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ARTICLES

THE CONUNDRUM OF EXECUTIVE COMPENSATION

Mark J. Loewenstein*

Much of the scholarship on executive compensation that appears in law reviews assumes that large U.S. corporations overpay their chief executive officers ("CEOs"). This assumption is understandable, as many of these compensation packages are indeed stunning. The question of whether CEOs are overpaid, however, is complicated. Some scholars in other disciplines, principally in economics and management science, have studied the issue but, as this Article demonstrates, this literature does not confirm the assumption. Indeed, some studies suggest that CEO pay is competitive. Moreover, efforts to reduce the level of executive compensation may have the unintended consequence of achieving the opposite result. Thus, those seeking to rein in compensation should proceed with caution. This Article concludes with some thoughts on a methodology for further research.

* Professor of Law, University of Colorado School of Law. The author wishes to thank his colleague, Professor Dale Oesterle, for his comments on an earlier draft of this Article and Margaret Leary of the University of Michigan Law Library for her research assistance. The author was a visiting professor of law at the University of Michigan during the preparation of this Article.
INTRODUCTION

Executive compensation1 is like global warming; true believers and doubters are sharply arrayed against one another debating whether there is a problem and, if so, what are its causes and cures. Some observers believe that the compensation paid to America's top executives is clearly excessive,2 while others doubt that a problem exists.3 The doubters may point to the large pool of potential executives and the companies bidding for their services and conclude that the free market fixes compensation. The free market analysis also notes the wealth of information available about compensation and the talents and experience of the executives who receive that compensation. Under this analysis, the market for chief executives is large, active, and informed, and executives are not overpaid.4

On the other hand, those who believe that executives are “overpaid” may point to numerous studies that suggest the lack of relation between executive compensation and corporation performance and argue that, unless there is such a relation, the executives’ compensation cannot be justified.5 They also point to the compensation

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1. As used in this essay, the term “executive compensation” refers to the pay of the highest paid executive officer of a corporation, generally its chief executive officer (“CEO”). I use the terms “executive compensation” and “CEO compensation or pay” as synonyms.

2. The proponents for this side of the debate are more numerous. One of the leading critics of executive compensation is Graef S. Crystal, who writes and speaks regularly on the subject. For a statement of his case, see generally GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991). Derek Bok, former President of Harvard University takes a somewhat broader view of the matter and notes that excess is not limited to corporate executives. DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA (1993).


of foreign executives, who, on average, earn considerably less than U.S. CEOs, and to the structural aspects of corporate boards that might bias compensation upward.

This debate has raged on for nearly two decades—a period that has seen the compensation of the CEOs of large U.S. companies increase from 42 times the compensation of their labor force to 419 times. In the interim, there have been two modest legal reforms that some thought might have an effect on executive compensation. What effect these reforms have had is difficult to determine; suffice it to say, executive compensation has not declined in response to them. At the same time, scholars have explored a number of theories to explain executive compensation and suggested a number of solutions to improve the way CEOs are compensated.

This Article reviews and evaluates the principal empirical and theoretical issues surrounding executive compensation, looking at various, and sometimes competing, theories. Its conclusion may be somewhat surprising, particularly at a symposium devoted to dis-

6. A recent study undertaken jointly by The Conference Board and Monks Partnership Limited examined compensation practices in 2169 companies in the United States, Canada, the United Kingdom, and France in 1997. See CHARLES A. PECK ET AL., TOP EXECUTIVE COMPENSATION: CANADA, FRANCE, THE UNITED KINGDOM, AND THE UNITED STATES 7 (The Conference Board 1999). The study found that the United States had the highest total current compensation (salary and annual bonus) at 573,000 euros (approximately $550,000 on July 15, 1999, when the study was published) followed by the United Kingdom (470,000 euros), Canada (355,000 euros), and France (227,000 euros). See id. at 5. If the study had included long-term incentive compensation, the differential between the United States and the other countries would have been greater.


8. See Detlev Vagts, Challenges to Executive Compensation: For the Markets or the Courts?, 8 J. CORP. L. 231, 232 (1983) (indicating that a new wave of concern about the generosity of management compensation may be on the way); see also Rogers v. Hill, 289 U.S. 582, 591-92 (1933) (showing that executive compensation has seen controversy in the past, with the issue finding its way to the United States Supreme Court).


10. See infra notes 115-148 and accompanying text.

cussing executive compensation: current research simply does not support the conclusion that, on average, the CEOs of large U.S. companies are overpaid. Thus, measures to "rein in" compensation are ill-vised and possibly counter-productive. In light of the various conundrums presented by the debate over executive compensation, this Article concludes with a suggested method of research that might prove more enlightening.

