.¹⁵

Another frequently cited reason for the board's poor bargaining is the interdependent relationship between the board's outside directors and the CEO. These directors, who bear the responsibility of approving compensation plans, are dependent on the CEO for their compensation as board members, compensation which has also risen dramatically in recent years.

These observations and conclusions are not, of course, unchallenged, but scholarly work disputing the proposition that U.S. CEOs are overcompensated is thin. For instance, in 1992, the *Harvard Business Review* ("Review") published an article by two Wall Street lawyers that, in effect, disputed the proposition that CEOs are overpaid.¹⁶ Instead, the authors argued, the debate over CEO pay has been fueled by "political correctness," and, in fact, CEOs are fairly compensated in relation to their performance.¹⁷ To support this latter conclusion, the authors relied primarily on a then unpublished study by a compensation expert with a national accounting firm.¹⁸ That expert concluded that the pay of CEOs matches performance in 80% of the cases.¹⁹ According to the authors, the superior methodology of this study, which accounts for industry complexity, management initiatives, and risk in a way that other studies do not, justifies reliance on its conclusions.²⁰ This study was immediately attacked, in a subsequent issue of the *Review*, by Crystal and others.²¹

15. A survey of 100 companies conducted by Crystal indicated that 35 companies aim at the top quarter of the distribution, 65 aim for the middle, and none aim to fix compensation below average. Graef Crystal, *Why CEO Compensation Is So High*, CAL. MGMT. REV., Fall 1991, at 20. See also *Great Divide*, *supra* note 2, at R4 ("The success of CEO celebrity heroes triggered a wave of financial leapfrogging by other chiefs who didn't necessarily deserve gold-plated pay. Boards contributed to this ratcheting effect by increasingly pegging a leader's compensation at the highest quartile of a survey group, rather than the median.").

16. Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28.

17. *Id.* at 29.

18. *Id.* at 30.

19. *Id.*

20. *Id.*

21. In the succeeding issue of the *Review*, Crystal and other critics of executive compensation took issue with the cited study, which was done by Michael Kesner of Arthur Andersen & Company. *CEO Pay: How Much is Enough?*, HARV. BUS. REV., July-Aug. 1992, at 130.

Crystal's criticism of Kesner focused on these and other factors:

1. Kesner's work was unpublished and thus unavailable for scholarly critique.

2. Kesner defined performance as one-year growth in sales and one-year return on equity, eschewing the more traditional measure of total shareholder return.

3. In Crystal's view, Kesner's data does not support the conclusion that CEO pay matches performance. *Id.*

Crystal is similarly critical of Jensen and Murphy's oft-cited article, see *Jensen & Murphy*, *supra* note 13, at 183, which recommends that CEO pay be linked to performance. *Id.* at 130-31. Jensen and Murphy had concluded, based on a study of 430 publicly-held corporations, that pay was not adequately linked to performance, but that CEOs would perform more effectively if that were the case. *Id.* at 131. In response, Crystal writes, "[u]sing their

Criticisms aside, it is noteworthy that these defenders of CEO pay relied on a single, unpublished study as their principle authority for the proposition that CEO pay is commensurate with performance.²² This is not a reflection of poor research by the authors, but rather a reflection of the paucity of literature defending CEO pay.²³ Furthermore, the literature that does exist tends to be in professional journals and tends to focus on the presence or absence of a statistical relationship between executive compensation and corporate performance.²⁴

The work of those who criticize CEO pay, although appealing, simply does not "prove" that any particular CEO is overpaid, much less that an entire class of CEOs is overpaid. What is lacking in such work is some indication of what the CEOs would earn if the market for their services were more efficient. In the absence of evidence that the "overpaid" individuals would have been willing to accept less for their services, or that CEOs occupy some sort of monopoly position regarding executive services, it is difficult to accept the proposition as proven. On the other hand, the "opposing" studies tend to conclude, at best, that executive pay does bear a statistical relationship to corporate performance.²⁵ Such studies do not prove that CEOs are not being overpaid, at least in the sense of proving that the market for CEOs is working efficiently.

Nevertheless, the systemic shortcomings in the operation of the typical corporate board noted above combined with the staggering pay levels certainly give rise to a strong inference that overcompensation is present. This inference, in turn, has been the justification for governmental interference, through judicial activism and administrative and congressional action. Rather than seeking to rebut this inference, writers who have resisted governmental interference have tended to focus on the importance

430 companies and their sensitivity numbers, I discovered that there is no significant relationship between pay-package sensitivity and total shareholder return, whether the time window is one year, ten years, or any intervening period." *Id.*

Interestingly, Kesner also wrote in the same issue, but did not defend his analysis. *Id.* at 133.

22. Kesner subsequently published an article on the subject. See Michael Kesner, *Are U.S. Executives Paid Too Much?*, CORPORATION, Feb. 1, 1993, at 1.

23. There are, of course, other defenders. See, e.g., Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125. In addition, some studies in academic journals also support the proposition that there is a statistical correlation between executive compensation and corporate performance. See, e.g., Michael C. Jensen & Jerold L. Zimmerman, *Managerial Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3 (1985); Wilbur Lewellen et al., *Executive Compensation and the Performance of the Firm*, 13 MANAGERIAL & DECISION ECON. 65 (1992); Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11 (1985); Ahmed Riahi-Belkaoui, *Executive Compensation, Organizational Effectiveness, Social Performance and Firm Performance: An Empirical Investigation*, 19 J. BUS. FIN. & ACCT. 125 (1992). While such studies tend to prove a positive correlation between executive compensation and corporate performance, they have nothing to say about the level of compensation. Moreover, economists are hardly in agreement that pay reflects corporate performance. See, e.g., ROBERT C. CLARK, *CORPORATE LAW* 193 n.6 (1985); John E. Garen, *Executive Compensation and Principal-Agent Theory*, 102 J. POL. ECON. 1175 (1994).

24. See *supra* note 23.

25. *Id.*

of pay plans that better “align” the CEO’s incentives with shareholder interests, arguing that if shareholders benefit, the problem of overcompensation—and the necessity of governmental interference—becomes moot. Indeed, the literature is full of writings extolling the virtues of such plans, proposing either that CEO pay be heavily dependent on meeting certain performance goals (for example, earnings per share, return on investment, or increases in stock price and dividends) or that compensation be heavily weighted toward stock options or restricted stock.²⁶ Another frequently proposed remedy, which often accompanies the suggestion that pay be linked to performance, is to increase the representation of independent directors on the board, on the theory that directors independent of management will bargain harder (with management) and direct more effectively. None of these solutions is without significant problems.

