CEO & Employee Pay Discrepancy: How the Government's Policies Have Encouraged the Gap

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CEO & EMPLOYEE PAY DISCREPANCY:
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HAVE ENCOURAGED THE GAP

DAVID R. MEALS*
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I. INTRODUCTION

In the United States, one of the most striking illustrations of the increased inequality of income distribution over recent decades is the outsized growth in CEO compensation in contrast to the compensation of the contemporaneous average working man or women.\(^1\) The ratio of CEO pay to factory worker pay rose from 42-to-1 in 1960, to a height of 531-to-1 in 2000 at the height of the stock market bubble,\(^2\) and it was at 411-to-1 in 2005 and 344-to-1 in 2007.\(^3\) Interestingly; this ratio is about 25-to-1 in Europe.\(^4\) “[A]fter adjusting for inflation, CEO pay in 2009 more than doubled the CEO pay average for the decade of the 1990’s, more than quadrupled the CEO pay average for the 1980’s, and ran approximately eight times the CEO average for all the decades of the mid-20th century.”\(^5\)

The increase of the CEO versus employee pay gap, along with the subject of growing income inequality in the United States, has been of concern for some time, but is an issue in particular during the current prolonged economic slump that began with the burst of the housing bubble and subsequent financial crisis, especially mortgage derivatives.\(^6\) As the United States endures its worst economic conditions since the Great Depression of the 1930’s,\(^7\) populist rhetoric has coalesced around the theme of the “99%” versus the “1%”, with the 1% loosely defined as the “richest” citizens of our country.\(^8\) Indeed, there continues to be calls to action in the form of “Occupy” movements that have no set organization or agenda, other than self-identified members of the so-called 99% publicly protesting what they perceive as the injustice around the concentration of income and wealth into the hands of fewer and fewer individuals, i.e., those that comprise

\(^3\) Id.
\(^4\) Id.
\(^5\) Anderson et al., supra note 1, at 3.
\(^7\) Anderson et al., supra note 1, at 5.
the top 1%. Some of the “Occupy” protesters are socialists and anarchists, who are genuinely seeking to overthrow capitalism, some are just hangers-on looking to take advantage of the feel-good circus atmosphere that comes with any large outdoor gathering, and some are the usual malcontents that will show up at any venue that offers them a way to rebel against social norms. But what likely triggers the concern of large numbers of ordinary American citizens, whether they simply sympathize, or actually show up at a protest event, is the media reports of the very real compensation packages granted to top corporate executives and to top earners in the financial industry.

Although less than a fifth of the income of the nation’s wealthiest individuals actually comes from wages and salaries, the symbolism of a CEO making hundreds of times more than their average employee during a time of massive layoffs, rampant underemployment, and persistent unemployment is undeniable. Even in other, better economic times this growing discrepancy would violate the average American’s sense of what is fair and unfair. In this extraordinarily negative economy, the sense of unfairness is magnified and widespread, and invites the implementation of yet another wave of solutions aimed at “fixing” the causes of this growing economic injustice.

In the past, a wide variety of political players have sought to confront what their constituents see as excessive executive bonuses and inappropriately high incentives, and thus the U.S. government has a history of attempting to use policies, regulations, and taxes to temper or reverse the CEO versus worker pay gap in real income terms. Indeed, many combinations have been tried in the United States, but as discussed in this paper, so far none have proved effective. The goal of this paper will be to examine the role of the U.S. Government in

12 Domhoff, supra note 2.
13 Id.
14 Anderson et al., supra note 1, at 13.
16 Id.
17 See discussion infra Part VII.
the CEO versus worker pay gap, both in contributing to its creation and the ability to reverse it. To better understand this issue, this paper will include a survey of current U.S. and foreign CEO compensation practices, a survey of theories proposed to explain the divergence between U.S. and foreign CEO compensation, a review of the social and business impact of excessive CEO compensation, and identify socioeconomic theories regarding the excessive CEO pay trend. This will be followed by a review of the history of attempted solutions along with newly enacted and proposed future solutions to further inhibit the growth of excessive CEO pay, and concluding remarks.

II. CURRENT U.S. EXECUTIVE COMPENSATION PRACTICES

Generally, the board of directors exists to advise and monitor top management, protect the interests of the shareholders and, of significance to this paper, establish executive compensation.18 “A significant component of a management control system is the incentive mechanism and motivational underpinning of compensation contracts.”19 A properly planned incentive and compensation system can deal with both adverse-selection and moral hazard issues.20

A. The Nature of Cash and Company Stock Compensation Packages

The most popular forms of compensation are cash and company stock. Cash compensation to executives has two main facets: fixed salary and bonus.21 Bonuses are generally attributed to a successful implementation of organizational objectives through managerial decisions made by an executive.22 “Stock grants and stock option grants are intended to reward executives for choices that influence positive changes in the stock prices and as such may be considered a future-oriented reward system, as opposed to bonuses that are typically based on some accounting measure of profitability.”23 It has been suggested that accounting performance measures are used in order to protect executives from being negatively affected by circumstances that are out of their control, such as marketwide fluctuations in firm value.24

Stock prices are clouded by collateral as they are affected by large market-wide fluctuations, such as ordinary business cycles, as well as monetary and fiscal decisions and policies, and therefore do not create a direct and absolute correlation

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20 Id.
21 Id. at 403.
22 Id.
23 Id. It has been argued that accounting-based measures are historical measures of performance, and thus conceptually less relevant from a shareholder’s perspective. Id.
24 Id. at 404–05. (citing another source).
with executive performance. The actual compensation received through stock–based incentives depends on economic variables and contractual restrictions that affect these stocks and grants. Various factors, including the volatility of the stock, and fiscal and monetary policies, are beyond the control of the CEO. Because of this, stock-based compensation carries with it a significant amount of risk into the agency relationship that exists between the CEO and the company, making compensation less responsive as a measure of performance. Some have observed a “lower sensitivity of CEO compensation to the rate of return to shareholders as the stock becomes more volatile.”

Nourayi and Krishnan found that while both accounting and market measures of performance affect the amount realized by a CEO through cash compensation, market-based analyses saw a more direct correlation with total compensation. They also found that “CEO compensation contracts with stock options are more significantly influenced by the market-based performance measure than by the accounting-based measure”, and concluded ultimately “that firms with market-based returns are less likely to offer market-based incentives.”

B. Indirect Components of CEO Compensation

CEO compensation can be both direct and indirect. Direct compensation includes cash and stock options. Indirect compensation exists in forms other than those paid directly to the executive, among which are tax breaks.

C. Government Response

As discussed in more detail later in this paper, the government has put forth measures within the last few decades to encourage less excessive executive compensation. For example, in 1993, Congress capped the deductibility of CEOs’ salaries at $1 million, unless the extra pay was linked to performance incentives. As a result, boards of directors raised CEOs’ potential income with increasingly generous stock options, which helped drive executive compensation off the charts.

