Reforming Executive Compensation: What Do We Know and Where Do We Go?

Priyanka Rajagopalan

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ABSTRACT

In this Article, I study a fascinating problem – what are the legal, political and economic implications of regulating executive bonuses? While the Administration's recent consideration of proposals to tax bonuses of AIG executives has sparked a great deal of media speculation and attention, there has been little legal scholarship discussing the various possible consequences of this and other methods of regulating executive compensation. Especially given the growing interest in executive compensation and the possible benefits and costs of regulation in this arena, I believe this paper will make a significant scholarly contribution to the existing literature on corporate governance and tax policy with respect to executive compensation.

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While the media has focused on public outrage and resulting political pressures to punish executives that took excessive risk while compensating themselves handsomely, the little legal literature on the subject has focused almost exclusively on constitutional and contractual dimensions. Economists and scholars of human capital, however, also raise issues around potential disincentive effects of such measures (for instance, would excessive controls on compensation dissuade talent from seeking such jobs?). In addition, there is an ongoing debate on whether or not there is even a relationship between executive incentive mechanisms and firm performance – while some scholars argue that performance-contingent compensation does indeed improve firm-level financial outcomes others argue just the opposite. In general, the literature on incentive effects and the pay for performance relationship has the potential to inform the current debate on taxing executive bonuses.

In sum, to the best of my knowledge, there has been no attempt to integrate or synthesize the different factors - legal, political, and economic- that impact the potential costs and benefits of taxing or otherwise regulating executive bonuses and other forms of incentive compensation retroactively. I conduct a systematic review of the legal studies literature and the literature on incentive effects of executive bonuses, and consolidate them into a concise, simple framework that distinguishes ex ante controls on compensation with ex post controls, and contrasts process-oriented policy options with content-oriented ones. As I offer a concise and comprehensive account of the various factors that affect the costs and benefits of regulating executive compensation and identify unanswered issues, legal and other, I conclude that no single policy is going to act as a "silver bullet." My critical review of each of these policy choices reveals that the problems associated with executive compensation are endemic to the flawed U.S. corporate governance structure, and thus cannot be mitigated without fundamental structural reform in that broader system.

1. INTRODUCTION

The financial crisis of 2008-2009 that began with the collapse of the subprime mortgage market also led to the collapse of several preeminent financial firms, the paralysis of credit markets, and significant declines in the stock markets. These events in the U.S. threatened to plunge the world economies into a deep and lasting global recession. On October 3, 2008, the 110th Congress of the United States passed the Emergency Economic Stabilization Act (EESA) which included, among other measures aimed at mitigating the duration and severity of the financial crisis, four major provisions that would potentially limit executive pay levels and compensation mechanisms that encouraged excessive risk taking. These four provisions included limits on pay (to ensure that senior executives were not incentivized to undertake excessive risks), lowering of the cap on tax-deductibility of top executive officer compensation from $1 million to $500,000 (including performance-based pay), "clawbacks" of any bonuses or incentive compensation paid to senior executives if subsequent financial reports were proven to be materially inaccurate, and the probation or limitation on golden parachutes in cases of severance. A subsequent press released by the Treasury Department on October

14th clarified, however, that the applicability of these provisions was contingent on whether the government (i) had purchased the firm's assets through the Troubled Assets Auction Program, or (ii) had provided equity capital to the financial institution through the Capital Purchase Program and/or (iii) had provided direct assistance to an institution at risk of failing.[2] In February 2009, President Obama observed that executive pay schemes that rewarded risk taking while protecting the executive from the downside to such risk taking had played a major role in the financial crisis.[3]

Longitudinal analyses of the executive compensation practices at three major financial institutions also lend scholarly credence to President Obama's aforementioned observation. In a case study of Fannie Mae's executive compensation practices during the 2000-2004 time period,[4] Bebchuk and Fried conclude that Fannie Mae's executive pay arrangements "provided executives with large amounts of camouflaged pay unrelated to performance, diluted and even distorted the executives incentives, and failed to clearly disclose the value of the retirement packages promised and given to executives."[5] In another case study of compensation practices at Bear Stearns and Lehman Bros. during the 2000-2008 time period, the researchers again conclude that the top executives of those two firms cashed out large amounts of performance-contingent compensation that were not clawed back when their firms collapsed and also gained significant wealth through equity sales.[6] While the firms collapsed and shareholders suffered catastrophic losses, its top executives experienced substantive positive net payoffs for the period.[7]

Two central concerns remain at the core of the renewed attention of lawmakers on executive pay, the continued media attention[8] on executive bonuses and payouts, especially at firms that benefitted from the government bailout, and the surge in scholarly articles dissecting pay practices and executive decisions at firms that collapsed. Interestingly, neither one of these two concerns is particularly new, in that both concerns have not only received extensive scholarly attention but have also been the focus of multiple regulatory interventions in the past two decades. The first concern revolves around the issue of executive pay levels and

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[2] V.G. Narayanan, Fabrizio Ferri & Lisa Brem, *Executive Pay and the Credit Crisis of 2008* 1, 20 (Harvard Business School 109-036, 2009) (summarizing executive compensation provisions in the Emergency Economic Stabilization Act of 2008).

[3] V.G. Narayanan & Lisa Brem, *Executive Pay and the Credit Crisis of 2008*(B) 1, 1 (Harvard Business School 110-005, 2009).

[4] Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005).

[5] *Id.* at 821.

[6] Lucian A. Bebchuk, Alma Cohen, & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008* (The Harvard John M. Olin Discussion Paper Series, No. 657, 2009), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_657.pdf.

[7] *See* Louise Story, *Executives Kept Wealth as Firms Failed, Study Says*, N.Y. TIMES, Nov. 23, 2009, at B3.

[8] *See id.*; *see also* Basil J. Whiting & Joseph Mirzoeff et al., Letters to the Editor, *Time to Tax Those Bankers' Bonuses?*, N.Y. TIMES, Dec. 25, 2009, at A30; Graham Bowley, *Morgan Stanley's Quarter is Weak, Unlike Its Pay Pool*, N.Y. TIMES, Jan. 21, 2010, at B1; *Attacking the Corporate Gravy Train*, ECONOMIST, May 30, 2009; *Bank Incentives Are All Wrong*, ECONOMIST, Jan. 29, 2009.

whether CEOs (and other senior executives) receive excessive amounts of compensation. Some scholars have argued that executive pay levels reflect the marginal product of the executive that is assumed to be proportional to the talent of the executive and the size of the firm, such that larger firms are willing to pay more for the same talent.[9] A related argument suggests that pressure from the market for managers forces firms to develop the optimal compensation strategies, including pay levels, because otherwise they will fail to attract talented managers.[10] An increasingly visible group of scholars, however, believe that excessively high pay levels are a reflection not of rare talent or exceptional skills, but of executive power and lax corporate governance regimes,[11] and that a significant proportion of CEOs are paid too much relative to the benchmarks of firm size or complexity.[12] The increasing disparity between average CEO pay and the average hourly employee's pay during the 1980s and 1990s further fueled this concern and manifested itself in increasingly public expressions of anger and outrage at the pay levels of executives.[13]

The second concern is focused on whether or not executives who have been compensated handsomely through performance-contingent pay schemes (notably stock options) have indeed contributed to stronger firm performance (typically measured in terms of appreciation in shareholder value). The pay-for-performance issue has garnered intense academic scrutiny in a wide range of fields including accounting, finance, management, and legal studies. With the exception of a small number of scholars who argue that executive pay is positively correlated with firm performance,[14] the general consensus is that there is either a very weak or no relationship between executives' incentive pay and their firms' financial performance. Indeed, the most recent crises in the financial sector have prompted the observation that option-loaded executives led to the failure of their firms through excessive risk taking.[15]

Nearly two decades ago, Jensen and Murphy concluded that senior executives do not seem to be paid according to their performance, based on their empirical finding of low pay-performance sensitivity in a sample of Forbes executives from 1977-1988.[16] Ten years after that study, Murphy concluded,

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[9] *See generally* Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981).

[10] *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACAD. MGMT. PERSP. 5 (May 2008).

[11] *See generally* LUCIAN A. BEBCHUK & J.M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard Univ. Press 2004); *see also* Andrei Shleifer & Robert W. Vishny, *Managerial Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123 (1989).