The pay-for-performance idea is often expressed in these terms: The amount of compensation is not important; rather, what is important is the method by which compensation is determined. Proponents of this view argue that CEO pay should be tied to increases in shareholder wealth, that if the CEO’s efforts make the shareholders better off, the shareholders should have no complaints. But such arguments beg the question. Even assuming that the CEO should share in the wealth he has helped to create, the question is still open as to what portion of that additional wealth should be paid to the CEO. Intuitively, it seems that the CEO ought not to receive half of the gain, particularly if the gain in shareholder wealth is in the tens of million of dollars. But why not, under this reasoning? The intuition is based on the notion that in most, if not all, cases, the CEO cannot take sole credit for the gain, and ought not to receive the lion’s share of it. The intuition is also based on notions of fairness and equity, notions that underlay the entire debate on executive compensation. It is no answer to dismiss such notions as romantic and irrelevant. The notions are relevant and result in real consequences, such as the administrative and legislative responses discussed below.²⁷

There is little debate over the proposition that executive compensation should, at least in part, be tied to performance, or put differently, that the executive’s incentives and shareholder interests should converge.²⁸ But

26. See, e.g., *Jensen & Murphy*, *supra* note 13, at 138; Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713 (1995).

27. There is some basis for believing that seemingly excessive CEO pay has a deleterious affect on employee morale. See ROBERT A.G. MONKS & NELL MINOW, *POWER AND ACCOUNTABILITY* 170 (1991). See also *Great Divide*, *supra* note 2, at R4 (discussing the effect of high CEO pay on employee morale); Bok, *supra* note 14, at 104:

The entire country has an interest in whether earnings are above what is needed to attract and motivate corporate leaders. After all, the distribution of income affects the degree of justice in the society, the public’s confidence in the economic system, even the balance of political power and influence in the nation.

28. But see Bok, *supra* note 14, at 108-14 (questioning the wisdom of pay-for-performance plans). Consider, as well, the discontinuity between close corporation tax cases and the controversy surrounding the publicly-held companies. The Service will scrutinize com-

in serious consideration about executive compensation those propositions are only the beginning of the inquiry, not the end.²⁹ As noted above, the absolute amount of compensation, regardless of formula, is still important.

Of equal importance is the design of the plan itself. For instance, the popular idea, that executive compensation should be tied to increases in shareholder wealth, that is, increases in stock price and dividends, may not necessarily redound to the long-term interests of shareholders. Increases in shareholder wealth are a function not only of managerial competence and effort, but also of factors beyond the executives' influence, such as general economic conditions, the strategies and operations of competitors, and political events. To the extent that corporate management bears the risk of the occurrence (or nonoccurrence) of these and other such variables over which they have no control, management may have an incentive to pursue strategies such as diversification that will reduce these risks. But shareholders, through the diversification of their portfolios, have already reduced these risks to the extent they deem appropriate. Thus, further risk reduction by managers may be contrary to

pensation paid to shareholder-employees in closely-held corporations and if it deems the compensation to be "unreasonable," it will disallow the deduction for the compensation and treat the payment as a dividend to the recipient. The corporation may challenge that determination, but it bears the burden of proving reasonableness. Interestingly, in close corporation cases, if the employee-shareholder's compensation rises dramatically in one year because of a formula based on profits, the Service (and the courts) are skeptical that the increased profits were the result of the employee's efforts. See, e.g., *Miller Mfg. Co. v. Commissioner*, 149 F.2d 421 (4th Cir. 1945). Thus "performance-based compensation" formulae carry far less weight in close corporation cases than when compensation in publicly-held corporations is reviewed. Put differently, in publicly-held corporations there is now an irrebuttable presumption that the CEO is responsible for improving earnings, while for close corporations, the presumption is almost the opposite. Should this be so?

More accurately, corporate boards in publicly-held corporations probably overly attribute improved performance to CEO performance, while the Service and the courts probably underestimate the effect that the employee-shareholder's efforts have on corporate performance. For some reason, the cases questioning compensation in close corporations rarely focus on the amount of capital invested in the taxpayer company. If the output of a company is a result of human capital and financial capital, and the latter is not significant in relation to the former, then compensation to the employee-shareholder should pass muster. But, typically, the courts do not focus on invested capital, preferring instead to consider factors such as the employee's responsibilities, the size of the business, and prevailing rates of compensation for comparable positions in comparable firms. See, e.g., *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 152 (8th Cir. 1974) (citing *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949)).

On the other hand, in large publicly-held corporations, in which large amounts of capital are invested, some portion of the profits must be attributable to capital, not to mention human resources other than the CEO and other factors. One reviewing CEO compensation in such corporations should take such factors into account.

29. Increases in shareholder wealth, as measured by increases in stock price and dividends, are not the only measure of performance. For instance, performance might be measured by economic value added to the corporation. This measure is the company's operating profit less the cost of all capital to produce those profits. See, e.g., Ira S. Walter, *Pay Executives for Their Performance*, J. COMPENSATION & BENEFITS, July-Aug. 1992, at 5.

the best interests of shareholders.³⁰ To compensate for this additional risk, the incentive portion of the executive's package would have to be relatively large, so that the total compensation package would be larger than a package not similarly risky, even assuming that the base salary is lower in the riskier package.³¹ Furthermore, as the performance incentives become more and more attractive, the risk of over-incentivization increases; that is, the prospect of very high rewards may encourage questionable behavior to achieve those rewards. Such behavior is hardly unknown in the corporate world.³²

Similarly, pay plans that include a large component of compensation in stock, either through stock options or restricted stock, are no panacea. The number of shares involved, presumably to align interests, has been staggering and has given rise to shareholder dissatisfaction because of the resulting dilution.³³ Additionally, as the executive becomes over-invested in the company, the ownership of a large block of stock can misalign shareholder and executive interests.

The other quick fix—increasing the representation of independent directors—is similarly overly simplistic. As a preliminary matter, independent directors dominate most corporate boards, particularly the boards of larger corporations where much of the concern over executive compensation has focused.³⁴ So this suggestion is ill-timed, at best. Second, even independent directors may feel loyalty to the CEO, either because of personal relationships with the CEO or because the director was or is a CEO of another company. Third, there is empirical evidence that corporations dominated by independent directors do not outperform companies not so dominated.³⁵ Indeed, it is somewhat counter-intuitive that they would. Like employee-directors, directors with a large stake in the company they manage are likely to pay careful attention to that company's business. Directors with only casual affiliation, on the other hand, may shirk their duty.

To respond to this possibility, that is, to increase the incentives for independent directors to manage more effectively, Professor Charles Elson

30. See John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 16-24 (1986); Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, 24 INST. ON SEC. REG. 647, 666 (1993).