25 Id. at 403.
26 Id. at 406.
27 Id.
28 Id. (citing another source).
29 Id. (citing another source).
30 Id. at 418.
31 Id. at 418–419.
32 David O. Friedrichs, Exorbitant CEO Compensation: Just Reward or Grand Theft?, 51 CRIME, LAW & SOC. CHANGE 45, 50 (2009).
33 See id.
D. Outcome

While CEOs themselves are not struggling, they are causing others to – by cutting jobs to attribute more wealth to their own already bountiful assets. The CEOs in 2009 who slashed their payrolls the most “took home 42[%] more compensation than the year’s chief executive pay average for S&P 500 companies.” These excessive rewards gave an enticement and encouragement to behave irresponsibly and to behave in such a way that would effectively contribute to the financial crisis.

III. COMPENSATION PRACTICES OUTSIDE THE UNITED STATES

As previously noted in this paper’s introduction, the CEO-to-factory-worker pay ratio in the United States went from 42-to-1 in 1960 to its peak at 531-to-1 in the year 2000. The ratio of CEO pay to factory worker pay then decreased post-Internet Bubble, and was at 411-to-1 in 2005 and 344-to-1 in 2007, while during this same time frame in Europe, this ratio was about 25-to-1. This section will examine the practices, proposals, and trends related to executive compensation practices that are underway in several other countries.

A. France

France is a country with a very powerful and decentralized administration and regulatory system. In the years leading up to Nicolas Sarkozy’s election as President, French public opinion was shaken by the reports of very large severance pay packages given to a number of CEOs who had been forced out of their positions by reason of disastrous corporate results. Mr. Sarkozy promised to respond to the outrage, and after being elected President he introduced a bill regarding severance packages that was passed into law on August 21, 2007. The law called for “clear, publically available performance criteria to be used” in determining severance pay, and that severance packages account for both individual executive and overall corporate performance.

In the fall of 2008, seeking to further inhibit excessive executive pay, the French government examined other options, including creating a new government entity and encouraging the adoption of say on pay shareholder rights. These two

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36 See generally Anderson, et al., supra note 1.
37 Id. at 4.
38 Id.
39 Domhoff, supra note 2.
40 Id.
41 Jurow et al., supra note 15, at 11–12.
42 Id. at 11.
43 Id.
44 Id.
45 Id. “Say on pay” shareholders rights “shift additional power to shareholders through binding or advisory votes on compensation issues so that they may effectively prod the board to refine poorly designed proposals to better represent shareholder interest.” Id. at 9.
ideas were rejected in favor of allowing employers a chance at further reform through self-regulation. The voluntary rules included not allowing executives to be members of their own company’s board of directors, not issuing severance for executives who voluntarily leave their company to go work somewhere else or for those who leave because of poor performance, no granting of stock options without all employees participating, not discounting stock grants (executives must buy stock at market prices), and capping special annual retirement funds.

Unfortunately, voluntary compliance with these rules was found to be severely lacking, and this lead to ratification of a new law on executive compensation on March 31, 2009. This new law contains multiple innovative provisions such as prohibiting the granting of stock options or discounted stock to the executives and board members of any company that has received bailout monies from the French government. The law also includes the provision that if a company is involved in massive layoffs of employees, any variable compensation plan for corporate executives is automatically suspended. Additionally, the law includes the requirement that forces the exclusion of CEOs from board membership, as well as prohibits board chairmen from employment at the same company where they sit on the board. Moreover, severance pay can only be given upon forced termination, provided the company is not in financial trouble, and may not exceed two years in duration.

B. Netherlands

The New Dutch Corporate Governance Code (the “Code”) went into effect on January 1, 2009. The Code strictly defines the acceptable structure of executive management compensation schemes, which can include a fixed and variable component, with the variable component consisting of predetermined, predominately long-term targets. In any case, it is mandated that management remuneration schemes cannot encourage executives to act in their sole best interests. The remuneration schemes must also be analyzed against scenarios that examine the extent of the risks that the variable portion of a remuneration scheme may expose the company, and a report of this risk analysis must be made public through the company’s web site. Implicit in this requirement is the acknowledgment that certain executive compensation practice can pose a threat to

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46 Id.
47 Id. at 11–12.
48 Id. at 12.
49 Id.
50 Id.
51 Id.
52 Id.
53 Id.
54 Id. at 13.
55 Id.
56 Id.
the integrity of a firm.\textsuperscript{57}

\textbf{C. Japan}

Japan differs from other countries in that seniority, not performance, is the most important factor determining executive compensation.\textsuperscript{58} Another difference is that within the Japanese culture, large executive compensation packages are held to be “socially offensive.”\textsuperscript{59} These two cultural factors have resulted in a stark difference between the average pay of Japanese CEOs and that of their Western counterparts.\textsuperscript{60} It has also resulted in a low multiple, about 30 to 40 times, between average CEO pay and the minimum wage.\textsuperscript{61}

These two cultural factors have another interesting effect. Japanese CEO pay, since it is based on seniority, does not change whether a company has a good year or a bad year.\textsuperscript{62} There is little or nothing in Japanese CEO pay related to annual or long-term incentives.\textsuperscript{63} Both the good and bad of this is that there is little incentive for risk-taking.\textsuperscript{64} It has been recently observed that the Japanese national culture is slowly changing, and reward for individual excellence is increasing.\textsuperscript{65}

\textbf{D. Germany}

Germany is transitioning to the view that businesses must go beyond being merely profit-oriented, to being “responsible citizens” within their society.\textsuperscript{66} Consistent with this idea, along with Austria, Germany is considering incorporating environmental, social, and governance metrics alongside the expected executive compensation components of individual and firm performance.\textsuperscript{67} If this level of social accountability becomes a mandated part of every CEO pay package in Germany, it will force a level of transparency that makes explicit the social compact that many likely feel should be at least implicit in other capitalistic systems, including the United States.

\textbf{IV. THEORIES EXPLAINING DIFFERENCE IN U.S. VERSUS FOREIGN CEO PAY}

In Asia, executive compensation is “far more modest than what it is in the
United States', exemplifying this is the average compensation of Japanese corporate presidents coming in at under $500,000. Even the Western world counterpart, Britain, had much more socially acceptable and modest executive pay packages than its American counterparts. "Yet there is no particular evidence that American corporations during this period have been more effectively managed or led than their Asian or British counterparts, or that American CEOs are more talented and harder working." If it were possible to subtract out the unintended consequences of U.S. government actions that actually had the perverse effect of increasing CEO pay rather than dampening its rate of increase relative to the average worker, are there still understandable and socially acceptable reasons why American CEOs would earn more on average than their foreign counterparts?

There are multiple theories that possibly explain why foreign CEOs have not experienced the same rapid increase in pay as seen in the United States, independent of deleterious government actions and interference. This section will briefly summarize five of them. Explaining

A. Marginal Revenue Product Theory

Marginal Revenue Product is the amount that a factor of production, including management labor, contributes to the value of a firm. In a well-functioning competitive labor market, the negotiations between an informed buyer (i.e. the Board of Directors), and an informed seller (i.e. the CEO), should result in the CEO being paid their marginal revenue product. This is because the company will hire "labor up to the point that . . . the wage rate, [which represents the cost of an additional worker], equals the additional revenue" contribution of that worker. Thus, the position of CEO would be more highly compensated, based on the extent of the potential and real higher contribution to the firm.