[12] *See* Eugene Kandel, *In Search of Reasonable Executive Compensation*, 55 CESIFO ECON. STUD. 405 (2009).

[13] In 1980, the average CEO made forty-two times the average hourly worker; this ratio increased to 107 times by 1990 and, by 2000, the ratio had climbed to 525 times. *See* Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 384 (2008).

[14] Kaplan, *supra* note 10, at 11.

[15] Bebchuk & Fried, *Compensation at Fannie Mae*, *supra* note 4, at 814-15; Bebchuk et al., *supra* note 6, at 12-16.

[16] *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*,

based on a comprehensive review of the empirical and theoretical research on pay practices for chief executive officers, that a large gap remained between the interests of managers and shareholders;[17] and that, while factors such as executive risk aversion,[18] company size, and volatility may partly explain low pay-performance sensitivities, these factors still exacerbate rather than ameliorate the major conflict of interest between executives and shareholders. Bertrand and Mullainathan found that CEOs are more frequently rewarded for luck rather than performance,[19] suggesting that managers are either paid too much or they are paid inefficiently. Bebchuk and Fried in particular document a long list of executive pay practices that have little to do with performance and impose a huge cost on shareholders, while providing senior executives with extremely generous benefits especially in the forms of huge loans, consulting, pension benefits and stock option grants with high upside returns and zero downside risk.[20]

Interestingly, not only are these concerns about excessive executive pay both old and recurring, but the allegedly 'new' policies being implemented under the EESA are in fact little more than targeted applications of existing regulations. In particular, starting in the mid 1980s several tax-related reforms were put in place to rein in executive pay and motivate a closer link between pay and performance.[21] In addition to tax-focused reforms, several other regulations (e.g., under the auspices of the Sarbanes-Oxley Act ("SOX") passed in 2002)[22] enacted in the past two decades have also focused on addressing executive compensation-related issues.[23] What have been the outcomes of these efforts? And what can we learn from these outcomes going forward? To answer these questions, the rest of the Article provides a focused review of these reforms as follows. The second section

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98 J. POL. ECON. 225 (1990).

[17] *See generally* Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS (O. Ashfelter & David Card eds., 1999).

[18] *See, e.g.*, Joseph G. Haubrich, *Risk Aversion, Performance Pay, and the Principal-Agent Problem*, 102 J. POL. ECON. 258 (1994). Haubrich notes that the Jensen-Murphy conclusion of low pay-performance sensitivity is quite consistent with the predictions of agency theory for sufficiently risk-averse executives. *Id.* at 260.

[19] *See* Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded For Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 901 (2001). Bertrand and Mullainathan defined luck as "changes in firm performance beyond the CEO's control" and used oil price movements, changes in exchange rates, and average industry performance to measure luck. *Id.* at 901-02.

[20] *See* BEBCHUK & FRIED, supra note 11, at 121-46.

[21] *Id.*

[22] Sarbanes–Oxley Act of 2002, 18 U.S.C. § 1514A (2009). Specifically, the Act:

> disallows loans from corporations to their executives, a type of compensation heavily criticized by Bebchuk and Fried (2004). Second, since the CEO and Chief Financial Officer must now personally certify financial statements, if those statements are materially revised, the CEO is required to give the company back 100% of his or her performance-based compensation. Third, it requires that the majority of the board be independent, and that the nominating and compensation committees be entirely independent.

Id. Ian Dew-Becker, *How Much Sunlight Does It Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation in America*, 55 CESIFO ECON. STUD. 434, 452-53 (2009) (detailing empirical studies of say-on-pay).

[23] Joy S. Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 490 (2009).

of this Article reviews the intent and consequences of major tax policy changes focused on executive compensation. In the third section, a simple framework is developed to organize and critically review other non-tax related reforms and solutions. Finally, the concluding section relates executive compensation challenges to the broader structural issues that have plagued corporate governance reforms over several decades, and identifies some useful policy implications of these challenges.

2. USING TAX POLICY TO REGULATE EXECUTIVE COMPENSATION: HAS IT WORKED?

Prior to the mid-1980s, tax law did not play a direct role in regulating executive compensation, in that the tax code's effect applied to the executive only as it applied to any and all other taxpayers.[24] However, following the increasing public (and media) attention on excessive executive pay levels, and continued focus on the low sensitivity of pay to corporate performance, Congress enacted tax code provisions intended to (a) curtail excessive growth in pay levels and (b) align executive pay closer to firm performance. The two most important tax code provisions implemented to achieve these twin objectives were section 162(m)[25] and section 280(g). The rest of this section will mainly focus on section 162(m) because it has garnered the most attention in the legal studies literature and is generally recognized as the tax provision that was intended to have the most far-reaching effects on executive compensation. In the interest of being complete, however, a brief commentary on the effectiveness of the other provision will be provided at the conclusion of this section.

2.1 § 162(m): Has it Worked?

On August 10, 1993, Congress enacted section 162(m) to disallow deduction for annual compensation that was considered allowable as an ordinary and necessary business expense under prevalent tax code.[26] Specifically, section 162(m) prohibits a deduction in excess of $1 million for compensation paid by a publicly held corporation to its CEO and the next four highest paid officers in the corporation subject to the following exceptions.[27] The $1 million limit does not apply to commissions, performance-based compensation, qualified retirement plan contributions, and nontaxable fringe benefits, with the most significant of these exceptions being the one for performance-based compensation. Section 162(m) deemed compensation as performance-based only if it is "payable solely on account of the attainment of one or more performance goals," where such goals must be "established by a compensation committee of outside directors, approved by shareholders, and certified by the company's compensation committee as

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[24] *Id.*

[25] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 162(m), 107 Stat. 312 (1993) [hereinafter § 162(m)].

[26] *Id.*

[27] *Id.*

having been met."[28] The caps on deductibility of non-performance based pay and the exceptions granted for performance based-pay reflect the twin objectives of curtailing executive pay levels and encouraging stronger connection between pay and performance. However, a review of the evidence on the effectiveness of this provision yields some dismal conclusions. In sum, as revealed next through a focused review of scholarly evidence, the consensus is that section 162(m) has resulted in many unintended negative consequences even as it has not reduced either overall compensation levels for senior executives or strengthened the pay-for-performance relationship.

Section 162(m) was intended to stop or at least curb increases in executive salaries. Instead, many studies have found that it resulted in higher salaries because of several reasons. First, it allowed corporations to avoid the problem merely by substituting cash forms of compensation with stock options and other types of performance-contingent pay that were exempt under this provision.[29] Alternatively, firms awarded higher salaries but then deferred payment until retirement, thus circumventing completely the $1 million cap. Of particular note was the unintended effect this legislation had on firms that paid their CEOs less than $1 million and that were not directly affected by the provision. Because the new law decreased such firms' implicit costs of contracting, firms who expected to pay their CEOs less than $1 million had unexpected increases in their CEOs' cash compensation and the magnitude of these increases was directly proportional to how far the CEO's expected compensation fell below the $1 million standard.[30] These changes occurred relative to the period before the enactment of section 162(m) and persisted into the following year offering support for the conclusion that the changes were indeed precipitated by the tax legislation.[31] Furthermore, although this provision was intended to discourage corporations from paying excessive non-performance-based compensation to their executives by making it more costly to do so, many corporations demonstrated a willingness to forego a deduction in order to pay their executives whatever they deemed appropriate. In other words, by forfeiting deductions, the companies signal their willingness to shoulder increased tax liability rather than forcing their executives to accept lower pay levels.[32] Reflecting these unintended effects of the new tax rule, executive pay

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[28] I.R.C. § 162(m)(4)(C) (2006).

[29] *See* Conway, *supra* note 13, at 410.

[30] *See* David G. Harris & J.R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997, 1015 (2002). Harris and Livingstone define implicit contracting costs as "non contractual costs that third parties impose on firms by reacting adversely to firms' behaviors." *Id.*

[31] *See id.* at 998.

> Our results are consistent with the theory of implicit contracting costs. If Congress's $1 million standard influenced third parties' beliefs about how much compensation was reasonable, then the implicit contracting costs of CEO compensation for firms paying less than $1 million fell when Congress enacted a standard for reasonable compensation at a level higher than such firms otherwise would have paid. A reduction in implicit contracting cost should induce firms to pay more CEO compensation to earn greater revenue and additional profits.