31. See John E. Garen, *Executive Compensation and Principal-Agent Theory*, 102 J. POL. ECON. 1175, 1178, 1180-84 (1994); Murphy, *supra* note 26, at 723.

32. See, e.g., Arthur P. Brief et al., *What's Wrong with the Treadway Commission Report? Experimental Analysis of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting*, 15 J. BUS. ETHICS 183 (1996).

33. See Sarah Bowen, *Enough!*, WALL ST. J., Apr. 11, 1996, at R6:

According to Pearl Meyer & Partners Inc., executive-compensation consultants in New York, the proportion of stock allocated to management and employee equity-compensation plans at the country's 200 largest publicly-traded industrial and service companies averaged just under 11% of shares outstanding in the 1995 proxy season. That allocation was a 59% increase from the 1989 proxy season.

34. See CLARK, *supra* note 23, at 194 n.11.

35. See Sanjai Bhagat & Bernard Black, *Do Independent Directors Matter?* (1996)(unpublished manuscript, on file with the author).

has proposed a variant of the independent director model, suggesting that directors be elected for five year terms, and compensated solely in the company's stock.³⁶ Such a model, he argues, would "reinvigorate the board from within . . . creat[ing] effective management monitoring based on board self-motivation."³⁷ Professor Elson supports his recommendation with an admittedly unscientific survey indicating that companies with independent boards whose directors own a large amount of the company's stock (in excess of \$100,000 in market value per independent director) are more likely to have "reasonable" compensation packages for senior executives.³⁸ For these purposes, "reasonable" means pay that is sensitive to corporate performance.³⁹

This recommendation, and others that would radically restructure corporate boards,⁴⁰ may or may not be a good thing for corporate governance in the long term, but they are definitely inappropriate for dealing solely with a perceived problem of excessive compensation. In that regard, Elson's suggestion would be quite costly to the shareholders because the outside directors would receive large grants of corporate stock and the cash to pay the applicable income taxes. Depending on the size of the board, the number of shares outstanding, and the liquidity of the stock, the outside directors as a group may end up holding a key block of stock. Moreover, to implement this suggestion, the corporate law of every state would have to be amended in a substantial fashion, which is not very likely.

Shareholders frustrated by the levels of executive compensation, whether or not compensation is linked to a performance plan, have had little success in seeking relief from the courts. The next section sets forth the obstacles to judicial relief, obstacles that are unlikely to be altered any time soon. Given the continuing political concern over executive compensation and the lack of a judicial remedy, the Securities and Exchange Commission and the Congress each reacted in the early 1990s with complimentary "solutions." These solutions are also analyzed and criticized below.

Because executive compensation remains a hot button topic, I conclude this Article with a proposal for further reform based on the notion that further reform might perfect the shareholder involvement in the process (a goal of both the SEC proposal and the Congressional tax-based solution) and adequately respond to public concern that the process by

36. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937 (1993).

37. *Id.* at 996.

38. *Id.* at 990-95.

39. *Id.* at 990.

40. See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) (calling for the creation of a cadre of professional directors); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991) (proposing a five-year term for directors, and restrictions on corporate takeovers).

which compensation is determined is flawed.⁴¹

III. JUDICIAL INTERVENTION

The shareholder seeking to challenge executive compensation must persuade the court that, on the merits, the compensation is so excessive as to constitute a waste of corporate assets. This "rule" was stated in the oft-cited U.S. Supreme Court case of *Rogers v. Hill*:⁴² "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority of stockholders have no power to give away corporate property against the protest of the minority."⁴³ As daunting as this standard is, requiring proof that there is "no relation" between the compensation and the value of the services, it pales in comparison to the procedural obstacles of demand (on the board of directors and shareholders) and the business judgment rule,⁴⁴ which the plaintiff must overcome before the merits are reached.

The courts, in the case of the business judgment rule, and the legislatures, in the case of the demand requirement, have constructed procedural obstacles because they have recognized the importance of limiting the review of business decisions in the courts. Judges face a particularly difficult task in determining the proper compensation of corporate executives. While courts do determine "reasonable compensation" for purposes of determining the deductibility of compensation paid to shareholder-employees of closely-held corporations, and in cases where majority shareholders of closely-held corporations allegedly abused their positions to the detriment of minority shareholders, such cases are not

41. Some writers have suggested a greater role for the judiciary. See, e.g., Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 *BUFF. L. REV.* 1 (1993); Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 *DUKE L.J.* 138 (1995); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 *J. CORP. L.* 231 (1983).

42. 289 U.S. 582 (1933).

43. *Id.* at 591-92 (quoting *Rogers v. Hill*, 60 F.2d 109, 113-14 (2d Cir. 1932) (Swan, J., dissenting)). In Delaware, the standard is probably even more difficult for the plaintiff. In a case in which a shareholder challenged, as a waste of corporate assets, the grant of stock options approved by the shareholders of a Delaware corporation, the Delaware Supreme Court said that the presence of shareholder ratification shifts the burden to the plaintiff to demonstrate that "no person of ordinary sound business judgment would say that the consideration received for the options was a fair exchange." *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979) (quoting *Kaufman v. Schoenberg*, 91 A.2d 786, 791 (Del Ch. 1952)).

44. Though variously stated, the business judgment rule immunizes a business decision of the board of directors from judicial review if the directors had no conflict of interest with respect to the decision in question, acted in good faith and on an informed basis, and rationally believed that their action was in the best interests of the corporation. The courts have adopted a presumption that the directors behaved in this fashion, and this presumption has meant that the courts rarely reach the merits of a challenge to executive compensation. Thus, were *Rogers* to arise today, it is likely that application of the business judgment rule would not allow it to get as far as it did in 1933. For a general discussion of the business judgment rule, see Mark J. Loewenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 *S. CAL. L. REV.* 65, 70-72 (1989).

easily applied to cases alleging excessive compensation in publicly-held corporations.

Tax cases are decided in a unique environment. The parties are the IRS and the corporate taxpayer. The question of how much the executive should be paid is in some sense not at issue. The employee will retain all payments made; only the deductibility of those payments is at issue. More importantly, because of the structure of the Internal Revenue Code, and section 162, the relevant Code provision at issue, it is clear that the burden of proof is on the taxpayer to sustain the reasonableness of the compensation for purposes of deductibility. Finally, it is worth noting that there is a necessity of judicial review here; otherwise the final arbiter is the Internal Revenue Service, an obviously unacceptable situation.