Good individual managers can have significant impact on the growth in a firm’s value, and firms with higher growth potential can therefore afford to discriminate and pay what it takes to attract and retain management with the skills to realize that potential. Correspondingly, CEOs who can handle more complex tasks and more complex organizations are more talented and thus better paid. The same is true of CEOs who have both the skills and opportunity to operate within economic systems that permit them to exercise more organizational

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68 Friedrichs, supra note 32, at 52.
69 Id. (based on figures for the year 2005).
70 Id.
71 Id.
73 Id. at 1200.
74 Id.
75 Id.
76 Id. at 1201.
77 Id. at 1202.
power. Therefore, a straightforward explanation of the tendency of foreign CEOs to be paid less than American CEOs may be found in some combination of comparative circumstances where foreign CEOs have less growth opportunity, smaller and less complex organizations, or weaker corporate powers.

**B. Tournament Theory**

The Tournament Theory holds that each round of management advancement is a competition characterized by what are essentially single-elimination rounds. Thus, high senior executive pay is the prize money given to the ultimate winner of the contests that make up each firm’s internal labor market. Big tournaments tend to award big prize money, and the CEOs of U.S. firms tend to have much more power than the CEOs of foreign firms, so American CEO jobs are comparatively the bigger tournaments and the American CEO pay the bigger prizes. The disparity in U.S. versus foreign CEO pay is further amplified by acceptance of the “winner-take-all” attitude in American culture. This theory also explains internal corporate pay differences such as the often large difference in middle management pay and CEO pay within U.S. firms.

**C. Opportunity Cost Theory**

The Opportunity Cost Theory asserts that CEO pay is largely determined by the amount they would be paid in their next best alternative job opportunity. In order to attract and retain CEO talent, a firm must pay at least an amount equal to an individual’s specific opportunity costs.

Applying this theory, the rise in American CEO pay starting in the 1980s can be explained by the opening up of financial markets, which in turn gave American CEOs many more employment alternatives. In contrast, foreign markets tended to be more fragmented and regulated, have less capital available for starting new business ventures, which left foreign CEOs historically with fewer employment options. Thus, relatively lower opportunity cost drives relatively lower pay for foreign CEOs.

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78 Id.
79 Id. at 1203–09.
80 Id. at 1209–10.
81 Id. at 1176.
82 Id. at 1176–77.
83 Id. at 1177.
84 Id. at 1212.
85 Id. at 1177.
86 Id.
87 See id.
88 See id.
D. Bargaining Power Theory

The Bargaining Power Theory accounts for the shift in power in the mid-1980s that increased the relative bargaining power of American CEOs in takeover bids. As a result of court decisions, legal entitlement to approve hostile takeovers shifted from a firm’s shareholders to its management and board of directors. Specifically, in Moran v. Household International, Inc., the Delaware Supreme Court, for the first time, upheld the ability to block hostile takeovers through Shareholder Rights Plans. The United States Supreme Court further added to management’s powers by upholding stringent state anti-takeover laws. At about the same time there was a push for pay-for-performance by big institutional investors that caused a dramatic increase in the use of stock options and restricted stock in CEO pay packages.

All of the changes in the mid-1980s that dramatically increased the bargaining power of American CEOs, in turn, caused U.S. CEO pay packages to dramatically increase relative to the pay packages of foreign CEOs, who saw no corresponding increase in their bargaining power. American CEOs subsequently had the power to negotiate large pay and severance packages, and agreements with terms that favored them in exchange for a relinquishment of their block of a hostile acquisition of their firm.

E. Risk Adjustment Theory

The Risk Adjustment Theory recognizes that American CEOs, unlike foreign CEOs, tend to receive much of their pay in stock options. As a result, American CEOs likely have much of their personal wealth in company stock. This unbalanced personal financial portfolio constitutes a relatively large risk, and thus American CEOs seek to be compensated for the size of this risk. In turn, companies are forced to pay CEOs more to get them to take the risk of narrowly concentrating their wealth in a single financial instrument.

Foreign CEOs face much less pressure to hold company stock and there is usually no incentive for foreign companies to use stock options instead of cash when it comes to bonus pay. Without the concentration of wealth caused by the

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89 Id. at 1241.
90 Id.
93 Thomas, supra note 72, at 1241.
94 See Domhoff, supra note 2.
95 See Thomas, supra note 72, at 1244.
96 Id. at 1179.
97 Id.
98 Id.
99 Id.
100 Id. at 1179–80. Many foreign CEOs work in countries with debt-based systems (versus the equity-based system of the United States) where the creditors “care about minimizing the agency costs
extensive use of stock options as a form of executive pay, there is less firm-
specific risk to be compensated for.  

V. THE SOCIAL AND BUSINESS IMPACT

Since every government action impacting an aspect of the American
economic system has associated direct and indirect costs and risks, a fundamental
question is whether the distortions resulting from the current CEO compensation
practices are fair or harmful to society as a whole, i.e., is there a compelling,
rational, justifiable need to act. Perhaps the real issue of CEO pay is more the
results of powerful symbolism, with concern resulting from the (artificially
elevated?) sensationalism surrounding the big income numbers of a few outliers
that are occasionally reported in the news media, that is then picked up and used by
special interest groups to fit their own propaganda scripts. Is this a case of envy
magnified by the combination of the current economic downturn and the very
connected world of social media, instant communications, and around-the-clock
news outlets? In such a case, rather than a direct economic link to harming other
members of society, maybe the real harm could be the impact of the sensationalism
itself, as it serves to undermine confidence in the legal, corporate, and political
institutions that are woven together to create the economic engine of the United
States. While such a new-found lack of faith in the American system of capitalism
does seem to be a major theme repeatedly reported on in the current prolonged
economic downturn, some hold that movements such as “Occupy Wall Street” are
simply “a natural reaction to a downturn in the [economic] cycle.”  

If that is the
case, short of the remotely slim chance of provoking a revolution, possibly the
worst harm would be contributing enough to negative consumer sentiment to
somewhat delay the economy’s recovery. Thus, pursuing government remedies
and countermeasure for current CEO pay practices would then be waste of time
and taxpayer monies.