Id.

[32] Gregg D. Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE

levels seem to have grown considerably in the period after the introduction of section 162(m).[33] The average total pay of S&P 500 CEOs rose from $2.6 million in 1993 to $14 million in 2000. Even after the stock market crash of 2002, the average total CEO pay was $9.4 million. In addition, the new provision appears to have resulted in significant changes in the composition of executive pay – while base salary contributed 37% of average total CEO pay in 1991, it dropped by 19% by 2002, a change mainly explained by the increased use of stock options whose share in average total CEO pay went up from 24% in 1993 to 47% in 2002. The increased use of performance-contingent pay may appear consistent with the intention of section 162(m), namely, to increase the sensitivity of performance to pay among publicly held corporations. But a deeper look at the evidence reveals that the structural shifts in executive pay have had minimal, if at all any, positive effects on increasing pay-for-performance sensitivity.

The empirical evidence on whether and how much section 162(m) increased the pay-performance sensitivity among public U.S. corporations in general supports the conclusion that, at best, this provision has been a "blunt" policy instrument with little effect on either firm growth rates, or the overall pay-performance relationship.[34] Because stock-options are considered performance-based and therefore excluded from the deduction of limitations of section 162(m), there was a dramatic increase in the use of stock options to compensate executives even as the stock market itself experienced unanticipated massive growth in the late 1990s. On average, stock options made up three to five percent of a company's stock in 1994 but this percentage tripled to twelve to fifteen percent by 2002. In addition, about 80% of the increase in average compensation of CEOs between 1992 and 2000 was primarily due to the increased use of stock options.[35] The tax treatment of stock options became even more attractive with the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998 (these acts lowered the maximum capital gains tax rate from 28% to 20%). Under the new laws, executives did not have to pay income taxes on incentive-based stock options

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L. REV. 877 (2007) (detailing a more nuanced analysis of the implications of deduction forfeiture by corporations pursuant to § 162(m)).

[33] *See* Robert F. Gox, *Tax Incentives for Inefficient Executive Pay and Reward for Luck*, 13 REV. ACCT. STUD. 452, 453 (2008). *See also* Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y. & ECON. 1 (2000); Hall and Liebman use the Execucomp database to examine pay levels for the highest-paid executives in each of the firms in the S&P 500, S&P Midcap 400, and S&P Smallcap 600, and conclude that "executive compensation clearly continued to rise at a rapid rate after the implementation of the million-dollar rule, though perhaps at a slower rate than it otherwise would have." *Id.* at 33.

[34] *See* Nancy L. Rose & C. Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation*, 20 J. LAB. ECON. 138, 139 (2002). In their empirical analysis, Rose and Wolfram use data on nearly 1400 publicly-traded U.S. corporations to examine the effects of § 162(m) on CEO pay to observe as follows,

> [t]here is little evidence that the deductibility cap has had some significant effects on overall executive compensation levels or growth rates at firms likely to be affected by the deductibility cap, however, nor is there evidence that it has increased the performance sensitivity of CEO pay at these firms. We conclude that corporate pay decisions seem to be relatively insulated from this type of blunt policy intervention.

Id. (excerpted from their abstract).

[35] *See* Conway, *supra* note 13, at 408.

(also known as qualified options) as long as they did not exercise it within two years of the grant date. Further reductions in capital gains tax rates that occurred in 2003 made qualified options even more attractive for executives.

However, as noted earlier in the introduction section of the Article, empirical studies of compensation practices during the 1990s reveal little, if any, systematic positive effects of the use of stock options (and other forms of performance-contingent pay) on corporate performance. Indeed, many scholars believe that CEOs are more frequently awarded for luck rather than performance and that any gains that shareholders may have experienced during the 1990s are more attributable to stock price fluctuations than the performance of the executive.[36] Indeed, some scholars have gone as far as to argue that the increased use of stock options resulted in an incentive for executives to engage in risky or illegal behavior to maximize short-term returns. Representing this viewpoint, Conway observes,

> because executive compensation was tied to stock prices, executives had a motive to try to increase stock price to allow the executives to cash out their stock options at a profit. Because the executives did not represent true ownership interests in the corporation and instead were employees, they could have been motivated to act in the interests of short-term benefits to realize their compensation rather than what would be in the best interests of the corporation in the long term. This resulted in many executives taking unnecessary risks and engaging in unethical and sometimes illegal activities to maximize short-term profits to ensure a sizeable compensation amount.[37]

At their peak in 2001, when stock options accounted for over 50% of the pay of CEOs of major US corporations, options-loaded CEOs delivered more big losses than big gains.[38] Moreover, the use of options also gives executives an incentive to manipulate the options grants dates, leading to the corporate fraud of stock option back-dating.[39] Congress obviously did not anticipate (or intend) the well-documented adverse effects of certain types of performance-contingent plans (especially stock options) and executive behaviors that compromised shareholder interests may have occurred even in the absence of legislative changes. However, a reasonable conclusion that is best reflective of available empirical evidence is that section 162(m) did not address in any significant manner a major concern that precipitated the rule, i.e., the absence of a significant relationship between executive pay and performance. Instead, it may have actually exacerbated excessive risk taking by executives seeking to maximize their personal gains at the expense of shareholders.[40]

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[36] Bertrand & Mullainathan, *supra* note 19; *see also* Gox, *supra* note 33.

[37] Conway, *supra* note 13, at 413-14.

[38] Gerard Sanders & Donald C. Hambrick, *Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance*, 50 ACAD. MGMT. J. 1055 (2007).

[39] *See* Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 MGMT. SCI. 513 (2009). They estimate that 13.6% of all option grants to top executives during the 1996-2005 time period were backdated or otherwise manipulated. *Id.*

[40] Mullane, *supra* note 23, at 536. Mullane argues that tax penalties may be good politics, but are ineffective policy tools that penalize shareholders, consumers, and workers more than the executives. *Id.* For example, if a company absorbs the corporate tax rather than passing this cost to their executives

2.2 § 280G (Tax Penalty on Golden Parachute Compensation): Has that Worked?

The first direct attempt by Congress to regulate executive compensation through tax penalties took place in 1984 when it enacted section 280G and section 4999 to limit excessive payments under golden parachute[41] agreements. While section 280G applied to the corporation, section 4999 applied to the individual receiving payments under the golden parachute agreement. Section 280G disallowed a deduction for any "excess parachute payment."[42] Section 4999 then imposed a nondeductible twenty percent tax on any executive who has received an excess parachute payment under the preceding provision. Section 280G (and section 4999) were enacted in response to the enormous golden parachute payments executives received in the 1980s as a result of the flurry of mergers that took place during that time period. They were also intended to discourage companies from unduly influencing the market for corporate control – for example, by putting in place golden parachute agreements that would make acquiring the company prohibitively expensive. However, while the legislative intent of these provisions was to protect the shareholders from excessive amounts paid to executives, the realized effects have been far from positive.

For one, companies exploited the exceptions in the provisions to avoid tax penalties. For example, companies could sidestep the restrictions just by showing that golden parachute payments reflected personal services offered by the executive on or after the date of change in control of the corporation or that such payments were made for services already provided by the executive before the change in control occurred. Even more problematic, companies opted more often than not to pay additional amounts to executives to cover the additional taxes, thus costing the shareholders even more.[43] Summarizing the unintended (negative) effects of restrictions on golden parachutes imposed by section 280G, Mullane notes,

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(in order to protect the executive's pay levels in the post 162(m) period) it effectively lowers the company's after-tax profits and shareholders will then bear the burden in the form of a smaller after-tax return on their equity investments. *Id.*

[41] *See* BLACK'S LAW DICTIONARY 692 (6th ed. 1990). "Golden parachute" is a term used to describe a lucrative compensation package granted as severance payment to executives in the event of a change in control (e.g., because of a merger or acquisition). *Id.* Although specific forms and terms of payment vary across golden parachute agreements, in general such agreements "provide[] for substantial bonuses and other benefits for top management and certain directors who may be forced to leave the target company or otherwise voluntarily leave upon a change in control." *Id.*

[42] *See* I.R.C. §§ 280G(b)(3), (d)(2). A parachute payment under this provision is defined as a payment made under the conditions of change in corporate control and is an amount equal to or greater than three times a "base amount." *Id.* The base amount is defined as the executive's average annualized taxable compensation for the last five years or the average compensation during the executive's tenure with the company, whichever time period is shorter. *Id.* The difference between the base amount and the actual payment under the parachute is considered "excess parachute payment" and the difference is non-deductible. *Id.*

[43] Omari S. Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 347 (2009). Conway, *supra* note 13, at 414-19 (providing a detailed discussion of the provisions, exceptions, and gaps between the intent and the realized consequences of § 280G).