Similarly, the necessity for judicial review in the case of compensation decisions in closely-held corporations is manifest. In litigation challenging compensation in closely-held corporations, the majority shareholders are typically the officers and directors who, in effect, set their own compensation. In those circumstances, the courts are concerned about majority shareholders "oppressing" the minority, diverting assets that might otherwise go to the minority in the form of dividends or additional compensation.⁴⁵ Because there is in effect no independent board of directors to protect the minority shareholders from overreaching by the majority and generally no market for the stock of the minority shareholders, judicial review is the only protection available to minority shareholders. Even then, the burden of proof in some states rests with the complaining minority shareholder to prove that the compensation is unjust, oppressive, or fraudulent.⁴⁶

By comparison, in a shareholder derivative action attacking the propriety of the compensation paid to the CEO of a publicly-held corporation, the burden of proof is always on the shareholder-plaintiff, as it ought to be, and the relevant standard (if the merits were ever reached) is not simply unreasonableness, but waste or fraudulent conduct. This, too, is as it ought to be. Otherwise, the courts would be overwhelmed with litigation and would become the primary determiners of corporate compensation, not a happy turn of events.

The procedural barriers that allow the courts to avoid these disputes are typified in cases such as *Aronson v. Lewis*,⁴⁷ a Delaware case, and *Saigh v. Busch*,⁴⁸ a Missouri case. In Delaware, for instance, a derivative plaintiff must make demand on the board of directors unless demand is excused because it would be futile. If demand is made, and the board

45. *Iwasaki v. Iwasaki Bros., Inc.*, 649 P.2d 598, 601 (Or. App. 1982) ("Payment of excessive salaries can constitute oppressive conduct.").

46. *Krukemeier v. Krukemeier*, 551 N.E.2d 885, 887-88 (Ind. App. 1990). In other states, the burden of proof is on the defendant-directors. See, e.g., *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1146 (Kan. 1978); see generally 1 F. H. O'NEAL & R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 3:08 (2d ed. 1985 & Supp. 1996).

47. 473 A.2d 805 (Del. 1983).

48. 396 S.W.2d 9 (Mo. Ct. App. 1965).

decides to dismiss the litigation, the plaintiff must demonstrate that the board's decision to dismiss the litigation—itsself a business decision—is not entitled to the generous protections of the business judgment rule, a heavy burden if the board follows certain procedures.⁴⁹ Typically, therefore, the derivative plaintiff does not make demand on the board, but instead alleges in the complaint that demand was not made because it would be futile to do so. The plaintiff's self-interested determination of futility is typically challenged by the defendants, thereby requiring the plaintiff to justify the conclusion that demand would be futile. At this stage, the plaintiff is confined to its complaint, which must allege with particularity facts which create a reasonable doubt that the directors' action being challenged in the litigation (the compensation decision) was entitled to the protections of the business judgment rule.⁵⁰

On its face, this standard does not sound terribly onerous; after all, there need only be a doubt that the business judgment rule applies. But the difficulty arises from the way the *Aronson* court determined that a doubt arises—from *specific* facts alleged in the complaint.⁵¹ Thus, the plaintiff may wish to allege that the directors are not entitled to the protections of the business judgment rule because they were controlled by the CEO whose compensation they determined and, therefore, their decision was not the product of their independent judgment. But such an allegation will not create the necessary doubt unless specific facts are alleged that demonstrate, for instance, "that through personal or other relationships the directors are beholden to the controlling person."⁵² The court said control could not be demonstrated by the mere fact that the controlling person owned a majority of the corporation's shares. Even directors in such a corporation remain clothed with the "presumptions of independence."⁵³ Moreover, at this stage of the litigation, the plaintiff is not yet entitled to discovery and so may not know the existence of such personal or other relationships. This is not necessarily a bad thing—it has the effect of deterring plaintiffs who wish to engage in a fishing expedition.

On the other hand, there are instances—and *Aronson* may be one—where the compensation arrangement being challenged and the CEO's apparent control suggest that maybe the directors were not all that independent. Put in other words, the plaintiff's allegations arguably raised a reasonable inference that the directors' actions were not protected by the business judgment rule. The Delaware Court of Chancery at least so found in this case.⁵⁴ Withstanding the motion to dismiss would then allow the plaintiff the opportunity to conduct the necessary discovery to prove the inference. But the Delaware Supreme Court would not allow

49. See CLARK, *supra* note 23, at 645-49.

50. *Aronson*, 473 A.2d at 815.

51. *Id.* at 814.

52. *Id.* at 815.

53. *Id.*

54. 466 A.2d 375, 385 (Del. Ch. 1983).

the plaintiff to go forward, absent more specific allegations.⁵⁵

Saigh suggests another procedural hurdle—demand on the shareholders. Many statutes dealing with derivative actions require the derivative plaintiff to make demand on the board and the shareholders.⁵⁶ The reason for demand on the board is clear—the board ought to be able to pursue or abandon the claim based on its sound business judgment. The rationale for requiring demand on the shareholders is less clear. The Missouri statute at issue in *Saigh* provided, as statutes typically do, that:

The petition shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees, and, if necessary, from the shareholders, such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.⁵⁷

In *Saigh*, the plaintiff alleged that Anheuser-Busch, Inc., a publicly-held corporation, had paid excessive compensation to its CEO, August A. Busch, Jr. The trial court dismissed the claim, and the Missouri Court of Appeals affirmed the dismissal on the grounds that the plaintiff failed to make demand on the shareholders or adequately allege why demand should be excused.⁵⁸ Read literally, the above-quoted rule of civil procedure arguably doesn't apply as the plaintiff was seeking to cause the corporation to recover excessive compensation from an officer, and the plaintiff could not "secure . . . from the shareholders . . . such action . . ." The shareholders, as a group, did not have the ability to recover the excessive compensation in the absence of litigation. They could only pursue litigation through the board. Therefore, it should not have been necessary for the plaintiff to approach the shareholders at all. Moreover, the rule in *Rogers*, quoted above, states that the shareholders cannot ratify compensation that is so excessive as to constitute a gift or waste of corporate property.⁵⁹ So, it would seem that where the plaintiff alleges such compensation, it would make no sense to require him to seek shareholder input in any form.

But, consistent with judicial avoidance of compensation cases, the court did not read the rule in this fashion. Instead, the court said demand on the shareholders as a body would be excused only where the petition alleges that the officers and directors of the corporation engaged in acts that were *ultra vires*, *illegal*, or *fraudulent*, because such acts cannot be ratified by even a majority of the stockholders.⁶⁰ Claims of excessive compensation, the court said, merely call into question the board's exer-

55. *Aronson*, 473 A.2d at 816. See also *Schwartz v. Rosenthal*, 171 N.Y.S.2d 698 (1958) (in the absence of factual allegations establishing dominance by the president of the corporation, conclusory allegations would not sustain the complaint).