On the other hand, perhaps there is a direct economic link to harming other
members of society because of distortions resulting from the current CEO
compensation practices. Conceivably, it is possible that CEO compensation
practices are more than bad optics for the social media to rant about and are
actually causing distortions in the economy that are harming large segments of
American society or even the American economy’s health, growth, and
competitiveness as a whole. And perhaps the harm created is both direct, such as
decisions that hurt the results and potential of individual corporations, and indirect,
such as giving permission to other actors in the economic arena, like members of
financial institutions, to equally pursue outrageous, excessive, unjustified, and

101 Id. at 1180.
102 Fonevecchia, supra note 11.
even corrupt compensation practices. It may be that the real ultimate harm of bad 
CEO compensation practices is that it drives, across the entire economy, CEO 
behavior and decisions that result in producing suboptimal long-term performance 
in American corporations. This, in turn, is causing a transfer of American wealth, 
power, prestige, and political strength to other nations less prone to American-style 
corporate executive compensation practices. If indeed this is the situation, with 
potentially dire geopolitical consequences for the American public, the appropriate 
follow-on is to discover whether current and past attempts in government 
sponsored remedies and countermeasures are a cure or a cause of problematic CEO 
compensation practices.

Therefore, it is important that the question of whether the distortions 
resulting from the current CEO compensation practices are fair or harmful to 
society as a whole be considered in the context of the bigger issue of the 
concentration of wealth and power in American society and its potential 
consequences. In other words, does the envy of highly paid executives have 
enough underlying substance accompanying it to justify anger and action, or is 
perception distinct from reality in this case?

A. Wealth Distribution

In the United States, wealth is highly concentrated in a relatively few hands. 
As of 2010, the top 1% of households (the upper class) owned 35.4% of all 
privately held wealth, and the next 19% (the managerial, professional, and small 
business stratum) had 53.5%, which means that just 20% of the people owned a 
remarkable 89%, leaving only 11% of the wealth for the bottom 80% (wage and 
salary workers).103

Between 1983 and 2004, the top 1% of American saw their net worth grow 
$6 million on average, a 78% inflation adjusted increase, while the bottom 40% 
experienced a drop of 59% in their average net worth, and the middle class 
experienced a remarkable increase in debt.104

B. Income Distribution

“As of 2007, income inequality in the United States was at an all-time high 
for the past 95 years, with the top 0.01% . . . receiving 6% of all U.S. wages, 
double what it was . . . in 2000; the top 10% received 49.7%, the highest since 
1917.”105 From 1949 to 1979, “the income of the bottom 80% of wage earners 
rose at a higher rate than that of the top 1%” of wage earners.106 Since 1979, and 
especially more recently, this has changed considerably.107 “Between 1966 and 
2001, median wage salary income increased by just 11%, after inflation[, whereas,]
These numbers alone should be a major cause for concern and a probing analysis. But further, at the 99.99th percentile, the rise was 617%. Internal Revenue Service (IRS) data released in 2007 shows that the top 3 million Americans represented income equivalent to that of the bottom 150 million Americans combined in 2005. Compared with the current gap between the top and bottom of the income ladder, inequality of this magnitude has not existed since prior to the stock market crash of the 1920’s.

C. Examples of Harm

A research paper entitled “When Executives Rake in Millions: Meanness in Organizations” was published in 2010. The authors looked for correlations between executive compensation and how employees are treated. Their key finding: the larger the disparity between executive pay and that of the typical employee, the more likely employees are to be mistreated. The hypothesis: the larger the pay gap, the more likely executives are to be arrogant and dictatorial.

Beyond the harm to a firm caused by the damaging behavior driven by distorted risk-taking incentives built into current CEO compensation practices, there are multiple associated forms of social harm that arise. First, if CEO compensation is excessive, then the unwarranted or unnecessary portion of that compensation takes away returns, wages, or benefits that could, or should, go to others such as employees and shareholders. Secondly, given the potent symbolism of perceived excess in CEO compensation, it can damage the social fabric by generating widely diffused distrust, resentment, and anger. Finally, excessive CEO pay can ultimately create a “poisoning” effect that could jeopardize continuation of the political-economic structure our system exists within.

108 Id.
109 Id. This percentile “represent[s] the 13,000 highest-paid workers in the American economy.”
110 Id.
111 Id. at 51 (citing Paul Krugman, An Unjustified Privilege, N.Y. TIMES, July 13, 2007, http://www.nytimes.com/2007/07/13/opinion/13krugman.html). “For some commentators, then, the recent pattern justifies calling the current era a ‘New Gilded Age,’ returning us to the type of blatant social inequality characterizing the United States more than a century ago.” Friedrichs, supra note 32, at 51.
113 Id.
114 Id.
115 Id.
116 Id.
117 Id. Friedrichs, supra note 32, at 58.
118 Id.
VI. PROPOSED THEORETICAL PERSPECTIVES

A. The Agency Problem

The board of directors of a corporation may be ineffective in acting as a proper check on executive performance and behavior “because board culture inhibits constructive criticism, and because of informational asymmetry problems that exist between management and the board.”119 The board is compensated by the company, and coupled with excessive compensation to the board may further encourage a lack of criticism.120 Expanding on this, the lack of control of the rapid increase in executive pay can be viewed as an agency problem between shareholders and management, because public companies have dispersed ownership that cannot be expected to effectively bargain at arm’s length with management.121 As a result, managers exercise extensive influence over their own compensation. “Any discussion of executive compensation must proceed against the background of the fundamental agency problem afflicting management decision-making.”122 There are two prevailing views on how the executive compensation and agency problems may be linked: the “optimal contracting approach” and the “managerial power approach.”123

B. Optimal Contracting Approach

The financial economists’ dominant approach to the study of executive compensation—the “optimal contracting approach”—views these pay arrangements as a partial remedy to the agency problem.124 The board attempts to use the compensation packages to cost-effectively incentivize the managers.125 Under this model, the main flaw with the existing practice of executive compensation seems to be that compensation schemes are not sufficiently high powered “due to political limitations on how generously executives can be treated.”126 “Optimal compensation contracts could result either from effective arm’s length bargaining between the board and the executives, or from market constraints that induce these parties to adopt such contracts even in the absence of arm’s length bargaining.”127 A large problem arises when one sees the favoritism among the board-CEO relationship. “Directors will generally wish to be re-

119 Brick et al., supra note 18, at 404.
120 Id. Compensation for each Enron director is reported to have been $380,619 for the year 2001. Id. “Most observers agree that the high compensation of Enron’s directors may have compromised their objectivity in monitoring management on behalf of shareholders.” Id.
122 Id. at 1.
123 Id. at 1–2.
124 Id. at 1.
125 Id. at 2–3.
126 Id. at 1–2.
127 Id. at 3.
appointed to the board[,]” which, “[b]esides an attractive salary . . . provide[s] prestige and valuable business and social connections.”

CEOs play an integral role in choosing boards, which provides most directors with an “incentive to favor the CEO.”

C. Managerial Power Approach

Another approach, termed the “managerial power approach,” views executive compensation “not only as a potential instrument for addressing agency problems[,] but also as part of the agency problem itself.” Because executives seem to have substantial influence over their own pay, as this increases, so does their ability to extract greater rents. A major component of the managerial power approach is “outrage’ costs and constraints.” This constraint is based around how much outrage a proposed compensation package is expected to cause with shareholders and relevant outsiders—the more outrage that is expected, the less likely directors will be to approve the arrangement in order to avoid embarrassment or reputational harm, and reduce shareholders’ support for the incumbent board in proxy contests and takeover bids. There is evidence that suggests pay arrangements are indeed influenced by outsider perception. This “outrage” pillar of the managerial power approach leads into the next—the “camouflage,” which is the means by which managers try to “obscure” or “legitimize” (“camouflage”) their extraction of rents to avoid the previously discussed “outrage.” This helps explain many otherwise unexplainable occurrences in executive compensation practices.