I. ARE AMERICAN CEOs OVERPAID?

No serious consideration of solutions to the "problem" of executive compensation should proceed before determining whether, in fact, CEOs are overpaid. Many articles and books simply assume that to be the case, in part because the data regarding CEO pay seems so compelling. The conclusion that U.S. CEOs are paid excessively is generally based on one or more of these arguments: first, that the differential between CEO pay and that of blue collar workers has increased "exponentially" in the past two decades; second, that U.S. CEOs earn dramatically more than their counterparts in Europe and Japan, who head companies that compete with U.S. firms; and third, that CEO pay is not correlated to corporate performance, particularly increases in shareholder wealth. Overlaying all of these arguments is the structural argument—corporate boards are "captured" by the CEO and thus incapable of bargaining with the CEO. Under this scenario, CEOs use their leverage over these captive boards to extract excessive compensation. These arguments do not, however, prove the premise, no matter how forcefully (or indignantly) they are stated.

A. Comparisons with Rank and File Workers and Foreign CEOs

The first two arguments are not persuasive, and for similar reasons. Much of the increase in CEO pay is directly attributable to the increase in stock prices over the past two decades, as the portion of

12. See, e.g., Crystal, supra note 2, at 27 (citing facts that indicate that, while the pay of an average American worker has decreased significantly over the past twenty years, the compensation for a typical company's CEO has increased threefold); Charles M. Elson, The Duty of Care, Compensation, and Stock Ownership, 63 U. Cin. L. Rev. 649, 649 (1995) ("In the United States today, many corporate executives are paid much more than their performance seems to justify."); Elson, supra note 7, at 945-49 (providing a typical analysis in which Professor Elson addresses the question by asserting that directors on the typical board are beholden for their positions to the CEO, with whom they must negotiate, and therefore, are incapable of engaging in meaningful negotiations).

13. See Smart, supra note 9, at A12.

14. See Vagts, supra note 8, at 232.


16. See id.
CEO pay in stock options has risen dramatically in the past several years. Had the stock market declined over this period, the change in the differential between CEO and average worker compensation would look quite different, as the average worker is not paid in stock options. Similarly, stock options have not been common overseas. One compensation consultant has noted that CEO pay differences are not that dramatic between Europe and the United States unless long-term incentives—typically stock options—are taken into account. In other countries, various obstacles, including unfavorable tax treatment, have limited the use of stock options as compensation. More importantly, whether comparison is to the average worker or the foreign CEO, neither of these arguments addresses the normal market forces, either as they affect the average worker or as they affect U.S. and foreign CEOs.

One legitimate question in this area, rarely considered in reference to CEO pay, is why the wages of average workers have risen so slowly. The answer, of course, relates to the supply and demand for workers. Less skilled workers are increasingly competing with workers in foreign countries, where wages are low. This has reduced the bargaining power of U.S. workers to demand wage increases, as such workers face the threat of plant closings or technological replacement. While a more thorough analysis of this question is beyond the scope of this Article, there is little dispute that economic forces are holding down the wages of the average worker relative to CEO pay. These same economic forces may explain the rise in CEO pay, as the demand for highly skilled corpo-

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17. See Clawson & Klein, supra note 11, at 42 (citing Frederick W. Cook & Co., Inc., Long-Term and Stock-Based Grant Practices for Executives and Directors 5 (1996), which reported that 94% of the nation's 250 largest companies compensate their executives with stock options).


19. See id. at 37 (quoting Robert Freedman of the New York-based consulting firm Towers Perrin); see also Peck et al., supra note 6, at 22 & 41 (concluding that, in terms of salary, United States and United Kingdom compensation was nearly equal); Richard Morais et al., The Global Boss' Pay: Where (and How) the Money Is, FORBES, June 7, 1993, at 93 (pointing out that a 1992 Towers Perrin study indicated that Brazilian and Mexican CEOs earn the highest cash compensation globally).

20. See Peck et al., supra note 6, at 7 (describing, in the discussion of each country, the tax and regulatory considerations). But see David Cay Johnston, American-Style Pay Moves Abroad, N.Y. TIMES, Sept. 3, 1998, at C1 (noting that the use of options abroad is increasing); Luisa Kroll, Warning: Capitalism Is Contagious, FORBES, May 18, 1998, at 220, 221 (stating that two Towers Perrin surveys revealed a jump in the number of incentive and option plans offered by international manufacturers); Deborah Orr, Damn Yankees, FORBES, May 17, 1999, at 206, 207 (pointing out that European companies are reluctantly adopting stock option plans).

rate chieftains may be outstripping the supply. Indeed, recent stories in the Wall Street Journal note the extreme shortage of talent in this market.\(^{22}\) Notably, while CEO pay has risen much faster than the pay of average workers, CEO pay has risen much slower than the pay of professional athletes. During the period 1980-95, the pay of the average worker increased 60%, that of CEOs 380%, National Basketball Association players 640%, National Football League players 800%, and Major League Baseball players 1000%.\(^{23}\) Again, market forces are likely at work in all cases.