56. See generally J. R. Kemper, Annotation, *Circumstances Excusing Demand Upon Other Shareholders Which Is Otherwise Prerequisite to Bringing of Stockholder's Derivative Suit on Behalf of Corporation*, 48 A.L.R. 3d 595 (1973).

57. MO. ANN. STAT. § 507.070(2) (Vernon 1952).

58. *Saigh*, 396 S.W.2d at 24.

59. *Rogers*, 289 U.S. at 734.

60. *Saigh*, 396 S.W.2d at 17 (emphasis added).

cise of its managerial discretion, which does not rise to the level of ultra vires, illegality, or fraud.⁶¹ More importantly, the court suggested that shareholders *could* ratify the payments or, alternatively, could decide (in some unspecified procedure) to “call upon the board of directors to bring the action . . . or . . . replace the board of directors.”⁶² The court thus held that before the derivative plaintiff can challenge the compensation, the shareholders must first be asked whether they wish to ratify the action, instruct the board of directors to pursue a lawsuit, or replace the board.⁶³ One can easily imagine the difficulties the plaintiff would face, financially and logistically, of calling such a meeting in a large publicly-held corporation.

The affect of cases such as *Aronson* and *Saigh* is to make the rule of *Rogers v. Hill* an illusive promise. While *Rogers* suggests that there is some outer limit to executive compensation in publicly-held corporations, in fact the courts just do not reach the merits of a claim of excessive compensation.⁶⁴ This is well illustrated in litigation involving Victor Posner, a financier whose exploits have been reported in the popular press. Among other controversies that have involved Mr. Posner are claims that he caused corporations controlled by him to pay him excessive compensation. These claims were litigated in a shareholder derivative action that was ultimately settled.⁶⁵ The settlement came before Vice Chancellor Hartnett who, with expressed reluctance, approved the settlement. The Vice Chancellor was reluctant because the terms of the settlement did not include any recovery for previous payments to Mr. Posner, which he suggested were “grossly excessive.”⁶⁶ The Vice Chancellor noted that Mr. Posner was paid in excess of \$7 million per annum by the defendant corporations, putting him among the highest paid corporate executives in the country at a time when the corporate defendants “are suffering great losses and some are in, or have been, or [may] soon be, bankrupt.”⁶⁷ But the Vice Chancellor acknowledged “that *Aronson v. Lewis and Pogostin v. Rice*⁶⁸ impose a great burden on a plaintiff who seeks to challenge [excessive compensation].”⁶⁹

Vice Chancellor Hartnett was not subtle in his opinion. His distaste for the actions of the defendants and procedural obstacles to trial was evident. While there were other reasons why the court affirmed the settlement,⁷⁰ it was clear that *Aronson* would make it difficult to reach the merits, about which the court harbored no doubt. It is not surprising,

61. *Id.* at 18.

62. *Id.* at 19.

63. *Id.* at 24.

64. *Rogers*, 289 U.S. at 234.

65. *Kovacs v. NVF Co.*, No. 8466, 1987 WL 17042, at *1 (Del. Ch. Sept. 16, 1987).

66. *Id.* at *4.

67. *Id.*

68. 480 A.2d 619 (Del. 1984).

69. *Kovacs*, 1987 WL 17042, at *3.

70. Among the reasons cited by the Vice Chancellor was the fact that no one came forth with an offer to take over the litigation on behalf of the stockholders. *Id.* at *5.

therefore, that there are no appellate court cases affirming an order reducing the compensation of an executive in a publicly-held corporation on the theory of waste or gift.⁷¹

In sum, then, a self-help remedy of litigation is essentially unavailable to the disgruntled shareholder. Although this may be regrettable, because the judiciary is often looked to as the ultimate guarantor of fairness, second guessing corporate business decisions is an area about which the courts have long felt insecure,⁷² and are likely to remain so. Moreover, because these are publicly-traded corporations, shareholders do have the alternative of selling their stock. But this is not a complete remedy because, to the extent the problem is widespread, alternative investments would not avoid the problem. Furthermore, even if a sale were a complete remedy, the perception problem would remain. This likely explains, I believe, the motivation for the involvement of the Securities and Exchange Commission.

IV. THE SECURITIES AND EXCHANGE COMMISSION'S RESPONSE

It is important to recognize the two independent concerns with respect to claims that corporate executives are overcompensated: first, that there is a deficiency in the structure of corporate governance that must be rectified; and, second, that even if there is no deficiency in corporate govern-

71. Plaintiffs have had some modest success in challenging stock option grants, golden parachutes, and pension grants, on the basis of lack of consideration. See, e.g., *Fogelson v. American Woolen Co.*, 170 F.2d 660 (2d Cir. 1948) (reversing the grant of summary judgment in favor of defendant in a suit challenging the creation and funding of a retirement plan allegedly created to benefit the corporation's president, who planned to retire 18 months after the creation of the plan); *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979) (reversing a grant of summary judgment in favor of defendant in a shareholder derivative suit challenging the cancellation and reissuance of stock options at a lower price); *Kerbs v. California Eastern Airways, Inc.*, 90 A.2d 652 (Del. 1952) (holding that stock options which were immediately exercisable upon grant (and for a period of six months after termination) would be enjoined because the grant would not induce an employee to remain in the employ of the company); *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250 (1989) (reversing a grant of summary judgment in favor of defendants in a case challenging the amendment, in the heat of a takeover battle, to a golden parachute plan that substantially improved the benefits payable to officers of the target company, all of whom resigned after the takeover).

Compare *Cohen v. Ayers*, 449 F. Supp 298 (N.D. Ill. 1978) (holding that the cancellation and reissuance of a stock option grant was supported by consideration since the corporation received the continued service of the benefited employees) and *Teich v. National Castings Co.*, 201 F. Supp. 451 (N.D. Ohio 1962) (upholding an amendment by the directors to a shareholder-approved pension plan that doubled the pension of a retired CEO).

72. *Heller v. Boylan*, 29 N.Y.S.2d 653, 679 (Sup. Ct.), *aff'd*, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941) (mem.):

Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity? Equity is but another name for human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing [a] corporation than its stockholders?

See also *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1970).

ance, the rate of pay is too high as a matter of social policy. The Securities and Exchange Commission has reacted to the first concern in what might be characterized as a weak foray into the field of corporate governance. In October 1992, the Commission amended its rules "governing disclosure of executive compensation in proxy and information statements and other Commission filings."⁷³

Some on the Commission may have felt that shareholders would more knowledgeably exercise their franchise with additional information, or that when required to make full disclosure, corporate boards would exercise more restraint in determining executive compensation. Indeed, the SEC's Chief Economist, Susan Woodward, defended the rules "as a moderate course aimed at diffusing some of the political rhetoric about executive pay."⁷⁴ In any case, the new rules are less than ideal.