> [t]he theory was that the tax penalties would in most instances render them too costly to authorize or receive. The reality is many companies continue to authorize golden parachutes that, if triggered, would provide payments above the limit defined as reasonable by Congress. In that way, these companies have voluntarily assumed potentially greater costs than Congress imposed.[44]

3. CURBING EXCESSIVE PAY AND INCREASING SENSITIVITY OF PAY TO PERFORMANCE: IF TAX PENALTIES DO NOT WORK, WHAT DOES?

The empirical effects of two major tax–related regulations on executive compensation practices reviewed in the previous section can perhaps best be summarized as good for politics but bad for economics. Reflecting the view that taxation policy appears to be of limited use when it comes to either curbing excessive pay or strengthening the pay-for-performance relationship, there has been a renewed debate on evaluating alternative mechanisms (most of which are already being used) to address the two issues around executive compensation that have provoked so much public outrage and political attention. These alternatives vary in terms of their focus on the process versus content of executive pay packages as well as in their relative emphasis on ex-ante versus ex-post solutions. Process-focused (or procedural) solutions include calls for increased transparency, increased board vigilance and monitoring, and shareholder say-on-pay; content-oriented solutions primarily focus on the amount/type of pay and include equity-based pay and contingent compensation contracts, pay caps and tax penalties, and clawbacks. Ex-ante solutions focus on actions that are taken prior to the determination of an executive pay package such as say-on-pay votes, caps on pay levels, greater board oversight and monitoring through independent compensation committees and the like, while ex-post remedies include mechanisms such as retroactive clawbacks and shareholder lawsuits against board members for breach of fiduciary duty.

While a comprehensive review of these alternatives and their relative pros and cons is beyond the scope of this Article, a focused critical review of the most frequently used options is a worthwhile exercise because such a review can provide the basis for a deeper debate on the costs versus benefits of various options from a policy standpoint. The table below categorizes these options into a simple conceptual scheme, using the process versus content and ex-ante versus ex-post dimensions described earlier.

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[44] Mullane, *supra* note 23, at 519.

	Content-oriented	***Process-oriented***
Ex-ante	Pay caps and tax penalties; Equity-based pay (including contingent pay contracts) Prospective clawbacks	Greater shareholder involvement: Say-on-Pay and the role of institutional owners; Increased board vigilance & monitoring
Ex-post	Retroactive clawbacks	Greater transparency and completeness in disclosure; Increased board accountability and shareholder lawsuits

3.1 Pay Caps and Tax Penalties

While there is a general sense of outrage over the increasing disparity between CEO pay and the average worker's earnings (as discussed in the introduction part of the Article), it appears that most of this outrage (at least in contemporary legal scholarship and among financial economists) stems not so much from the actual amounts of pay as it does from the weak justification of pay from the standpoint of firm performance. This viewpoint is shared even by those legal scholars who have been most vocal about the need for serious reform in executive compensation.[45] Most corporate law scholars seem to care more about corporate governance rather than general inequality in income.[46] Financial economists also by and large agree that compensation levels should be determined by the unfettered interplay of market forces reflecting the demand and supply of managerial talent (and hence, the value of specific types of human capital) and should be based on efficient contracting principles that reflect the preferences of both the parties to the compensation contract (the firm and the manager).[47] In fact, some have even questioned the appropriateness of the pay caps most recently imposed under the 2008 Emergency Economic Stabilization Act ("EESA") on financial institutions benefitting from tax-payer funded bailouts. For example, in his testimony before the House Committee on Oversight and Government Reform, J.W. Verret noted,

> [p]ay restrictions will also limit banks in their competition for top talent, which risks exacerbating the banking crisis. Immediately following the announcement of compensation restrictions by the Obama Administration, Bank of America

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[45] *See, e.g.*, BEBCHUK & FRIED, *supra* note 11, at 9. They note that

> [i]t is worth emphasizing that our criticism of executive pay arrangements does not focus on the amount of compensation received by executives. In our view, high absolute levels of pay do not by themselves imply that compensation arrangements deviate from arms-length contracting. Our conclusion that such deviations have been common is based primarily on an analysis of the processes by which pay is set, as well as on examining the inefficient, distorted, and nontransparent structure of pay arrangements.

Id.

[46] Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585 (2007).

[47] *See, e.g.*, Rosen, *supra* note 6; Kaplan, *supra* note 10, at 2.

> indicated that Deutsche Bank poached 12 of its highest performing executives and other reports indicated that UBS was hiring financial advisors from TARP firms with compensation increases as high as 200%. In a global environment, restrictions may place American banks at a competitive disadvantage.[48]

Notwithstanding the aforementioned reservations, the current pay caps imposed under EESA can at least be justified from a political standpoint (public sentiment and related political fallout would have been even more negative if the government had not imposed these caps on firms being bailed out with taxpayer money). However, the evidence on the effectiveness of pay caps imposed under more permanent tax reforms (discussed earlier in the second section of this Article) clearly indicates that ex-ante pay caps have most likely had greater adverse than positive outcomes. While such caps may assuage public resentment of excessive payments at the highest levels of corporate America, the evidence on their effectiveness to date indicates that pay caps, per se, are among the least effective either in curbing unjustified pay increases or in aligning compensation more closely with the interests of shareholders. Accordingly, to address these problems, changes to the structure (rather than levels) of pay have been proposed and the most significant structural changes focus on the proportion of equity-based pay in the compensation package. Again, various forms of equity-based pay (especially stock options) have been extensively used especially in the two decades – the pros and cons of using equity-based pay schemes to alleviate the pay-performance problem is discussed next.

3.2 Equity-Based Pay and Contingent Pay Contracts

The lack of a strong relationship between executive pay and performance (and the negative effects of an increased reliance on stock options to tie managerial incentives to firm performance as documented earlier in this Article) have led to a renewed focus on the pros and cons of equity-based pay. In principle, equity-based compensation can provide managers with desirable incentives even though, in practice, such plans have enabled executives to reap substantial rewards even when their firms' suffered huge financial losses. If not designed with care, equity-based pay plans can end up motivating executive behaviors that destroy shareholder value. Hall identifies six major challenges in designing equity-based pay plans that can appropriately align executives' incentives with those of shareholders: mismatched time horizons, gaming, the value-cost wedge, the leverage-fragility tradeoff, the alignment of risk-taking incentives, and the

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[48] J.W. Verret, *Unintended Consequences of Executive Compensation Regulation Threatens to Worsen the Financial Crisis* (GEORGE MASON UNIV. LAW & ECON. PAPER SERIES, Paper No. 34, 2009), *available at* http://ssrn.com/abstract id= 1436658. Jamal Ibrahim Haidar, *A Note on the Regulation of Executive Compensation Within the 2009 US (Bailout)*, INT'L J. REG. & GOVERNANCE (2009), *available at* http://ssrn.com/abstract=1515508 (voicing similar concerns as a World Bank Economist). Haidar observes that the caps on executive compensation placed by EESA are counterproductive because these caps will result in the flight of more able executives and place damaged firms in the hands of less-able managers, further exacerbating the problems of mismanagement.

avoidance of excessive compensation.[49] The challenge of mismatched time horizons between executives and shareholders is manifested in executive behaviors aimed at maximizing the short-term earnings to boost the value of their equity holdings. Executives prefer shorter vesting periods for their stock plans because it makes their compensation less risky and many companies also give executives broad freedom to exercise their options as soon as they are vested such that executives are able to time the unloading of their shares to benefit from short-term surges in share value. The second challenge – gaming – refers to managers' tendencies to engage in questionable and even illegal behaviors to artificially boost stock prices. Such behaviors may be motivated not only by the incentives to reap the enormous gains from unloading shares at their peak prices but to also meet the quarterly earnings' expectations of Wall Street. Indeed, some have argued that the root of the short-term behavior in corporate America lies in the pressure companies feel to meet quarterly predictions on their earnings and a focus on reforming pay schemes without addressing this fundamental problem will be of very limited use.[50]