When comparing pay across borders, one must consider first that, outside of the United States, Canada, and Great Britain, data on executive pay is very difficult to obtain and comparisons often depend on estimates.\(^{24}\) Of equal importance, critics of CEO pay rarely discuss many factors that may account for pay disparities. For instance, German companies may pay executives a second salary in a tax haven, which is not reported.\(^{25}\) In many countries overseas, perquisites are an important component of compensation and do not appear on comparison tables.\(^{26}\) In addition to their monetary value, perquisites may have an important non-monetary component. For instance, Japanese executives place a greater value than U.S. CEOs on the prestige of being a chief executive and, therefore, may be willing to accept a lower salary.\(^{27}\) Similarly, tax rates and purchasing power vary from country to country and should be considered in cross-country comparisons.

\begin{itemize}
  \item \textbf{B. Comparisons with Corporate Performance}

  The final argument—that CEO pay is not correlated to performance—is the most forceful of these arguments, but it is still unpersuasive as a basis to conclude that CEOs are overpaid. Part of the problem in this area relates to what constitutes “performance.” Critics of CEO pay tend to compare changes in CEO pay to changes in shareholder wealth, that is, dividends paid and increases in share

\end{itemize}

\(^{22}\) See generally Joann S. Lublin, To Find CEOs, Web Firms Rev Up Search Engines: In the Big Race to Go Public, Too Many Dot-Coms Chase Too Few Star Executives, WALL ST. J., Oct. 26, 1999, at B1 (noting that there is a huge demand for CEOs among Internet companies).


\(^{24}\) See PECK ET AL., supra note 6, at 8 (relying on survey data and interviews to supply French data); see also Steven N. Kaplan, Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States, 102 J. POL. ECON. 510, 533 (1994) (stating that there is not as much evidence of management compensation for Japan as there is for the United States).

\(^{25}\) See Morais et al., supra note 19, at 90.


\(^{27}\) See Morais et al., supra note 19, at 98.
There is some logic to this comparison, as increasing share prices are the primary way that shareholders can benefit from their investments and, therefore, the CEO should be focused on that goal. On the other hand, CEOs have no control over the stock market, which is affected by factors such as general economic conditions, politics, and a wide array of other factors. Consequently, firms often correlate CEO pay to other performance measures, such as profits, return on equity, earnings per share, etc., that the CEO and management team presumably can influence. In the long term, achieving these financial goals should redound to the benefit of shareholders, but, given the vagaries of the stock markets, these accomplishments might not be immediately reflected in share prices.

In addition to oversimplifying the pay-performance issue, critics often explain increases in CEO pay as a function of the tendency of compensation committees to rely on salary surveys and peg the pay of their CEO in the top quadrant of the survey. This practice results in a "ratcheting up" effect as firms leap frog one another in fixing pay. Critics then argue that the market becomes distorted and that pay is more rational if related to performance, again narrowly defined. While the use of salary surveys seems to be wide-
spread and their effect inflationary,\textsuperscript{36} as a practical matter, boards and compensation committees cannot set pay without regard to the pay of executives in comparable firms. Relying, at least in part, on pay surveys accommodates a firm’s important motivational, recruitment, and retention concerns.\textsuperscript{37} Moreover, critics assume that use of the surveys results in an increase in compensation that otherwise would not have occurred.\textsuperscript{38} There is, however, reason to doubt this. The theory suggests that, in the absence of surveys, directors would bargain harder with the CEO, with the result of lower compensation, and that surveys somehow make the directors less effective bargainers.\textsuperscript{39} The executive finding himself or herself below the median may be motivated to seek higher compensation, but then why is the board not similarly motivated to hold down compensation when it discovers it is paying well above the median?\textsuperscript{40} Finally, executive pay has informational attributes: in light of disclosure, a firm may wish to convey information about its success or prospects through its CEO pay.\textsuperscript{41}

More to the point, much of the dramatic increase in CEO compensation is a direct result of the increase in incentive compensation in the form of stock options,\textsuperscript{42} which, in turn, were implemented by corporate boards in response to demands that CEO compensation be more closely linked to shareholder returns.\textsuperscript{43} This linkage is a justified measure to address the agency cost that shareholders otherwise bear: corporate executives have natural incentives to devote less than their greatest efforts to corporate business and to consume more leisure and other perquisites than is in the best interests of shareholders.\textsuperscript{44} Aligning executive and shareholder interests reduces this agency cost and provides a justification for granting large stock options to executives.\textsuperscript{45}


\textsuperscript{37} See CRYSTAL, supra note 2, at 223; Iacobucci, supra note 34, at 511.