The rules do accomplish their stated purpose: to increase disclosure to shareholders. But like so many Commission disclosure rules, these rules result in too much disclosure. The rules, which occupy nineteen pages of three-column fine print in the Federal Register, require, among other things, that the annual proxy statement include:

- a table covering a three-year period which sets forth the major components of the pay of the CEO and other highly-paid executives;
- tables detailing option grants, holdings, and exercises, including values of options granted;
- a chart comparing the company's performance, in terms of stock price and dividends to shareholders, to the performance of a "peer group" of publicly-held corporations and to the stock market as a whole; and
- a narrative report from the company's compensation committee which describes its compensation philosophy.⁷⁵

That is a lot of disclosure, probably more than would interest the typical shareholder. Even a conscientious shareholder is likely to focus on the first table—the annual compensation summary—to the exclusion of the other information in the statement. Furthermore, having discovered compensation that the shareholder considers excessive, the shareholder's only readily available option, other than selling the stock, is to vote against the entire board. Such a vote, by its very nature, is ambiguous: was the dissenting shareholder displeased with the corporation's performance, its environmental record, its business plan, or the qualifications of the directors? Not surprisingly, the SEC's initiative has not been embraced as a solution to the perceived problem.

Soon after the Commission promulgated its new disclosure rules, Congress weighed in with a solution of its own, amending section 162 of the IRC to add a new subsection capping the deductibility of executive

73. 57 Fed. Reg. 48,126 (1992).

74. *Tax Cap on Executive Pay Likely, Former SEC Chief Economist Predicts*, 24 Sec. Reg. & L. Rep. (BNA) No. 45, at 1739 (Nov. 13, 1992).

75. 57 Fed. Reg. 48,126-27 (1992).

compensation.⁷⁶

V. AMENDMENT TO THE INTERNAL REVENUE CODE

In 1993, Congress amended the tax code to limit the deductibility of executive compensation paid to officers in publicly-held corporations to \$1 million, unless the excess compensation is paid pursuant to a performance-based plan meeting certain criteria.⁷⁷ The criteria include two requirements that might be characterized as federal corporate governance standards: first, the performance-based plan must be approved by both a compensation committee and the shareholders; and second, the compensation committee must be comprised solely of two or more "outside directors" (a defined term).⁷⁸ By limiting deductibility, Congress might have sought to create incentives to adopt performance-based plans and the corresponding reforms in corporate governance. Some in Congress might have held the expectation that the effect of the section would be to somehow limit compensation. Regardless of motivation, the congressional approach is cumbersome, ineffective in limiting compensation, and ill-advised.

This code-based solution to excessive executive compensation is unsatisfactory for many reasons. First, one might question whether the Internal Revenue Code ought to be used to police this area. Should the income tax code be used merely to raise revenue, or, additionally, to implement public policy?⁷⁹ This is, of course, a fundamental policy question currently being debated in the public arena, and further discussion is beyond the purview of this Article. Moreover, if any of the major tax reform proposals currently under discussion—such as a flat tax or a value added tax—were to be adopted, the reforms of section 162(m) might be lost.

But more to the point, regulating executive compensation through the Internal Revenue Code results in long and complicated regulations, revenue rulings, and, inevitably, a layer of litigation. Regulations, by their very nature, tend to treat unlike cases alike, limiting flexibility in corpo-

76. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,211, 107 Stat. 312, 449 (1993).

77. These criteria are:

1. The compensation was payable solely because the executive achieved a pre-established, nondiscretionary, objective performance goal.
2. The goal was determined by a committee of the board of directors comprised solely of two or more "outside" directors.
3. The shareholders approved the goals by a majority vote.
4. Prior to payment of the performance compensation, the board's compensation committee verifies the propriety of the payment.

Kevin J. Ryan, Note, *Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary*, 15 VA. TAX. REV. 371, 379 (1995).

78. *Id.*

79. In enacting § 162(m), Congress estimated that additional tax revenue generated in 1995 would amount to only \$55 million. STAFF OF JOINT COMM. ON TAXATION, 103D CONG., 1ST SESS., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS OF H.R. 2264 1 (Aug. 4, 1993).

rate planning that may be desirable. For instance, the regulations provide that the performance goals must be "nondiscretionary," which precludes the compensation committee from creating a bonus pool and distributing the proceeds in accordance with the committee's discretion, even if the size of the pool itself is based on an objective formula. (The regulations do permit discretion to reduce, but not increase, a performance bonus.)

The rationale behind the regulation is understandable, but the effect is unfortunate. Allowing a committee to distribute such a bonus pool might achieve more in terms of incentive and equity than a predetermined allocation formula would achieve. Moreover, the "reduce but not increase" discretion invites manipulation, encouraging a plan that fixes a large performance bonus that is intended to be reduced to a more reasonable level.⁸⁰

Because section 162(m) applies only to publicly-held corporations, it creates an unjustifiable distinction between publicly-held corporations and closely-held corporations. Compensation paid to executives in closely-held corporations is not subject to the rules of section 162(m); the base pay of such executives may exceed \$1 million and remain fully deductible if the compensation is reasonable under all of the facts and circumstances.⁸¹ In competing for chief executives, therefore, publicly-held corporations find themselves at a competitive disadvantage vis-à-vis closely-held corporations. This disadvantage may not be large, but it is unnecessary.

In addition, the \$1 million cap is both too high and too low. It is too high because many companies do not pay that much in compensation to their executives.⁸² Furthermore, as a theoretical matter at least, compensation may be excessive even if below \$1 million. At the other extreme, the largest companies have been paying well in excess of \$1 million in base pay, and that may be justified.

Another problem with this approach is the inevitable creation of loopholes. For instance, because deductibility turns on when the compensation is paid, compensation deferred and paid on retirement is not subject to the cap. Not surprisingly, companies are taking advantage of the deferred compensation loophole and paying interest on the amounts deferred. When paid, the entire amount is deductible. Similarly, the cap

80. One critic cited an example of this phenomenon. Salomon Bros. adopted a bonus plan that would allow payment of up to \$24 million per year to the CEO. In past years, according to this critic, Salomon had never paid a bonus larger than "a few million dollars." Graef Crystal, *Need a Good Laugh? Look At Caps on Executive Pay*, L.A. TIMES, May 21, 1995, at D2. Another critic has predicted that § 162(m) will result in higher pay just for this reason. Murphy, *supra* note 26, at 739.

81. I.R.C. § 162(a)(1) (West 1996); I.R.C. Reg. § 1.162-7(b)(2) (West 1996); Charles Schneider & Co. v. Commissioner, 500 F.2d 148 (8th Cir. 1974). The burden of proving reasonableness is on the taxpayer. *Botany Worsted Mills v. U.S.*, 278 U.S. 282, 290 (1929).