Some proposed solutions to these challenges include the following: reducing windfalls in equity-based compensation by indexing the exercise price of stock options (for example, to the stock price of the worst-performing firms in the industry); increasing the vesting period and requiring executives to hold company stock over longer time periods; and requiring executives to disclose in advance their intention to sell shares along with details on the proposed sale. However, while some of these steps may help, to some extent at least, mitigate the problems associated with mismatched time horizons and gaming, they are not likely to address the more fundamental issue associated with equity-based plans: the value-cost "wedge" that stems from the general rule that the value to the executive of equity pay is typically much lower than its cost to the shareholders.[51] The fourth trade-off in designing equity-based plans – between leverage and fragility – is particularly salient in the design of multi-year stock options plans, where the challenge is to create sufficiently high upside potential for incentive alignment (leverage) while at the same time protecting the company's ability to retain and motivate its executives in the event of sharp declines in stock prices (fragility). In addition, the design of optimal equity-based pay options are extremely complex because it is very hard, if not impossible, to assess, ex-ante, the optimal level of risk-taking for a given company (such that equity pay packages can be designed in a manner to incentivize executives to manage corporate assets in a manner that would be consistent with the firm's risk profile). And, finally, even the most conscientious boards may find it very difficult to determine the optimal level of equity-based pay because they may not always understand how much value they are transferring to executives, and ex-ante expectations may be completely out of

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[49] *See* Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN. 24, 30 (2003).

[50] Verret, *supra* note 48.

[51] Hall, *supra* note 49, at 26 (pointing out that the value-to-cost ratio depends, among other factors, on the degree of diversification of the executive's stock portfolio, the executive's risk aversion, stock volatility, and vesting period).

line with the ex-post gains from such grants.[52]

It is fairly obvious that there is no standard, "one-size-fits-all" approach that is optimal in determining the proportion of equity-based pay in the compensation package of the executive as well as the specific timing and structure of such plans. This, in turn, has prompted increasing attention to the design of contingent pay schemes that take into account critical firm-specific and executive-specific contingencies in determining the levels and types of incentive pay. Kandel argues that boards have to pay close attention to the specific CEO and the current state of the firm in determining the level and structure of pay packages, including the firm's growth options, the potential effect of the CEO on the firm, the CEO's wealth, likely tenure with the firm, etc. He proposes three generic contracts – aggressive, conservative, and intermediate – that take into account critical contingencies in the firm's operating context and the executive's wealth and risk preferences.[53] However, the key challenge in designing contingent pay contracts is determining the underlying contingencies, which will decide the optimal solution in a given situation, especially because such contingencies may be endogenous rather than exogenous to the pay scheme itself. For instance, the level of risk faced by the company can change as a function of the executive's strategic decisions and can also change over time as a result of changes in the broader operating context (e.g., changes in technology, competitive choices of other firms). It is also very difficult to reliably assess the level and type of effort that will be exerted by managers and their underlying abilities; indeed, the effort of the manager may be better revealed in ex-post performance metrics rather than ex-ante measures.[54]

Given the myriad of challenges associated with designing optimal ex-ante pay packages, many scholars and policy makers have suggested the use of measures that allow companies (and their shareholders) to force executives to refund their compensation if performance expectations are not met or if it becomes clear that the executives' actions and choices resulted in value destruction. One such mechanism that has been particularly prominent in the provisions of EESA and has garnered serious attention from legal scholars is that of clawbacks, discussed next.

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[52] Columbia Symposium, Kenneth West, Pay Without Performance: An Executive's Perspective on Bebchuk & Fried's Pay Without Performance: The Unfulfilled Promise of Executive Compensation (Oct. 15, 2004).

[53] For example, an aggressive contract (characterized by high proportion of stock-based pay) is appropriate in a context characterized by talented managers exerting utmost effort to generate high value; the firm facing high operating risk; and, the degree of damage the manager can inflict on the firm through suboptimal investments being not too high. *See* Kandel, *supra* note 12, at 426-27 (covering details on contingent pay contracts). In contrast, a conservative contract (combination of fixed salary and incentive-pay with lower levels of stock-based pay) is optimal for a firm that can be severely damaged by short-term executive actions. *Id.*

[54] While the executive may be well aware of his real ability and risk preferences, s/he is unlikely to reveal this to the firm. This information asymmetry between the executive (as agent) and shareholders (as principals) is a major contributor to the two problems discussed in agency theory: adverse selection and moral hazard. *See* Fama, *supra* note 9, at 289-92. Indeed, agency theorists have argued that equity-based compensation plans when designed appropriately can help mitigate the incentive misalignment problem.

3.3 Clawbacks

One of the key provisions of EESA was the requirement of clawbacks[55] of any bonuses or incentive compensation paid to senior executives if subsequent financial reports were proven to be materially inaccurate. More recently, the House of Representatives passed a bill (still pending in the Senate) to impose a retroactive marginal taxation rate of 90% on the bonuses paid to senior executives of AIG, following the outburst of public outrage in response to the bonus payments at the bailout firm.[56] However, advocating the use of clawbacks in order to deprive executives of compensation allegedly earned illegally (or, more recently, perceived as unfair) is not a particularly new approach. For instance, six years before the 2008 crisis, section 304 of SOX mandated that the CEO and CFO of any firm that had to restate its earnings due to material non-compliance of financial reporting requirements under the securities laws had to repay to their company any bonus or other incentive or equity-based compensation received during the twelve months following the filing of the inaccurate financial statement. Section 304 also applied to any profits that were realized by the executives from the sale of stock within that twelve-month period, if the restatement had resulted from misconduct. However, the effectiveness of the clawback provision under section 304 has been rather limited, for two reasons. First, there have been problems relating to interpretation; for instance, the statute does not specify what degree of misconduct or whose misconduct is necessary to activate the regulation. Also, while the statute does not explicitly require the officer from whom the clawback is sought to have personally engaged in misconduct, subsequent interpretations of the statute have been quite narrow. The second reason for the limited effectiveness of the section 304 clawback provision is that it gives enforcement rights only to the SEC. While a number of shareholders brought private securities lawsuits under section 304, they were without any exceptions turned away by the courts. In sum, due to interpretation as well as enforcement challenges, clawbacks under section 304 have only been successfully implemented in a handful of cases.[57]

In order to address some of the problems that have reportedly resulted in the low effectiveness of retroactive clawback provisions (such as attempts to recover bonus payments made to executives as in the recent AIG case), Cherry and Wong

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[55] *See* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 370 (2009) (detailing an exhaustive treatment of clawbacks). They define "clawback" "as a theory for recovering benefits that have been conferred under a claim of right, but that are nonetheless recoverable because unfairness would otherwise result." *Id.* at 371-72.

> This definition includes both *retroactive* clawbacks – those that, like the (pending) ninety percent tax on bonuses, are imposed after the contractual right to the bonuses has arisen and the benefits have been conferred – and *prospective* clawbacks that are introduced into contracts before the claim of right to the benefits has arisen.

Id. at 372.

[56] *See* Liam Pleven et al., *AIG Faces Growing Wrath Over Payouts*, WALL ST. J., Mar. 16, 2009, at A1.

[57] Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1 (2008). In the seven years since SOX has been in place, the SEC has only enforced two clawback actions. *Id*.

advocate the use of "prospective clawbacks," especially because such provisions reflect the voluntary adoption by corporations (perhaps, thus increasing their incentive to enforce it as well) and can be individually tailored to reflect company-specific contingencies that, as noted earlier, make contingent, rather than one-size-fit-all, pay schemes more attractive.[58] Unlike retroactive clawbacks, which have to contend with existing contractual rights of executives to whom compensation has already been paid, with prospective clawbacks such contractual rights are automatically altered, allowing for the recoupment of bonuses.[59] There is already some evidence that in the last two years some prominent, large publicly traded organizations like Dell, Intel and Morgan Stanley, have voluntarily adopted and implemented clawback provisions in their compensation policy.[60] However, given the relative newness of prospective clawbacks, several unresolved and highly complex issues related to the function, the structure, and the desirability of contractual clawbacks must be carefully analyzed.[61] It is especially important that, if these mechanisms are found to be quite effective in mitigating the compensation problems discussed throughout this report, they are adopted widely rather than sporadically. That, in turn, may mandate formal legislation and regulatory enforcement mechanisms that have yet to be debated. In sum, notwithstanding the attractiveness of clawbacks from a political standpoint (after all, the very public act of recovering compensation from executives whose reckless choices are perceived to have destroyed shareholder value and even hundreds of livelihoods may, at least temporarily, appease public sentiment) there are other less obvious pros and cons that need to be identified and debated rigorously. While the legal issues surrounding clawbacks are beginning to gain some attention (as noted earlier), the potential effects, especially of prospective clawbacks, from a managerial selection and retention standpoint need closer attention. For instance, will the voluntary adoption of clawback provisions prevent firms from attracting and retaining top managerial talent who may choose employers with less restrictive pay practices?