\textsuperscript{38} See Iacobucci, supra note 34, at 504.

\textsuperscript{39} See id. at 512-17.

\textsuperscript{40} See id. at 513.

\textsuperscript{41} See id. at 512-17.

\textsuperscript{42} See Jennifer Reingold & Ronald Grover, Executive Pay: Special Report, BUSINESS WEEK, Apr. 19, 1999, at 74 (stating that, in 1998, exercised options accounted for 80% of reported CEO pay, up from 72% just a year earlier).

\textsuperscript{43} See id. at 72, 73.

\textsuperscript{44} The leading academic work on agency theory is Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 313 (1976).

\textsuperscript{45} See id. at 308. There is evidence that the stock market views favorably the implementation of stock plans designed to address agency cost problems. See, e.g., James A. Brickley et al., The Impact of Long-Range Compensation Plans on Shareholder Wealth, 7 J. ACCT. & ECON. 115 (1985). The incentive effects of stock options also have some empirical support. See Hamid Mehran,
While generous stock plans are not the only means to reduce agency costs, they do provide some unique efficiencies. An alternative is to more closely monitor corporate executives; the board, presumably, could do this. Indeed, in other countries, boards commonly monitor their executives more closely, with Germany and Japan frequently cited as examples. The corporate directors in these countries, however, tend to have a stake in closer monitoring—they represent significant shareholders or lenders (in the case of Germany) or have other relationships that motivate them to assure the success of the corporation on whose board they sit (as in Japan). In contrast, directors in the United States do not have such a stake and, instead, often have no affiliation with the companies they direct other than their directorships. Thus, to be successful, corporations needed to develop a substitute to close monitoring. Two such alternatives, which are not mutually exclusive, have emerged: long-term incentive compensation schemes and the market for corporate control.

The use of long-term compensation schemes, which are designed to align CEO and shareholder interests, may be inexpensive relative to the alternatives. To be sure, shareholders do sacrifice equity in the corporation, and there is some indication that this sacrifice is becoming material, a problem which is discussed below. However,

Executive Compensation Structure, Ownership, and Firm Performance, 38 J. Fin. Econ. 163, 179-80 (1995) (finding that firms that pay executives in stock tend to have higher returns); see also Robert T. Masson, Executive Motivations, Earnings, and Consequent Equity Performance, 79 J. Pol. Econ. 1278, 1278-79 (1971) (finding that “firms with executives whose financial interests are more closely parallel to the goals of the stockholders and the long-run profitability of the firm do indeed outperform other firms in stock return”).

46. The grant of the option does not require the firm to expend any cash, and the firm might reasonably expect that the option will provide a performance incentive to the executive. Options granted with an exercise price equal to market price on the date of the grant do not generate taxable income to the recipient, nor does the grant generate an expense item to the firm. As a result of recent rules, however, the firm must disclose the estimated value of the option in a footnote to its financial statements. See Pat McConnell, Employee Stock Option Expense Pro Forma Impact on EPS and Operating Margin, BEAR STEARNS EQUITY RESEARCH, May 1, 1998, at 2.


50. See Elson, supra note 7, at 981.

51. See infra notes 65-81 and accompanying text.
If the CEO's compensation scheme does not provide the right incentives, the board must somehow be motivated to provide the close monitoring that would serve as a substitute, and that would come at a cost. Charles Elson has suggested that this motivation could be provided if individual directors had significant stock ownership in the companies they direct. If implemented, such a proposal would give directors the sort of motivation that, presumably, would drive German directors to undertake effective monitoring and that, presumably, would bring U.S. executive compensation in line with that of foreign companies.

Elson's proposal, however, is costly. He acknowledges that directors would have to receive "substantial" stock ownership and assumes that five years' worth of director fees paid in stock "should" be enough. However, judging how much stock is sufficient and whether stock acquired by the director in partial payment of a director's fee has the same motivational effects as stock purchased by the director is difficult. As to the former, a director with a multimillion-dollar portfolio of his or her own may not be highly motivated to enhance the value of $175,000 worth of stock to $250,000. In addition, all of the directors would have to receive substantial amounts of stock. The aggregate of these stakes may well exceed the stake that would properly motivate the CEO to perform in the shareholders' interests. Put differently, minimizing agency costs is not free, and a properly structured executive compensation package may be the least expensive means of accomplishing it.