82. In one analysis of 1000 proxy statements covering 1992, the author concluded that only 194 CEOs had nonperformance-based pay in excess of \$1 million (that is, excluding stock options, payments under long-term plans, and bonuses) and only 149 CEOs had base pay in excess of \$1 million. Murphy, *supra* note 26, at 739.

applies only to the officers of a publicly-traded company, not the employees of any non-public subsidiary. While it is unlikely that someone acting as CEO of a publicly-held corporation would not appear as an officer of that company, it is not unlikely that individuals with considerable authority, responsibilities, and compensation might be officers of a key, wholly-owned subsidiary.⁸³

A further objection to section 162(m) is that it discourages compensating executives in restricted stock unless the restricted stock is awarded as part of a performance-based plan. This is so because grants of restricted stock that substitute for cash have to be large in order to compensate grantees for the added risk of holding stock as opposed to cash. Arguably, from the shareholders' perspective, payment in restricted stock is preferable to stock options, the most popular way to "align" the executive's and the shareholders' interests. This is so because if the executive holds restricted stock, and the price of the stock declines, the executive continues to have a strong incentive to perform. But with stock options, those incentives may not continue to be so strong, particularly if the board has a practice of re-issuing options at a lower price. Also, while an option holder is disinclined to favor cash dividends, the owner of restricted stock is not.⁸⁴

Section 162(m) appears to be based on an unproven assumption and a faulty premise. The unproven assumption is that CEO pay dependent on stock performance will align shareholder and executive incentives so that executives will perform better, or more effectively. In fact, at least one recent study suggests that there is no relationship between stock option grants to executives and shareholder returns.⁸⁵

The faulty premise is that publicly-held corporations will not pay compensation that is not deductible. In fact, they will, thus increasing the after-tax cost of executive compensation to the shareholders.⁸⁶ But even if many or most affected companies are influenced to adjust their compensation practices to conform to the new rules, there is no reason to suppose that the level of compensation, which likely motivated Congress to act, will decline. In fact, in 1994 and 1995, the two years since the new

83. See Crystal, *supra* note 80, at D2. Graef speculates that Robert Daly and Terry Semel, who operated the Warner Bros. subsidiary of Time Warner, Inc., earned more than Gerald Levin, the CEO of Time Warner. See generally Ryan, *supra* note 77.

84. See Murphy, *supra* note 26, at 738 n.66.

85. Graef Crystal, *CEOs and Incentives: The Myth of 'Pay-for-Performance' Compensation: Analyst's Studies Find No Relationship Whatsoever Between Executive Salary Packages and Company Results*, L.A. TIMES, Jan. 8, 1995, at D1.

86. A review of 1995 proxy statements by William M. Mercer Inc., New York compensation consultants, undertaken for the *Wall Street Journal* and reported in the *Journal's* annual report on executive pay, disclosed that of the 350 companies surveyed, 38 reportedly paid *base salary* (that is, not including bonuses or long-term compensation) in excess of \$1 million. *The Boss's Pay*, WALL ST. J., Apr. 11, 1996, at R15. Graef Crystal conducted a survey of the pay of 155 CEOs of major corporations in 1994 and found that 25 paid their CEOs more than \$1 million in base salary alone. Crystal, *supra* note 80, at D2. See also Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28, 34.

section 162(m) became effective, the average CEO salary and bonus increased by more than 10%, far outstripping inflation and general wage increases.⁸⁷ Indeed, because Congress and the IRS have now created a safe harbor of sorts, there is some reason to suppose that the new rules will increase compensation levels. While, technically, executive compensation is subject to the same limitations that prevailed before the amendment to section 162,⁸⁸ plans conforming to the new rules will have a patina of legitimacy, a patina that may well grow into an armored suit.

If CEOs are overcompensated, it is because of a deficiency in corporate governance, not because of a deficiency in our income tax laws. The tinkering that Congress has done in the corporate governance area is not substantial. Compensation committees consisting of independent directors were common before the adoption of section 162(m). Shareholder ratification of performance-based plans is a worthwhile innovation, but of questionable significance. Under current New York Stock Exchange rules, for instance, listed companies cannot list securities issued to officers and directors pursuant to options or special remuneration plans unless the shareholders have approved the plans.⁸⁹ In addition, shareholders are asked to approve plans that may affect many employees not otherwise covered by section 162(m), and so may approve a plan because, on the whole, it is in the best interest of the corporation even if the plan may overcompensate one or more individuals. Furthermore, these plans tend to be abstract to the shareholders, making them difficult to evaluate. The resulting approval is correspondingly difficult to assess.

More fundamentally, section 162(m) starts from the presumption that the current system of corporate governance cannot be trusted with unbridled discretion to fix executive compensation. Under that approach, compensation committees are limited in their ability to act in the best interest of the corporation. The committee, therefore, may be reticent to award bonuses for the achievement of goals that do not lend themselves to neat quantification; these goals include improving customer satisfaction, improving employee morale, and diversifying the work force. Moreover, even a plan that bases compensation on the achievement of quantifiable goals, such as earnings per share or return on investment, might be a "better" plan if some discretion were left with a committee that could also consider how the company compared to competitors or how general economic conditions might have affected results. In short, the removal or limitation of discretion from a board that acts responsibly may have some unfortunate consequences.

87. *The Boss's Pay*, *supra* note 86, at R15.

88. See *supra* part IV.

89. The rule reads, in relevant part: "Shareholder approval of a plan or arrangement . . . will be prerequisite to listing when . . . [a] stock option or purchase plan is to be established or other arrangements made pursuant to which stock may be acquired by officers or directors . . ." NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL ¶ 312.03 (Supp. 1989).

Finally, the incentive to adopt performance-based plans may not necessarily operate in the shareholders' interest, especially if executive pay is too closely linked to share prices. If a CEO's compensation is largely dependent on share price, the CEO may pursue strategies that raise short-term profits and, thus, share prices, at the expense of long-term returns. For instance, a short-term reduction in advertising or research expenses may boost the company's stock price in the short term, as earnings increase, with the effect felt further down the road.⁹⁰ Furthermore, section 162(m) creates an incentive to use stock price as a proxy for performance.