Four patterns and practices can be somewhat attributed by power and camouflage: “the relationship between power and pay; the use of compensation consultants; executive loans; and golden good-bye payments to departing executives.”

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128 Id.
129 Id.
130 Id. at 2 (emphasis in original).
131 Id. at 5. Managerial rent seeking is when the pay arrangements are structured so that the payments are in excess of the manager’s opportunity costs. Aaron S. Edlin & Joseph E. Stiglitz, Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiencies, 85 AM. ECON. REV. 1301 (1995), available at http://works.bepress.com/aaron_edlin/6.
132 Bebchuk & Fried, supra note 121, at 5.
133 Id.
134 Id. Studies have shown that:
CEO’s of firms receiving negative media coverage of their compensation arrangements during 1992-94 received relatively small pay increases during subsequent years and had their compensation’s pay-performance sensitivity increased. [Additionally], during the 1990’s, CEO’s of firms that were the target of shareholder resolutions criticizing executive pay had their annual compensation reduced over the following two years by $2.7 million.
135 Id. at 6.
136 Id.
137 Id. at 7 (these golden good-bye payments are commonly known as “golden parachutes”).
A power-pay relationship that is advantageous for a CEO can result from a weak board or a lack of a large outside shareholder. \(^{138}\) Likewise, the presence of a large outside shareholder is likely to result in closer monitoring and thus is expected to reduce a CEO’s influence over his own compensation. \(^{139}\) Also, a large concentration of institutional shareholders might result in greater monitoring and scrutiny of the CEO and the board. \(^{140}\) A trend has shown that a more concentrated institutional ownership leads to lower executive compensation and more performance-sensitive compensation. \(^{141}\)

U.S. public companies often employ what are known as compensation consultants to aid in structuring pay packages, which also can result in furthering the camouflaging of rents. \(^{142}\) Providing advice that negatively affects the CEO or other executives would only hinder the consultant’s chances of future employment with the current firm or another firm, which provides a perverse incentive for them to apply their expertise in a way that helps increase the compensation packages. \(^{143}\) They can provide types of compensation data that are most favorable to accomplish their analyses and recommendation to that end. \(^{144}\)

Executive loans, \(^{145}\) “pension plans, deferred compensation, and post-retirement perks” are among the practices used to make the total compensation package less transparent. \(^{146}\) Along with being less transparent, these practices all make the executive pay less salient as well. \(^{147}\)

Finally, golden parachutes are the practice of the board giving a departing CEO payments and benefits that are gratuitous—not required under the terms of the CEO’s compensation contract. \(^{148}\) These can occur when the CEO’s performance has warranted his or her replacement. \(^{149}\) It is hard to reconcile such

\(^{138}\) Id.

\(^{139}\) Id. “[A] “negative relationship [has been observed] between the equity ownership of the largest shareholder and the amount of CEO compensation; doubling the percentage ownership of the outside shareholder reduces non-salary compensation by 12–14%.” Id. at 7–8.

\(^{140}\) Id. at 8.

\(^{141}\) Id.

\(^{142}\) Id. at 9.

\(^{143}\) Id.

\(^{144}\) Bebchuk & Fried provide the following examples:

\[\text{When firms do well, consultants recommend increasing compensation, arguing that pay should reflect performance and should be higher than the average in the industry—and certainly higher than that of CEO’s who are doing poorly. In contrast, when firms do poorly, the consultants focus not on performance data but rather on peer group pay to argue that CEO compensation should be higher to reflect prevailing industry levels.} \]

\(^{145}\) Id. (internal citation omitted).

\(^{146}\) While executive loans are now illegal under the Sarbanes-Oxley Act of 2002, “prior to the Act’s adoption more than 75[\%] of the 1,500 largest U.S. firms lent money to executives.” Id. at 10.

\(^{147}\) Id.

\(^{148}\) Id. at 11–12.

\(^{149}\) Id. at 12. An example of such golden parachutes:

\[\text{When Mattel CEO Jill Barad resigned under fire, the board forgave a $4.2 million loan, gave her an additional $3.3 million in cash to cover the taxes for} \]
gratuitous golden parachute payments with the efficient optimization that would or should occur as a result from an arm’s length, optimal contracting approach. However, a golden parachute pay package may be necessary to discard a CEO whom many directors are loyal to in order to assemble a board majority in favor of replacing him. These payments result from the CEO’s relationship with, and influence over, the board.

D. Extravagant Compensation as a Criminological Phenomenon

There is a compelling argument that extravagant CEO compensation is appropriately regarded as a criminological phenomenon, and thus it is a societal failure not to treat it as a crime. While criminal behavior can often be associated with social harm, they are not synonymous. This can be exemplified by having instances of criminal behavior that have no social harm and some perfectly legal actions that can cause great social harm—although later, many of these can become illegal, such as monopolistic practices. Friedrichs claims “that exorbitant CEO compensation should be recognized as a form of white-collar crime” in the same vein that other business practices have since become illegal.

Framing the exorbitant CEO compensation issue in criminological terms allows for a richer understanding of both the parallels and possible differences between such phenomena that occur in the most privileged circles within society and those forms of harm occurring principally in the most underprivileged circles that are conventionally—and without much controversy—regarded as crime.

Friedrichs explains a basic typology of views on such CEO compensation that can be introduced within three classifications: earned, excessive, and extortionate. The earned perspective takes the view that, however excessive CEO compensation may seem to be, it is fully merited for their hard work and unique talents. “CEOs . . . are . . . entitled to whatever extravagant compensation is awarded to them.” In the excessive view, extravagant CEO pay

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150 Id.
151 Id.
152 Id.
153 See Friedrichs, supra note 32, at 46–47.
154 Id. at 46.
155 Id. at 47.
156 Id.
157 Id.
158 Id. at 48.
159 Id.
160 Id.
is excessive; CEOs are entitled to be paid well, but certain levels that are extravagant are too excessive.\footnote{161}

While the first two classifications are all but mundane in comparison, the third introduces a more controversial, albeit not novel, approach. The extortionate “view regards excessive CEO compensation as a function of inherently corrupt dimensions of the present structure of corporate governance, rife with multiple conflicts of interest allowing for out-of-control self-dealing, and wholly unwarranted relative to the contribution to corporate profitability made by CEOs.”\footnote{162} When excessive pay accompanies poor performance of the firm, it becomes especially egregious.\footnote{163} Through this outlook, legal reform is the appropriate response, although whether it should be regarded as a civil and regulatory issue versus a criminal issue is another layer of argument.\footnote{164} One of the themes that Friedrichs explores is that the lines between instances of obvious criminal conduct and those of “exorbitant CEO compensation” can be quite ambiguous.\footnote{165}

A recent case in Germany in 2006 could be an indicator of the direction the issue could head.\footnote{166} Criminal charges were brought against directors of a mobile phone company for having awarded the CEO a bonus of $31 million.\footnote{167} While the case was resolved with a settlement, it can establish a standard for the criminalization of excessive and egregious compensation packages.