3.4 Greater Shareholder Involvement in the Pay-Setting Process: Say-on-Pay and the Role of Institutional Owners

After 2002 (and in the post-Enron world), shareholder activism, influenced by the efforts of corporate governance activists, institutional investors, and even legislatures, increased significantly, and this increased activism is particularly visible in the increased pressure on corporations to accept "say-on-pay."[62]

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[58] Cherry & Wong, *supra* note 55, at 38.

[59] *Id.* They note, "[i]f there is a prospective clawback provision in the original contract, the winning investor no longer has those contractual and restitutionary claims under specified unfair enrichment circumstances, because they were modified by the clawback provision in the investor agreement." *Id.*

[60] *Id.* at 17-18.

[61] Cherry and Wong provide many good ideas related to this issue in their discussion of the potential impact of clawback provisions on other concepts within contract law doctrine. *See id.* at 39-42.

[62] Standard say-on-pay rules mandate that companies submit executive compensation packages to the shareholders for a non-binding advisory note. *Id.* In 2006, The American Federation of State, County, and Municipal Employees ("AFSCME"), supported by a broader coalition of investors,

Supporters of say-on-pay view this as a low-cost mechanism to enhance dialogue between the board and shareholders over the design of compensation practices. While say-on-pay has been mandatory in the United Kingdom since 2002, and has been adopted since then by other countries including Australia, the Netherlands, Norway, and Sweden, it remains non-mandatory in the U.S. Unfortunately, say-on-pay measures are so recent that there is very limited empirical evidence on their effectiveness. Based on a review of surveys undertaken in other countries where say-on-pay has been in effect as a mandatory practice for several years, Dew-Becker concludes that while pay appears to have become more connected to performance in these contexts, there is little evidence that they have reduced the pay levels such that firms are unable to attract talent and pay them at market rates. Further, compensation packages are rejected very rarely, perhaps reflecting the improved communication between investors and board members, and special interest groups have rarely used pay proposals as levers for bargaining against the corporation.[63]

Notwithstanding the generally positive experience of say-on-pay in other countries, some scholars in the U.S have expressed major reservations about broader federal legislation that would entitle shareholders of all public corporations to a vote on executive compensation. One of the major objections is that say-on-pay will erode the primacy of the board of directors in a major area of corporate governance: setting executive compensation. It has also been noted that "shareholder involvement in corporate decision making seems likely to disrupt the very mechanism that makes the public corporation practicable, the vesting of 'authoritative control' in the board of directors."[64] Bainbridge also objects to say-on-pay provisions on the grounds that most shareholders, constrained by information asymmetries (boards will have better and more complete information than the typical shareholder) and collective action (it is more difficult to mobilize very large, dispersed groups) problems, will tend to be rationally apathetic.[65]

As noted in the preceding paragraph, a major challenge in implementing proposals centered around more active shareholder involvement in the governance of the public corporation stems from the widely dispersed nature of shareholdings in the typical large U.S. corporation because of which it is very difficult, if not impossible, to mobilize broad-based shareholder interest and involvement in the governance process.[66] However, institutional owners[67] are not subject to the same

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launched a campaign for the adoption of say-on-pay. *See* Narayanan, Ferri & Brem, *supra* note 2, at 7. In 2007, a say-on-pay bill was approved by the House of Representatives and a similar bill was introduced in the Senate as well. *See* Narayanan, Ferri & Brem, *supra* note 2, at 7. In February 2009, the U.S. Treasury announced a policy under which banks receiving "exceptional assistance" under the ongoing government bailout must fully disclose their executive compensation arrangements and obtain a non-binding shareholder vote on that structure. *See* Narayanan, Ferri & Brem, *supra* note 2, at 7. This is the first legally mandated say-on-pay provision in the U.S. *See* Narayanan, Ferri & Brem, *supra* note 2, at 7.

[63] *See* Dew-Becker, *supra* note 22.

[64] Stephen M. Bainbridge, *Is 'Say on Pay' Justified?*, 32 REG. 42, 46 (2009).

[65] *Id.*

[66] The separation of ownership and control is a central feature of the U.S. corporate governance context where ownership rests with distant and diffuse shareholders while control is exercised by hired managers. *See* Mark J. Roe, *The Inevitable Instability of American Corporate Governance*, 1 CORP.

constraints as the average shareholder in that they typically have a sizeable ownership or block holding in the firm and have experienced increasing power in the past twenty years.[68] Their increased power is evident in the number of instances of institutional owners challenging executives' agendas and attempting to influence or change target firms' governance practices.[69] Anecdotal evidence suggests that large institutional owners can play a critical role in mitigating conflicts around executive compensation. Most recently, institutional owners played a key role in motivating Royal Dutch Shell PLC to implement major changes in its senior executive compensation practices, including a two percent reduction in the salaries paid to the CEO and CFO relative to their predecessors and a ban on the award of performance-based shares to top three executives if they failed to meet targets. Standard Life Investments, an institutional shareholder, played a key role in the shareholder-staged revolt against executive compensation policies.[70] Available empirical evidence also largely supports anecdotal evidence that institutional investors can reduce executives' power in the compensation setting process. Hartzell and Starks found that institutional owners with large stakes lowered total compensation.[71] Other studies have similarly found that ownership stakes by institutional owners are negatively related to CEO total pay,[72] especially when the institutional owner is actively involved in the governance process and is resistant to pressure from the firm's managers.[73] In addition, Hartzell and Starks also found that large institutional owners act as more effective monitors in that they are associated with greater pay-for-performance sensitivity.[74]

Notwithstanding the many salutary effects of institutional investors on executive compensation, however, there are several challenges that place limits on

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GOVERNANCE L. REV. 1 (2004). Roe notes that separation of ownership and control is an important cause for the breakdowns in corporate governance among major U.S. public corporations including the competitive failures in the 1970s and 80s, excessive pay in the 90s, and the collapse of Enron in more recent history. *See id.* On the positive side, separation enhances the firm's ability to hire and retain qualified managers and also increases the availability of financial capital. *See id.* On the negative side, however, this separation also results in the entrenchment of powerful managers who may pursue self-serving behaviors to the detriment of owners. *See id.*

[67] Institutional owners are organizations such as banks, mutual funds, insurance companies, public and private pension funds, and investment companies. *See* Lori V. Ryan & Marguerite Schneider, *The Antecedents of Institutional Investor Activism*, 27 ACAD. OF MGMT. J. 554 (2002) (providing an empirical study of the evolving role of institutional ownership).

[68] *See* Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000).

[69] *See* Diana Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293 (1999).

[70] Guy Chazan, *Shell Plans to Reduce Executive Salaries*, WALL ST. J., Feb. 17, 2010.

[71] Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351, 2366 (2003).

[72] *See* R. Khan et al., *Institutional Ownership and CEO Compensation: A Longitudinal Examination*, 58 J. BUS. RES. 1078 (2005).

[73] *See* A. Almazan et al., *Active Institutional Investors and Costs of Monitoring: Evidence From Executive Compensation*, 34 FIN. MGMT. 5 (2005); *see also* P. David et al., *The Effect of Institutional Investors On the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200 (1998).