More fundamentally, the important empirical question is the relationship between firm performance and ownership structure. If the board owns a significant stake in the firm, intuitively it would have incentives to monitor effectively. However, those incentives might be offset by an entrenchment effect. Indeed, one study found that firm value initially rises with increases in inside ownership and then falls, presumably due to the entrenchment effect. One recent empirical study, examining the relationship between corporate governance, executive pay, and firm performance was unable to find evidence that greater equity ownership by outside directors results in improved governance systems. There does not appear to be a great deal of empirical work in this area, and recent studies have

52. Elson, supra note 7, at 981.
53. Id. at 985.
54. Id. at 986.
56. See John E. Core et al., Corporate Governance, Chief Executive Officer Compensation, and Firm Performance, 51 J. Fin. Econ. 371, 404 (1999). The authors used eight measures as proxies for effective governance, such as whether the CEO was also board chair, the portion of directors who are outside and independent, and the number of other boards on which directors served. See id. at 381-82.
mixed results. Thus, one might conclude that, even if greater director ownership of stock helped reduce executive compensation, it might be inadvisable because of the potentially adverse effect on firm value.

The alternative to a properly structured long-term incentive plan and active board-based monitoring is an active market for corporate control; that is, monitoring by the market. If a corporation is under-performing in the product market, or inefficiently employing its capital, this should be reflected in its stock market price. In theory, therefore, the market for corporate control would act as a monitor of excessive compensation. If resources are wasted on executive compensation, fewer resources are devoted to generating income and profits, and the corporation should be vulnerable to a takeover. There are several reasons why the market for corporate control is not a viable option, however. First, the amounts devoted to CEO compensation are, on average, immaterial. For instance, Kevin Murphy calculated that, in 1992, the 1000 largest U.S. corporations, whose total market capitalization was $3.4 trillion, paid their CEOs a total of $2.2 billion. Had these CEOs worked without compensation that year, shareholder returns, which averaged 24%, would have increased by only 0.06 percentage points. This sort of increase in returns would hardly justify a 30-40% premium over market price, which is typical in a hostile tender offer.

Second, the barriers in the market for corporate control are substantial. The financial, legal, regulatory, and other expenses of a takeover are considerable. Judicial approval of poison pills and other corporate-developed defenses to takeovers, combined with widespread adoption of state antitakeover statutes, have made corporations much less vulnerable to hostile takeovers than they were in the 1980s. Finally, it is somewhat ironic to think of a takeover bid being motivated by a perception that the corporation can be operated more efficiently with a "cheaper" CEO. Indeed, the opportunity to receive a generous compensation package often motivates (at least in part) a takeover and justifies the premium the purchaser is
willing to pay. In any case, the amount that can be saved in CEO compensation, standing alone, is unlikely to justify the considerable expenses of such a transaction.64

In sum, it would appear that performance-based pay plans that compensate managers with stock or stock options are an appropriate way to address the agency problem and award performance. Not surprisingly, such plans have become increasingly popular but with a downside risk that has been noted only recently: the amount of equity that is being acquired by management is reaching troubling proportions.65 A 1997 study by the consulting firm of Pearl Meyer & Partners determined that officers and directors of the 200 largest U.S. firms held, on average, shares and options (including options authorized but not yet granted) equal to 11.9% of the outstanding shares.66 A year later, the same firm found that the figure had increased to 13.2% of corporate equity, or around $1.1 trillion.67 Most of these option grants are awarded to the top managers in the form of "mega-options," which, if exercised, would be worth at least $10 million.68 In some firms, particularly in the high tech area, the portion of shares allocated to managers in options threatens to shift control to them.69

In addition to the potential dilution to public shareholders and the possibility of shifting control to managers through options, current trends in the awarding of options pose other problems. Current accounting rules do not require a charge against earnings upon the award of these options.70 Hence, profits are overstated and, to the extent compensation plans provide bonuses and even additional option awards tied to profits, the efficacy of the plans is compromised. To avoid potential dilution, some corporations have been funding option plans with repurchased shares.71 While this does avoid dilution, it has the effect of increasing management's stake in the firm. Given the large size of the options, for some firms the cash expenditures are material, diverting resources from profitable projects or

64. See Vagts, supra note 8, at 239-40.
65. See Richard H. Wagner & Catherine G. Wagner, Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors, 3 STAN. J.L. BUS. & FIN. 5, 5-7 (1997) (noting that nearly all large firms currently have such plans); Share and Share Unalike, ECONOMIST, Aug. 7, 1999, at 18 (asking if options are encouraging management to act in ways that may leave everyone worse off).
66. See Wagner & Wagner, supra note 65, at 10 (citing PEARL MAYER & PARTNERS, EQUITY STAKE 1996, EQUITY PARTICIPATION IN THE TOP 200 (1996)).
67. See Share and Share Unalike, supra note 65, at 18.
68. See id.
69. See Wagner & Wagner, supra note 65, at 10 (citing RADFORD ASSOCIATES/A&AGG, RADFORD EXECUTIVE REPORT (1996)).
71. See Wagner & Wagner, supra note 65, at 17.
dividends or increasing firm borrowings. In some instances, the share repurchases may materially increase the market price of the securities, which, ironically, may trigger the exercise of more options.