\subsection*{E. Cronyism}

A 2006 study investigated whether overcompensation of directors and CEOs is related to firm underperformance.\footnote{169} CEO and director compensation was modeled “using a variety of firm characteristics, CEO characteristics, and governance variables.”\footnote{170} The study found “that director compensation is closely related to the monitoring and effort required of directors to ensure value maximization.”\footnote{171} However, the study also found “a highly significant positive relation between CEO and director compensation.”\footnote{172} There is also a positive relation (0.472) between the annual director fee and the CEO total compensation.\footnote{173} They hypothesized that “this relation could be due to unobserved

\begin{thebibliography}{99}
\item \footnote{161} Id.
\item \footnote{162} Id.
\item \footnote{163} Id.
\item \footnote{164} Id.
\item \footnote{165} Id.
\item \footnote{166} Id. at 51.
\item \footnote{167} Id. at 51–52.
\item \footnote{168} Id. at 52.
\item \footnote{169} See Brick et al., supra note 18, at 403.
\item \footnote{170} Id. at 421.
\item \footnote{171} Id.
\item \footnote{172} Id.
\item \footnote{173} Id. at 409 tbl.3.
\end{thebibliography}
firm complexity (omitted variables) or to excessive compensations of directors and managers associated with an environment of ineffective monitoring, which is termed cronyism in the popular press. 174 Upon testing these, the evidence suggested and supported the hypothesis that the relationship between CEO and director compensation was symptomatic of cronyism where the relationship between firm performance and excess compensation was negative. 175

VII. ATTEMPTED U.S. SOLUTIONS AND THEIR RESULTS

Government regulation of executive pay has historically been not only incomplete and ineffective, but has also had perverse and unintended consequences. 176 The topics of what is fair compensation for executives and how to best tie executive compensation to long-term creation of shareholder value are not exactly recent points of contention. 177 In fact, from its creation, the U.S. Securities and Exchange Commission (“SEC”) has tried to determine whether the value a company created was being appropriately shared with employee and shareholders, or if it was inappropriately being hoarded or otherwise benefiting management. 178

A. SEC Rule Requiring Simple-To-Understand Table for Executive Compensation

Inevitably, when federal policymakers attempted to intercede, usually in response to considerable pressure from the public, and regulate compensation practices, they “succeeded only in moving executive pay from one pocket to another.” 179 The first example of this is the change the SEC made in 1942 that required “simple-to-understand” tables disclosing executive compensation. 180 Prior to this, firms would describe compensation in narrative form, so the change in SEC rules was indeed an improvement in clarity and better allowed a comparison between firms and from year-to-year. 181 However, the forms in effect limited the types of compensation that had to be reported, and thus invited the dramatic increase in use of a wide variety of compensation “hidden payment vehicles” that did not need to be reported. 182 This persisted up until 1978, when the SEC issued new rules requiring the inclusive reporting “of all compensation types.” 183 This change in 1978 resulted in executive compensation shifting back towards salary since there were no gains to be had by using hidden payment

174 Id. at 421.
175 Id.
176 Jurow et al., supra note 15, at 1.
177 Id. at 7.
178 Id.
179 Id.
180 Id.
181 Id.
182 Id.
183 Id.
vehicles or extravagant perks.\footnote{Id. at 8.}

\textit{B. Limiting the Tax Deductibility of Certain Executive Compensation}

Another example of a federal attempt to regulate compensation practices that only succeeded in moving executive pay from one pocket to another, with “the cure being worse than the disease,”\footnote{Id.} is I.R.C. § 162(m),\footnote{26 U.S.C. § 162(m) (2006).} which was signed in 1993.\footnote{Jurow et al., supra note 15, at 8.} In 1993, President Clinton proposed and Congress adopted I.R.C. § 162(m), “that disallows deductions for nonperformance related compensation over one million dollars for the CEO” as well as the other four highest compensated officers of the corporation.\footnote{“Perry & Zenner, supra note 35, at 458; 26 U.S.C. § 162(m)(3)(B) (2006).} This provision does not apply to compensation “on a commission basis, compensation that is performance-based, and compensation under a binding written contract in effect on February 13, 1993.”\footnote{Perry & Zenner, supra note 35, at 458.}

“Although the objective of Congress in enacting 162(m) was to reduce excessive compensation, shareholder activists were mostly concerned with enhancing relation between pay and performance.”\footnote{Id. at 471.} For example, the House Ways and Means Committee stated the following intent of the provision:

\begin{quote}
Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to $1 million per year.\footnote{Id. at 455 (citing 1993 U.S.C.C.A.N. 877).}
\end{quote}

To further support Congress’s intention of 162(m) being a measure to shape corporation behavior rather than raise substantial revenue, a “survey reports that 87% of the firms surveyed intended to implement [the required] changes for positive shareholder relations while only 43% [ ] mentioned [ ] [tax] considerations . . .”\footnote{Jurow et al., supra note 15, at 8.} While the firms were conscious of conforming to 162(m), it wasn’t necessarily evidenced by a reduction in a total executive compensation-bonus and long-term incentive plans and grants of restricted stock “nearly doubled from 1992 to 1997” following the implementation of 162(m).\footnote{Id. at 471.}

This new law called “any [corporate executive] pay above $1 million that [was not] tied to performance ‘excessive’” and thus made that portion of executive pay above $1 million not deductible from corporate income.\footnote{Id. at 455 (citing 1993 U.S.C.C.A.N. 877).} This had multiple perverse effects. One unintended effect was that it “legitimized” this $1 million amount as the baseline for executive pay, and thus over time, this had the net

\begin{footnotes}
\footnote{Id. at 8.}
\footnote{Id.}
\footnote{26 U.S.C. § 162(m) (2006).}
\footnote{Jurow et al., supra note 15, at 8.}
\footnote{Perry & Zenner, supra note 35, at 458.}
\footnote{Id. at 471.}
\footnote{Id. at 455 (citing 1993 U.S.C.C.A.N. 877).}
\footnote{Perry & Zenner, supra note 35, at 459.}
\footnote{Id. at 460.}
\footnote{Jurow et al., supra note 15, at 8.}
\end{footnotes}
impact of increasing, or ratcheting up, the average CEO pay. Additionally, because the stated purpose of the law was to tie CEO compensation to corporate performance, after 1993 there was a major shift and large increase to the use of employee stock option grants, which created an almost reckless obsession with short-term earnings and directly lead to the inevitable accompanying accounting scandals.