[74] Hartzell, *supra* note 71, at 2366. Hartzell and Starks report that large institutional shareholders lowered total compensation levels for executives thus "ensuring that management does not expropriate rents from shareholders in the form of greater compensation." *Id.* They also note that these shareholders are associated with greater pay-for-performance sensitivity. *Id.*

the effectiveness of this mechanism. The interests of institutional investors may not always align with those of the ordinary investor[75] and these differences can be further exacerbated by differences in their temporal horizons, the business ties of the owner to the firm, the owner's propensity to engage in active monitoring, and the importance of the firm within the owner's portfolio.[76] Further, even in cases where investor-prompted resolutions are passed with a majority, such resolutions remain advisory in nature and boards (and executives) can choose to ignore the wishes of their large shareholders, unless the owners resort to more public confrontational modes.[77] Institutional investors may also be reluctant to voice objections to an executive compensation package because of the potential for adverse stock market reactions and damage to the investor's relationships with the firm's executives.[78]

3.5 Greater Transparency and Completeness in Disclosures of Executive Pay Arrangements

There is a broad agreement in the literature that disclosure requirements have improved significantly over the past decade especially since the passage of SOX in 2002. Dew-Becker identifies the following provisions within SOX as directly relevant to executive compensation.[79] First, SOX disallowed corporations from granting loans to their executives. Second, if the financial statements (required to be personally certified by the CFO and CEO) are materially revised, the CEO is required to refund the corporation 100% of his performance-based pay (i.e., the clawback provision discussed in an earlier section). Third, the majority of the board has to be independent (with more stringent definitions of independence especially in relation to the compensation committee) and the independent directors are required meet without the presence of inside directors at least once a year. These regulations were followed by further tightening of disclosure rules by the SEC in 2006, including broader and more specific requirements for reporting director pay, deferred compensation, severance and retirement packages, performance targets for incentive plans, option valuations, and dollar amounts for

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[75] Bainbridge, *supra* note 64, at 46. The author raises this as a primary objection to increased interventions by institutional owners. He says,

> The interests of unions as investors differ radically from those of ordinary investors. The pension fund of the union representing Safeway workers, for example, is trying to oust directors who stood up to the union in collective bargaining negotiations. Union pension funds have used shareholder proposals to obtain employee benefits they couldn't get through bargaining . . . [i]ndeed, the *LA Times* recently reported that CalPERS' renewed activism is being "fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a CalPERS board member, who is considering running for governor of California in 2006."

Id. at 47.

[76] P. Brandes et al., *Navigating Shareholder Influence: Compensation Plans and the Shareholder Approval Process*, 22 ACAD. MGMT. PERSP. 41 (2008).

[77] *The Shareholders' Revolt*, ECONOMIST, June 15, 2006, at 71.

[78] *See* Conway, *supra* note 13, at 403.

[79] *See* Dew-Becker, *supra* note 22, at 449.

all components of compensation.[80]

The new chief of the Securities and Exchange Commission, Mary L. Schapiro, is especially being lauded for her efforts in pushing for more transparency when it comes to reporting executive pay.[81] However, there is also a widely-shared belief (especially since the most recent financial crisis) that there is considerable room for further increasing the completeness and transparency of executive compensation arrangements. Bebchuk and Fried propose the following specific steps to substantially increase the transparency of the pay process: placing a dollar value on all forms of compensation, disclosure of all non-deductible compensation, expensing of stock options, reporting of the relationship between pay and performance based on industry peers' performance benchmarks, and unloading of shares and options by top five executives.[82] Kandel takes these recommendations a step further in proposing that every firm must be required to publish two compensation-focused reports along with its annual report. In the first report, the firm must disclose the complete details of the contract signed with its executives, including its exact ex-ante cost to shareholders and related tax implications.[83] The second report must provide the actual payment schedule from the firm to the manager and should link each payment made to the specific contract it was awarded under.

Interestingly, while there is a general consensus about the need for greater transparency in the reporting of executive pay, increased transparency and additional reporting may have contributed, inadvertently, to the increase in executive pay levels during the Nineties. For instance, Hall observes that

> the use of surveys was encouraged by rule changes in 1993 that required companies to detail more fully the pay of their top executives in company proxy statements. One of the hopes of the new rules was that greater disclosure would slow the increase in executive pay, with the publicity about high pay working to curb abuses. But once executives began to see more clearly how much their peers were making, they wanted more – and boards granted more. Thus, although disclosure generally curbs excesses, in this case it may have had the opposite effect.[84]

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[80] *Id.* at 443-44.

[81] Floyd Norris, *A Window Opens on Pay for Bosses*, N.Y. TIMES, Jan. 15, 2010, at B1. Norris notes, "[i]n less than a year, Ms. Schapiro has established a reputation for careful but determined reform, of the commission itself and of the market it regulates." *Id.* The new rules for compensation reporting mandated by the SEC "will require companies to disclose if compensation policies are increasing the risk of the company having to take large losses, as seems to have happened in financial institutions before the crisis." *Id.*

[82] *See* Lucian A. Bebchuk & J.M. Fried, *Pay Without Performance: Overview of the Issues*, 17 J. APPL. CORP. FIN. 8 (2005) (providing a more detailed discussion of each of these steps).

[83] Kandel, *supra* note 12, at 416. He elaborates:

> This report must include all the planned financial obligations of the firm towards the top manager in the coming year. The firm must be required to obtain outside estimates for the costs of various benefits the manager receives . . . .The cost of the package to the firm's shareholders must be compared to several mandatory benchmarks . . . .[The report] should include all the shareholdings of the manager.

Id.

[84] Hall, *supra* note 49, at 32.

3.6 Increased Board Vigilance, Monitoring, and Accountability (Including Shareholder Lawsuits)

At a fundamental level, lapses in executive pay arrangements reflect a breakdown in corporate governance in that boards have failed to rein in excessive executive pay and push for a stronger alignment between incentive pay and firm performance.[85] Recent regulatory reforms mandate that most companies listed on major stock exchanges in the U.S. should have a majority of independent directors (i.e., they should not be employees of the firm nor should they have business relationships with the firm). However, while these reforms may have reduced to some extent managers' power over the board, they appear to have fallen considerably short when it comes to addressing the executive pay problems documented earlier. While some companies have strong and independent boards, others are populated by close associates of the CEO, thereby corrupting the pay process. In support of this assertion, several studies have found that companies with weaker boards award greater pay to their top executives than do firms with stronger boards.[86] The excessive risk-taking by some financial firms that precipitated the 2008 financial crisis (noted in the examples in the introduction section of the Article) is also widely believed to have been encouraged by improperly designed compensation systems and inadequate monitoring of executive decisions by corporate boards.[87] A recent report of the Conference Board notes:

> [I]n performing their duties, directors should be mindful of their responsibility to create sustainable, long-term wealth for all shareholders. It means designing compensation arrangements suitable to: 1) Attract and retain key talent in a competitive marketplace; 2) motivate managers in the pursuit of long-term goals; and 3) reward managers financially based on their actual performance.[88]

To achieve these objectives, the report identifies several practical actions especially focusing on the role of the board's compensation committee. The board's compensation committee has to not only fully understand the effects of

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[85] *See, e.g.*, BEBCHUK & FRIED, *supra* note 11, at 22. They observe,

> Past and current flaws in executive pay arrangements have resulted from underlying problems within the corporate governance system: specifically, directors' lack of sufficient incentives to focus solely on shareholder interests when setting pay. If directors could be relied on to focus on shareholder interests, the pay-setting process, and broad oversight of executives more generally, would be greatly improved.

Id.

[86] *See* Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Hall, *supra* note 49, at 32; Murphy, *supra* note 17. *See generally* BEBCHUK & FRIED, *supra* note 11, at 22.

[87] In recent decisions, Delaware courts have emphasized the importance of good faith as part of the director's duty of loyalty and have noted that directors are expected to understand current best practices, as well as ensure that business decisions are consistent with widely accepted corporate governance standards. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (focusing on Chancellor Chandler's dicta).