The stock option phenomenon has another, subtler aspect. If managers hold the shares that they acquire, they can more easily become entrenched in office, a consequence the public shareholders would like to avoid. More importantly, with so much capital invested in a single firm, managers may also become more risk-averse. This, also, is not in the interest of public shareholders, who are likely to hold a diversified portfolio and, therefore, are not risk-averse with respect to any particular investment. On the other hand, if managers sell the stock that they acquire on exercise of options or hedge their investment positions, then an important justification for stock options is lost because the managers' interests no longer are aligned with the shareholders'. These are knotty problems with no clear and easy answers. What does seem clear, however, is that political solutions are unlikely to match the most efficient economic solutions. The latter evolve over time as firms adjust their practices to take into account experience gained. The former, like the tax initiative described below, are less adaptable to change and run the risk of becoming outmoded and difficult to change.

The rush to stock options may reflect corporate responses to political pressures, and not necessarily the right responses. A recent study by Professor Murphy, for instance, concluded that "there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock performance." The empirical evidence is mixed on whether contingent compensation schemes are effective, and there is reason to question whether and how promises of additional compensation motivate CEOs. Pay for performance makes the most sense when the link between compensation and performance is clear. For instance, paying workers by the amount of their output surely motivates workers to increase their output. The output of CEOs is not so easily measured; the success or failure of the firms that they manage depends, in part at least, on the quality of the decisions that they make. So the relevant inquiry is whether performance-based pay improves those decisions, and there is little

72. See Share and Share Unalike, supra note 65, at 19.
73. See id.
75. See infra notes 150-156 and accompanying text.
76. Share and Share Unalike, supra note 65, at 20 (quoting Kevin Murphy, Executive Compensation, in A HANDBOOK OF LABOUR ECONOMICS (Orley Ashenfelter & David Card, eds. 1998)).
reason to assume that better decisions, as opposed to simply more decisions, will be made.

Nevertheless, the operating assumption has been that contingent compensation will provide the necessary motivation. A recent article by Professor Stabile raises some important questions about that assumption, based on research in psychology. This research suggests that the typical performance-based pay plan, which awards stock options for the achievement of certain goals, is poorly structured because it "does not serve as a sufficient motivator of executive performance." The reasons for this," Stabile says, "include high base salaries, the failure to distinguish between individual and group performance, insufficiently high performance barriers, and manipulative behavior."

Another implication of this conclusion is that very large option grants can be counter-productive as the incentive effect that they were supposed to create is diminished. This effect is exacerbated if the exercise price is the grant price because the executive does not have to do much to realize a large return. Yet this describes the options that are becoming increasingly common and generating the huge pay outs to CEOs. Many critics have argued that option grants should carry an exercise price above the market price at the date of grant and above some price that reflects the general increase in the stock market. For accounting reasons, and possibly other reasons as well, firms have typically avoided such "performance options," yet such options seem sensible and find support in social science literature. Thus, large corporations find themselves firmly committed to performance-based plans that may not be providing the incentives sought by them, yet have significant long-term costs to their shareholders.

II. STRUCTURAL DEFICIENCIES OF THE BOARD AS AN EXPLANATION FOR CEO PAY

Regardless of what comparative measure of evaluating CEO pay

78. Indeed, executive compensation in excess of $1 million is not deductible unless performance-based, suggesting that Congress believes that performance-based plans motivate executives to create shareholder value. See infra notes 150-156 and accompanying text.

79. Stabile, supra note 77, at 239-41.

80. Id. at 260.

81. Id.

82. See discussion supra note 46 and accompanying text.

83. See, e.g., Clawson & Klein, supra note 11, at 31; Stabile, supra note 77, at 274.

84. Stock options with an exercise price equal to the market price on the date of issue do not result in a charge against earnings. However, if the price is not at market, under applicable accounting standards, the firm may have a later charge to earnings. See Stabile, supra note 77, at 276-78 (describing in detail the accounting aspects of stock options).
the critic chooses, the overarching explanation, or story, is that the CEO essentially controls the process by which his or her compensation is determined. The CEO, presumably, "hand picks" the outside directors for board service, including service on a compensation committee. The committee, in turn, is advised by a consultant selected by, and beholden to, the CEO. The analysis concludes that the "captured committee" and the "captured board" are simply incapable of bargaining hard with the CEO and, as a result, inevitably overcompensate the CEO. A variant of this story posits that the board and compensation committee consist of CEOs of other companies who have an interest in high CEO pay. Challenges to this story, whether empirical or theoretical, are rare. There are, however, grounds to doubt it.