C. Other Examples of Using the Tax Code to Limit Executive Compensation

There are many examples to illustrate that the use of tax code to restrict what concerned politicians saw as excessive executive compensation has been notoriously ineffective. Both of the following examples once again illustrate a “ratchet effect” on CEO compensation, where the unintended consequence was to actually raise average compensation by increasing acceptable minimums for certain compensation practices. For instance, in 1984, IRC § 280G "disallowed tax deductions for golden parachutes in excess of 2.99 times [an executive’s] annual compensation . . . ." Naturally, as section 162(m) had standardized a $1 million CEO salary, section 280G effectively made a golden parachute at 2.99 times annual compensation the legitimized standard. In 1989, IRC § 4999 was adopted, which required executives to pay a 20% excise tax on golden parachutes above the 2.99 times annual compensation limit. The reaction of compensation committees to this was additional payments to executives to cover the new mandatory 20% excise tax on golden parachutes, plus cover the extra tax created by this additional payment itself. Thus section 4999 resulted in not only an additional transfer of shareholder value to a departed executive, additional shareholder value was also being transferred to the federal government. It is a straightforward conclusion that these types of efforts to “cap[] on compensation through the tax code do not work because they are specific and proscriptive, and therefore easily circumvented or abused by compensation committees.”

D. Comprehensive Disclosure of Executive Compensation

Since the Securities Act of 1933, the SEC has focused on disclosure rules, and in fact, “today the United States has the most comprehensive disclosure rules

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195 Id.
196 Id.
198 Jurow et al., supra note 15, at 8.
199 Id.
201 Jurow et al., supra note 15, at 8.
202 Id.
203 Id.
204 Id.
of any country." The SEC changes to disclosure rules in 1942 and 1978 have already been discussed above. The basic assumption driving the SEC to ever more transparent disclosure of corporate executive compensation policies and practices is that it will “shame” boards of directors into doing the right thing for their shareholders and employees.

The increased public attention on the pay for performance relation resulted in regulatory intervention by the SEC in 1993. These additional disclosure requirements included “enhanced disclosure on executive compensation and the enactment of tax legislation limiting the deductibility of nonperformance related compensation over one million dollars. . . .” The goal of these requirements was to make disclosure of executive compensation paid “clearer and more concise” and more useful to shareholders.

Some of the main features of the new rules were that companies: 1) compare financial performance to an industry benchmark with graphs and tables; 2) disclose the annual and long-term compensation for the CEO and four most highly paid executives; 3) estimate the present value of managerial stock options; and 4) provide a report by the compensation committee identifying measures used to evaluate executives. Interestingly, research has shown that upon examination, “managers choose industry- and peer-company stock return benchmarks that are downward biased”, which in turn overstate the firm’s performance.

In 2006, the SEC created the “Compensation Discussion and Analysis” filing which requires companies “to disclose all prior and potential payments [to executives], of any form or function[,]” including “perks, severance, and retirement packages, as well as payout ranges for incentive plans. . . .” All of this focus, decade after decade, on increased transparency of executive compensation, has been ineffective, as CEO pay has actually increased as disclosure requirements increased. Even with increasing SEC disclosure requirements, compensation committees and compensation experts seek loopholes, as well as more “opaque” methods of compensation. Plus, disclosure of compensation packages can actually lead to the ratchet effect as other executives and their supportive compensation committees seek to not fall behind other

206 Jurow et al., supra note 15, at 8.
207 See discussion supra Part VII.A.
208 Jurow et al., supra note 15, at 8.
209 New SEC rules on executive compensation disclosure were proposed in July 1992, became effective in October 1992, and were revised in August 1993 after an extensive review by the SEC of about 1,000 proxy statements. Securities and Exchange Commission, Release Nos. 33-6962; 33-6966; 33-7009; and 34-32723.
210 Perry & Zenner, supra note 35, at 453.
211 Id. at 455.
212 Id. at 457.
213 Id. at 458.
214 Jurow et al., supra note 15, at 8.
215 Id.
216 Id.
VIII. NEW AND PROPOSED EXECUTIVE COMPENSATION SOLUTIONS

A. Use of Progressive Tax System to Redistribute Income

Do taxes really redistribute income? In spite of the progressive structure of federal income tax in the United States, the answer to this question, according to multiple studies, appears to be “no.”218 While using government sources can “show a little bit of progressivity,” the effective tax rates do not really accomplish any real redistribution of income as a result of attempts to tax the rich to transfer income (and thus redistribute their wealth) to other members of society.219 There are multiple reasons for this. First, the effective tax rate for income earners is different from the official tax rates because all types of taxes across all governmental levels must be considered, including not just federal income taxes, but also state taxes, local taxes, payroll taxes, and sales taxes, among others.220 Additionally, the wealthy tend to earn much more of their income from sources other than wages and salaries, such as investments that are either tax-free or taxed at capital gains rates, which also reduce the intended impact of the sharply progressive federal tax rates for ordinary income.221 Although the top income earners do indeed pay the majority of income taxes, this is likely a result of the extreme concentration of income in the top percentile, and has done nothing to reverse the increase in income inequality or the concentration of wealth into the hands of fewer individuals and families.222 There is no reason to believe the American political system will suddenly allow or tolerate the use of the income tax system for the effective outright seizure of excessive CEO income. While it may appeal to some to further increase the federal income tax rates on higher income earners to extreme levels, historically, increasing the progressivity of the tax system to either discourage the increase in CEO wages or encourage after-the-fact taxing away of the effective disparity in income, has proven to be a failure.223

B. Dodd-Frank

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was signed into law.224 While Dodd-Frank as a whole “focuses primarily on the financial services industry,” some requirements are applicable to executive compensation, including Say on Pay, Shareholder Vote

217 Id. at 9.
218 See Domhoff, supra note 2.
219 Id.
220 Id.
221 Id.
222 Id.
223 Id.
on “Golden Parachutes,” Disclosure of Relationship of Pay to Performance, Disclosure of CEO Compensation Pay Ratio, Independence of Compensation Committee Members, and Independence of Compensation Committee Advisors.225 Dodd-Frank also includes rules for financial institutions that “[e]xpand[] regulation of compensation arrangements that may encourage inappropriate risk-taking.”226

Dodd-Frank will not work to stop this because, for the most part, we Americans tend not to invest directly in stocks; instead, we outsource this by investing in mutual and pension funds.227 These institutions own about two-thirds of all stock.228 Thus, when 98.5% of companies that put their executive pay plans up for a vote by shareholders, they received a resounding “yes,” the Wall Street Journal reports.229

The 2011 proxy season introduced Say on Pay (SOP), Say on Frequency (SOF), and Say on Golden Parachutes (SOGP).230 For the currently available 2011 data for Say on Pay, Say on Frequency, and Say on Golden Parachutes, companies have not had problems obtaining shareholder support.231

Following the implementation of SOGP, golden parachutes have been met with “overwhelming support” from shareholders, with every company that reported results as of September 26, 2011, receiving majority support.232 However, support for the bonuses and compensation packages for executives in the related mergers is lower than approval for the overall deals themselves.233 But, shareholders are not withholding support for golden parachutes in lieu of any claimed exorbitant compensation—they are “likely to support the [golden parachutes] when they believe the overall transaction makes sense.”234

C. Reforms that Seek to Balance Tensions Between a Firm’s Stakeholders

Matsumura and Shin discuss some of the more widely discussed and


228 Id.


231 Id.

232 Id. The lowest level of support was a 57% positive vote among shareholders in regard to pay arrangements for the Citadel Broadcasting Corporation/Cumulus Media transaction. Id.