VI. CONCLUSION: A MODEST PROPOSAL

The public outcry over executive compensation has produced modest and misguided administrative and legislative response at the federal level. But so long as there remains a reasonable doubt that there is market failure, the case for additional and significant legislative, administrative, or judicial intervention is not compelling. Even though existing legal standards may provide a marginal role, at best, for the judiciary, the prospect of judicial activism in this area is not attractive.⁹¹ But the unavailability of a judicial remedy and the shortcomings of the federal responses discussed above, when considered in light of the continuing public concern, suggests that additional, measured steps ought to be considered. In this light, I offer such a step: the requirement that shareholders vote annually to approve or disapprove the CEO's whole compensation package (the salary, bonus, and performance incentives).

I propose that this shareholder vote be an advisory vote only, cast in terms of a motion to the shareholders to ratify the CEO pay, even if they have already approved a long-term performance plan which accounts for a portion of the current pay package. In this regard, it is important to note that an incentive program passed in one year may be undercut by a salary and bonus plan proposed in a later year, which may have the effect of reducing the risk portion of the previously approved performance plan.

The idea of shareholder ratification is a modest and logical step from current SEC policy regarding shareholder voting on executive compensation. Under current SEC interpretations of Rule 14a-8 of the SEC's proxy rules, shareholders who otherwise meet the eligibility requirements under the rules for submitting proposals for inclusion in the proxy materials may submit nonbinding proposals regarding executive compensa-

90. See Dean Foust, *The SEC's CEO-Pay Plan: No Panacea*, Bus. Wk., July 6, 1992, at 37. Dean Foust describes the effects of an incentive plan that rewarded Ralston Purina executives nearly 500,000 shares if the stock closed above 100 for 10 straight days. Management borrowed funds and much of the company's free cash flow to buy back nearly one-third of the company's outstanding stock, with the resulting effect that the goal was reached. However, the stock soon drifted back down, which analysts reportedly attributed to "excessive financial engineering and a lack of attention to core businesses." *Id.* See also Bok, *supra* note 14, at 112-13.

91. See *supra* part III.

tion.⁹² But in adopting its disclosure on executive compensation, the SEC stopped short of requiring shareholder ratification of executive compensation, suggesting instead that shareholder dissatisfaction be expressed by voting the directors out of office.⁹³ The proposal suggested here would mandate shareholder input where it is now permitted (on shareholder initiative), and would cover more than just performance-based plans, as section 162(m) requires.⁹⁴ I thus propose only a logical extension of current law and SEC regulations.

Shareholder voting makes sense for another reason, suggested by the *Saigh* case: shareholders can ratify what is allegedly excessive compensation.⁹⁵ Thus, by providing a role for shareholders in advance of litigation, a procedural hurdle will either be eliminated (if shareholders fail to ratify) or will become insurmountable (if shareholders do ratify). The shareholder vote proposed here, then, would dovetail nicely with the demand requirement in derivative litigation, and act as a screening mechanism for such litigation.

Shareholder ratification of CEO compensation can serve other purposes as well. First, ratification provides an outlet for shareholders to express directly to the board their view of the matter. There is much speculation that shareholders are unhappy with the level of CEO compensation, but no hard proof of it exists. It may be the case that, in the vast majority of publicly-held corporations, the shareholders are perfectly satisfied with the level of CEO compensation. If so, the advisory vote would moot much of the speculation and sensationalistic stories in the popular media. On the other hand, if the shareholders are dissatisfied with the compensation, this vote gives them a way to voice their concerns—a way that may have an impact.

Second, the data received in such an advisory vote can be useful to the board. The board can compare the vote to the vote in prior years for the same corporation and to the vote in similarly-sized corporations in the same industry. This serves as a gauge by which to measure their compensation decisions. This sort of data is also more meaningful than a simple vote not to reelect the board.

This suggestion should be particularly welcomed by institutional shareholders who have become increasingly active in matters of executive

92. In 1992, the SEC reversed its previous policy of permitting reporting companies to omit shareholder proposals dealing with executive compensation. In letters issued to 10 companies, the Division of Corporate Finance staff told the companies that shareholder proposals must be included in the proxy materials. *See Staff Advises Shareholder Proposals on Pay Includible in Proxy Materials*, 24 *Sec. Reg. & L. Rep.* (BNA) No. 8, at 250-51 (Feb. 21, 1992).

93. *Id.*

94. When testifying before Congress, Chairman Breeden of the Securities and Exchange Commission said that "judging the appropriateness of the directors' decision [on compensation] should be up to the shareholders, not the government." *Hearings on § 119f Before the Subcomm. on Taxation of the Senate Comm. on Finance, 102d Cong., 2d Sess. (1992)* (statement of Richard C. Breeden, Chairman, SEC).

95. *Saigh v. Busch*, 396 S.W.2d 9, 20 (Mo. Ct. App. 1965).

compensation, but have lacked a convenient and systematic way to express their concerns. This proposal provides that means. Moreover, we ought not to be too shy in giving shareholders this role in CEO compensation. Executive compensation is a central component in the corporate governance system. In that regard, it is akin to the capital structure of the corporation, influencing management's business decisions and, therefore, shareholder returns.⁹⁶

Third, there is a serious argument that the level of executive compensation is destructive to the morale of rank and file employees, especially during a period of corporate downsizing and stagnating wages.⁹⁷ Resentment over executive compensation may account for some of the appeal of so-called populist candidates such as Patrick Buchanan, who criticize "big businesses" that have harmed the "little guy."⁹⁸ An approving vote by shareholders diffuses some of this criticism, as the responsibility for the compensation no longer rests solely with an "elite" board. Furthermore, disapproval by the shareholders may lead to action by the board which results in a reduction of the compensation.

This change could be accomplished easily by an amendment to state corporate codes, to section 162 of the Internal Revenue Code, to the listing requirements of national securities exchanges, or by a change to section 14 of the Securities and Exchange Act of 1934. Shareholders can force the change by amending the bylaws of the corporation to require such a vote, and corporations can adopt the concept voluntarily now by board resolution, without any change in the law.

A change in corporate governance of this nature will have neither a dramatic nor immediate impact on CEO compensation. But it may have a significant effect in the long term, as feedback from the shareholders works its way back to the board. It is a suggestion intended to complement regular market forces, not interfere with them. It could replace the ill-conceived amendment to the Internal Revenue Code as shareholders, not the Internal Revenue Service, play a more active role in compensation decisions. As a matter of policy, it is worth trying before the other, more radical suggestions that have already been made are implemented. Moreover, unlike many of the proposals in this area, it is easy to implement, both legally and practically.

96. See Gilson, *supra* note 30, at 656.

97. See MONKS & MINOW, *supra* note 27, at 170. See also *Great Divide*, *supra* note 2, at R1 (discussing the effect of high CEO pay on employee morale).

98. Roger Lowenstein, *Why Primary Voters Are So Angry*, WALL ST. J., Feb. 22, 1996, at C1 (indicating that "real median family income has been stagnant for 20 years").