As a preliminary matter, boards are far more independent of CEOs today than they were, say, twenty years ago when concerns about CEO pay became newsworthy, and this is particularly so since the early 1990s. Independent nominating and compensation com-

85. See Crystal, supra note 2, at 42-50.
86. The passive role of directors has been the prevailing view for decades. See Jay W. Lorsch & Elizabeth Maciver, Pawns or Potentates: The Reality of America's Corporate Boards 1 (1989); Myles L. Mace, Directors: Myth & Reality 1 (1971); Robert A.G. Monks & Nell Minow, Power and Accountability 77-79 (1991).
88. See Crystal, supra note 2, at 43-46, 49.
89. See Elson, supra note 7, at 656-59.
90. See O'Reilly et al., supra note 87, at 262 (discussing the social comparison theory).
91. See Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 Colum. L. Rev. 1283, 1286 (1998) (stating that "many boards of large companies operate in a different mode than they did a few short years ago"). The authors also describe the evolution of the board from passivity to active monitors, which they attribute to efforts by organizations such as the Business Roundtable, the American Law Institute, the National Association of Corporate Directors, the Conference Board, and the American Bar Association in publishing recommendations regarding corporate governance and the initiatives of a few large corporations to change governance structures and competitive pressures as the effectiveness of independent boards becomes more apparent. See id. at 1285-89. According to the authors, boards responded to pressures from institutional investors, takeover firms, and judicial decisions, such as Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990), which recognized the importance of independent, well-informed boards of directors. See id. at 1285 & n.11.
mittees are now common, particularly on stock exchange listed companies.\footnote{92} If anything, the story is based on a somewhat outdated view of corporate governance. Second, the story does not at all account for the pay packages of incoming CEOs, who, by definition, could not have captured the board yet receive large pay packages. The oft-cited example of Michael Eisner’s pay package at Disney illustrates some of these factors. His reported pay in 1993 of $203 million (which nearly equaled his combined pay for the preceding five years) astounded many people but reflected the value of options granted over nearly a decade at Disney, during which time Disney’s stock price rose more than six-fold.\footnote{93} Eisner negotiated this with a board he did not control, and it was the sort of deal that shareholders should applaud.

Third, the story depends on overbearing CEOs and timid boards in literally hundreds of public companies. The CEO must be able to: a) cause the nominating committee to nominate only individuals favorable to him, b) cause the board to appoint patsies to the compensation committee, and then c) dominate the compensation committee. Is this plausible? Are corporate boards heavily populated by individuals who simultaneously have the credentials to direct multibillion-dollar corporations but no capacity to exercise independent judgment when the issue is CEO compensation? A perspective on this issue is provided by a recent study suggesting that the boards of U.S. and Japanese companies exercise similar control over

Korn/Ferry’s 1998 survey of directors shows that the average U.S. board is dominated by outside directors who hold nine of 11 director seats—leaving only two seats for inside directors. Furthermore, companies increasingly are shying away from having those directors who do consulting, legal or other work from serving on the board.

This represents a considerable shift from 1973, when our survey found that nearly a quarter of U.S. boards were composed of between 16 and 25 members. More than half the respondents also reported that between four and six inside directors were employed by the corporation and another one or two were consultants to the corporation. Ten years ago, the average board was made up of 14 members—four of whom were insiders.\footnote{Id. This survey also disclosed the increasing use of nominating committees. See id. Seventy-five percent of all boards had nominating committees in 1998, compared to just two percent in 1973. See id.}

\footnote{92. See Millstein & MacAvoy, supra note 91, at 1286 & n.15 (stating that 40.2\% of companies have completely independent nominating committees). Under the current tax code, publicly-held companies are virtually required to have independent compensation committees; otherwise compensation paid to executive officers in excess of $1,000,000 would not be deductible. See infra note 150 and accompanying text. Similarly, under SEC rules, if an independent board committee approves a stock option plan, shareholder approval is not required for purposes of an exemption under section 16(b) of the Securities Act of 1934. See 17 C.F.R. § 240.16b-3(d) (1999).}

\footnote{93. See Jeffrey G. MacIntosh, Executive Compensation: The Importance of Context, in VALUE FOR MONEY: EXECUTIVE COMPENSATION IN THE 1990s 88, 106-07 (Edward Iacobucci ed., 1996).}
Steven Kaplan examined "the relation of top management turnover and cash compensation (salary and bonus) to earnings levels, changes in earnings, stock returns, and sales growth in large [U.S. and] Japanese companies in the 1980s." He concluded that:

Japanese management turnover and compensation respond to all four types of performance measures, and the responses are generally similar to those in the United States. Top executive turnover is negatively related and cash compensation is positively related to earnings, stock, and sales performance. In most cases, the sensitivities in the two countries are not statistically different.