233 Id. at 2 (noting a 99% median support for transactions and 91% median support of SOGP).

234 Id. at 3.
proposed principles and reforms for CEO compensation that seek to better balance the tensions that exist between each of a firm’s stakeholders. For each of five different proposals for reform they identify the intended and unintended consequences.

The first reform discussed by Matsumura and Shin is to require greater independence of compensation committees. The theory is that a truly independent compensation committee has the potential to play a significant role in limiting excessive CEO compensation practices. For instance, the New York Stock Exchange (“NYSE”) has rules that require firms to have compensation committees that are entirely composed of outside independent directors. Furthermore, the NYSE has a rule that the CEO cannot be a member of the nominating committee for directors, so that it is more likely that appointed directors will be truly independent and not beholden to the CEO. All of these rules appear theoretically sound when it comes to establishing appropriate CEO compensation that is not excessive. Unfortunately, multiple studies find no evidence that having affiliated versus independent directors leads to greater levels of CEO compensation.

Another principle examined by Matsumura and Shin is to require executives to hold significant equity positions in the corporation. The theory is to more directly align executive’s interest in the firm with shareholders’ interests. However, there is a mounting body of research that challenges this theory. One problem is that there is a “discrepancy between the economic value of [stock] options and the value of [stock] options to executives...” Plus, self-serving executives can time the release of news and the timing of certain other matters in ways that maximize their personal holdings of stock options. In fact, there is evidence that CEOs with large holdings of stock options will be tempted to use artificial means, such as accounting practices, to maximize their wealth.

Matsumura and Shin also examined whether enhanced transparency through requiring ever greater disclosure of executive compensation will limit excessive CEO compensation practices. In examining the research available they find it difficult to conclude whether firms enjoy any net benefit from increased disclosure

236 Id. at 105.
237 Id.
238 Id.
239 Id.
240 Id.
241 Id.
242 Id. at 106.
243 Id.
244 Id.
245 Id.
246 Id.
247 Id.
requirements. In fact, a firm may experience a negative impact through increased costs, as public disclosure may ratchet up CEO pay as firms participate in a “beauty contest” “as firms seek to ensure that their executives are among the higher paid.”

Matsumura and Shin examined the impact of increased institutional investor involvement in corporate governance, including monitoring CEO pay versus performance. They note that the literature available provides only mixed findings on the role that institutional investor involvement plays in restraining CEO compensation. Also, it is unclear whether institutional investors such as mutual fund advisors have much incentive to monitor and become involved in individual firms’ governance, since they can simply err on the side of liquidity if trading costs are low enough for firms they believe have bad governance.

The last reform that Matsumura and Shin examined is to require firms to expense stock options in their income statements. Some believe that doing this will lead to better compensation practices. However, an equal argument can be made that adding these expenses to the income statement will simply harm employees, since firms will now have a strong economic incentive to stop granting stock options to employees.

D. Dynamic Compensation Model

Maybe a fundamental rethink is in order. For instance, it has been proposed to solve the potential problem of CEO excessive and unmerited pay by introducing a dynamic compensation model, implemented using a mechanism called a “Dynamic Incentive Account.” This new model is designed to address problems such as short-term orientation, premature payouts, and inappropriate stock incentives after stock price declines. Many models of CEO compensation consider only a single period or single pay out. However, it is noted that such a static compensation contract may be found ineffective, given what is actually an ever changing and dynamic world. Incentives may lose their power over time, and “if firm value declines, options may fall out of the money and bear little

\[248\] Id. at 107.
\[249\] Id.
\[250\] Id.
\[251\] Id.
\[252\] Id. at 107–08.
\[253\] Id. at 108.
\[254\] Id.
\[255\] Id.
\[257\] Id.
\[258\] Id.
\[259\] Id.
sensitivity to the stock price.”260 Also, single-period contracts can encourage the CEO to engage in behavior that benefits him immediately in the current period that his compensation is tied to, such as inflating the current stock price and selling off without regard for the longevity and health of the organization.261 Conversely, a dynamic model in the form proposed, where the CEO’s expected incentive pay is placed into a “Dynamic Incentive Account,” provides opportunities for a firm to implement metrics that truly tie compensation to stock performance and firm value over the long run.262 The account, comprised of both cash and the firm’s equity, would serve to escrow a CEO’s expected pay.263 It would also incorporate the capability to rebalance the equity proportion to assure appropriate incentive, along with “time-dependent vesting” to deter “short-termism”264. This focus on rewarding effort with future rather than current pay can require the CEO to remain sensitive to a firm’s future performance, even beyond their own retirement.265

IX. CONCLUSION

The increase in the United States of the CEO versus employee pay gap is of legitimate concern and has been for some time. This growing gap is especially astonishing when compared to CEO pay levels in other countries.266 While part of the disparity between the pay of U.S. and foreign CEOs can be justified by differences in social and business environments, including systems that are debt-based rather than equity-based, the gap is so large by any standard it must be considered excessive. Excessive CEO pay can be, and is, harmful to both business and society.267 The potential harm to U.S. businesses includes suboptimal returns to stakeholders because of compensation practices that emphasize short-term over long-term management decisions and also tend to unnecessarily transfer capital and returns away from the company, its employees, and shareholders.268 The potential harm to society includes the very real danger that excessive executive pay and the bad corporate behavior and the poor results it causes will play a disruptive role in the American political and economic system.269 The recent near-collapse of the banking and financial systems, and the migration of whole segments of American industry overseas are evidence of this.

Thus, there is a very real need to curb any tendency of excess in CEO compensation. Unfortunately, past U.S. government actions related to excessive

260 Id.
261 Id. at 1604, 1607.
262 Id. at 1605.
263 Id. at 1693.
264 Id.
265 Id. at 1605.
266 See discussion supra Part III.
267 See discussion supra Part V.
268 See discussion supra Part V.C.
269 Id.
CEO compensation practices and reporting can be deemed a failure as they have actually had the perverse effect of introducing and amplifying the problem. However, this does not mean nothing can be done about the problem. Company policies emphasizing and rewarding long-term management decisions would be a start. As discussed in this paper, the deadly combination of an incentive system that excessively relies on stock options within a short-term reward structure and an imbalance of power between the CEO and the board of directors, both highlight much of the root cause of the excessive CEO compensation problem and where to look to fix it.

270 See discussion supra Part VII.
271 See discussion supra Part VI, VIII.