[88] Matteo Tonello, *Overseeing Risk Management and Executive Compensation "Pressure Points" for Corporate Directors* 1, 5 (Executive Action Series, Conference Board Paper No. 292, 2008).

each single component of the pay package, but also consider a wide array of financial and non-financial performance metrics and targets, use such metrics during the performance evaluation of each top executive, disclose performance targets to shareholders, and set compensation levels based on multiple external benchmarks. In addition, the report also argues that it is the responsibility of the board to oversee the firm's risk exposure because this "duty is inherent in determining a business strategy that generates long-term shareholder value" and "may be inferred from the provisions of SOX on internal controls."[89]

While there is widespread agreement on the important (ex-ante) roles that boards can (and should) play in the pay-setting and monitoring process, there is also increasing recognition of the need to hold boards more accountable (ex-post) when they fail to fulfill their fiduciary duties.[90] Bebchuk and Fried argue that not only must shareholders have the power to replace directors in the wake of poor performance but shareholders, and not the board, should have the power to initiate and adopt changes in governance arrangements in the corporate charter.[91] However, most of the cases that have been brought against directors by shareholders for paying executives excessive compensation have failed because courts are generally unwilling to question the decisions boards make under the principle of business judgment.[92] While many state legislatures have created statues that allow shareholders to seek recourse if a board is not sufficiently regulating executive compensation, courts have often responded unfavorably in such cases.[93] Finally, as observed earlier in the discussion of the say-on-pay initiatives, there is also concern that the separation of ownership and control, a bedrock of the American corporate governance system, may be seriously undermined if the balance of power were to shift too much in the direction of shareholders at the expense of a firm's board or its managers.[94]

CONCLUSION

This Article started with a brief summary of the major provisions under the EESA enacted in response to the financial crisis of 2008. These regulations were aimed at curbing excessive compensation payments made to executives whose

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[89] *Id.*

[90] *See* Dew-Becker, *supra* note 22, at 450. The fiduciary duties of boards of directors can be divided into a duty of care and a duty of loyalty. *Id.* The duty of loyalty says that the directors must act in the best interest of shareholders, rather than themselves. *Id.* The duty of care means that directors must take due care in their decisions and must base these decisions on all relevant information and applicable governance standards and laws. *Id.*

[91] *See* Bebchuk & Fried, *Compensation at Fannie Mae*, *supra* note 4, at 22-23.

[92] *See* Dew-Becker, *supra* note 22, at 450. The principle of business judgment dictates that as long as the process is considered reasonable and deliberative and the board had no personal stake, courts are unlikely to question the soundness of the actual decision and whether it reflected a breach of fiduciary duties. *Id.*

[93] *See*, *e.g.*, *In re Walt Disney Co*., 906 A.2d 27 (2006) (holding that the board of directors did not breach its fiduciary duties and the payment to Disney CEO Michael Ovitz did not constitute a waste of corporate assets despite Ovitz receiving $130 million in severance payment for only fourteen months of service on a five year contract).

[94] *See* Bainbridge, *supra* note 64, at 42; *see also* Roe, *supra* note 66, at 18-19 (providing a more balanced discussion of the implications of the separation of ownership and control).

reckless risk-taking has been widely acknowledged as a major contributor to the near-disastrous collapse of the financial sector and the related economic crises. However, as noted in the introduction, the two underlying problems brought to the fore by the financial crisis and the reforms it precipitated have received considerable attention from legislators as well as academic scholars. The desire to address these two problems (excessive executive pay levels and the low sensitivity of pay to performance) lies at the heart of several tax-related reforms enacted since the 1980s, as well as several other regulations aimed at controlling or influencing the content of pay packages and the process through which pay-related decisions are made. The evidence presented in Section 2 of the Article shows that, for the most part, tax policy has been a blunt policy instrument with significant gaps between the legislative intent and realized outcomes. The review of other non-tax-policy options (discussed in Section 3 of the Article), however, also reveals that these options create other challenges related to designing and implementing executive pay packages that protect and enhance shareholder value.

Interestingly, while the recent financial crisis (and ensuing reforms) has focused attention squarely on excessive executive compensation, the challenges discussed in this Article bring to the fore two foundational characteristics of the American corporate governance system discussed by Roe: the separation of ownership from control and the decentralized regulatory system.[95]

Because of the separation of ownership from control, managers can enjoy tremendous discretion not only in terms of making specific business decisions, but also in terms of choosing the type and extent of managerial rewards. Boards of directors are expected to represent the interests of shareholders and ensure that managers are monitored effectively (designing and enforcing appropriate pay packages is also part of the board's monitoring duty), but, as evidenced in the continued growth of executive pay and the very weak pay-for-performance relationship, boards have been relatively unsuccessful. Boards play a particularly crucial role in mitigating executive pay problems because they are closer to the executives of the firm than the typical shareholder, who is either too distant or too marginal to have any tangible impact. The problem of information asymmetry (e.g., managers know more about their own abilities, risk preferences, and potential decision outcomes, than the owners do) associated with the separation of ownership and control is not one that can be effectively dealt with by the shareholder of a large corporation. Instead, a vigilant, qualified, and experienced board is in a much better position. The misalignment of incentives between the owners and managers (also a byproduct of the separation of ownership and control) can also, to a large extent, be addressed by vigilant boards that pay close attention to individual managers' track records and company-specific contingencies in designing incentive pay schemes, and hold their executives responsible when they fail to deliver outcomes agreed on in ex-ante pay contracts. While extant regulations have focused on increasing board independence, there has been much less attention to the other important antecedent to board effectiveness: board experience and knowledge. Unless board members have relevant experience and

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[95] *See* Roe, *supra* note 66, at 2-4.

knowledge, especially in the industry their company operates in, they are unlikely to understand key context-specific contingencies that will affect the appropriateness of different types of pay packages. In this regard, McClendon has argued that self-regulatory organizations like the New York Stock Exchange should adopt new listing standards that strengthen board ability as well as accountability in linking executive compensation to long-term corporate performance.[96] Such standards should include, among others, limiting board memberships so that directors can pay more attention to the firms whose boards they sit on, and mandating industry experience in at least a subset of the board. Institutional shareholders can also be very useful because, as often noted by the renowned investor Warren Buffet, they have the knowledge as well as the power to influence the boards of the companies in which they have substantial equity stakes.[97] The ability of institutional investors to successfully pressurize boards can also be enhanced by regulations that force more transparent and complete reporting of executive pay packages and performance metrics, especially in relation to industry-specific benchmarks.

The second fundamental structural characteristic of the American corporate governance system noted by Roe is also relevant to the current debate on executive compensation reform: the existence of a decentralized regulatory system where multiple agencies (e.g., SEC, FTC, PCAOB) regulate different, sometimes even overlapping, domains of corporate conduct and there is no centralized regulatory agency responsible for overseeing corporate governance. While decentralized and pluralistic regulation has its advantages (among them, checks and balances and multiple points of oversight), the system can also lead to lapses in enforcement, multiple sometimes conflicting interpretation of the same regulation, leading to loopholes and regulatory gaps ripe for opportunistic exploitation by the regulated. The Obama Administration's recent appointment of a federal pay czar (Kenneth Feinberg) to oversee the executive compensation practices at bailout companies,[98] while potentially offensive to federalism principles that dictate such regulatory powers be left to the discretion of individual state authorities, has been quite effective in dramatically reducing executive pay packages at financial firms that have not repaid the money borrowed from the federal government. However, a method that is effective in achieving reforms for a comparatively small set of firms (those required to subject their practices to Feinberg's scrutiny based on their participation in the government's TARP initiative) may not necessarily transfer readily to the more general corporate context.

In sum, market mechanisms guided by thoughtful and consistent regulation may still be the most effective means of ensuring competitive pay practices and

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[96] *See* Janice K. McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wakeup Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 145-47 (2009).

[97] *See* Steven Brill, *What's a Bailed-Out Banker Really Worth?*, N.Y. TIMES, Jan. 3, 2010, at MM32, *available at* http://www.nytimes.com/2010/01/03/magazine/03Compensation-t.html?pagewanted=1&_r=1.

[98] *See* Jim Puzzanghera, *Corporate Salaries; Pay Czar Hits Execs in Their Wallets; Feinberg Slashes the Compensation for the Highest Earners at Five TARP Recipients*, L.A. TIMES, Mar. 24, 2010, at B1.

curbing executive behaviors that destroy shareholder value. Nevertheless, predictive power in this context is necessarily limited, and thus ex-ante regulatory mechanisms must be supplemented by ex-post counterparts such as litigation (and judicial cooperation) to ensure that executives and boards are ultimately held accountable for governance decisions that reflect serious breaches of fiduciary duty. Thus, reforms that target executive compensation in isolation are not likely to have significant positive effects; they must be accompanied by wide-ranging changes that go to the heart of the corporate governance system.