In the context of CEO pay, this study might provide evidence that, relative to Japan, U.S. CEOs do not dominate their boards. The pay and turnover of CEOs in both countries are similarly sensitive to standard measures of performance. If the conventional wisdom that U.S. CEOs virtually dictate their compensation were true, then we might expect them to have similar influence on turnover decisions. In other words, we would expect turnover in the United States to be less sensitive to performance data than in Japan if U.S. CEOs had so much influence over their boards. However, that appears not to be the case.

More importantly, a recent empirical study failed to confirm the hypothesis that "captured" directors or the presence of other CEOs on a compensation committee are correlated with higher levels or changes in CEO pay. This study examined "multiple measurements of board interdependence at the committee level and multiple measurements of CEO compensation over several years." The authors studied a random sample of 200 manufacturing companies on the 1992 Fortune 500 list. The study was unique because the authors looked at changes in both contingent and non-contingent

94. See Kaplan, supra note 24, at 510 (presenting a study of the relationship between executive turnover and compensation and firm performance in U.S. and Japanese firms).
95. Id. at 511.
96. Id. at 512.
97. See id. at 541.
98. See id. Kaplan did find, however, that turnover and compensation in Japan are relatively more sensitive to negative earnings, possibly reflecting the role of bank monitoring in Japan. Id.
100. Id. at 210. The authors defined "interdependent directors" as "[d]irectors appointed during the tenure of an incumbent CEO." Id. at 211. This term is thus equivalent to the term "captured directors" used in the text, which suggests directors who are beholden to the CEO for their board positions and, presumably, easily influenced by the CEO.
101. See id. at 212.
compensation over a three-year period on the theory that the decisions of a compensation committee with respect to contingent compensation (and, to some degree, non-contingent compensation) are only apparent over time.\textsuperscript{102} The results were surprising:

1. Higher proportions of affiliated directors on the compensation committee did not necessarily mean higher levels of CEO pay.\textsuperscript{103} (The authors define "affiliated directors" as directors with personal and/or professional relationships with the firm or its management.)\textsuperscript{104}

2. There was weak statistical support for the hypothesis that a higher proportion of "captured directors" on a compensation committee leads to higher CEO pay.\textsuperscript{105} (The authors did not use the term "captured directors;" instead, they employed the term "interdependent directors," which they defined as "[d]irectors appointed during the tenure of an incumbent CEO.")\textsuperscript{106}

3. Counter to expectations, "[a] high proportion of CEOs on a compensation committee was associated with a lower level of change" in total compensation.\textsuperscript{107}

Assessing these findings, the authors concluded: "In sum, these findings suggest that the presence on compensation committees of high proportions of the directors most implicated in discussions of excessive executive compensation does not result in higher levels of CEO compensation in subsequent years."\textsuperscript{108} One can only speculate on why this is so. One obvious explanation is that directors take their responsibilities seriously and act in the shareholders' interests, not the interest of the CEO. Regardless of the explanation, however, this study suggests caution in mandating reforms to corporate boards. If the relationship between a director and the CEO does not explain the directors' actions on compensation matters, then specifying the characteristics of directors who might serve on a compensation committee or board, with the expectation that a change will occur in CEO compensation, is unwarranted.

\textsuperscript{102} See id.
\textsuperscript{103} See id. at 214.
\textsuperscript{104} Id. at 212.
\textsuperscript{105} See id. at 214-15. In particular, the authors hypothesized that a higher proportion of interdependent directors on the compensation committee would lead to higher non-contingent and total pay in 1992 (the second year) and a higher change in non-contingent pay in 1992. See id. at 211. They concluded that these hypotheses were "not strongly supported." Id. at 214. John E. Core, Robert W. Holthausen, and David F. Larcker similarly concluded that "CEO compensation is higher when . . . there is a greater percentage of the board composed of outside directors." Core et al., supra note 56, at 372.
\textsuperscript{106} Daily et al., supra note 99, at 211.
\textsuperscript{107} Id. at 214 (emphasis added).
\textsuperscript{108} Id.
III. SOME EVIDENCE THAT THE MARKET IS FUNCTIONING

To this point, I have considered the arguments that CEOs are overcompensated and tried to demonstrate that neither the theoretical arguments nor the data unambiguously support the proposition that CEOs are overpaid. This analysis, of course, does not prove that there is an efficient and functioning market setting CEO pay at an appropriate level. There are, however, some indications that a market is functioning. For instance, several studies have found that CEO pay is positively correlated to the complexity of the organization that the CEO is managing.109 One recent study focused on the relationship between, among other things, the degree of a firm's internationalization and the level and structure of CEO compensation.110 Building on earlier work, the authors described the increased complexity of managing an international firm, noting the spatial complexity associated with geographic dispersion of sales, assets, and personnel.111 It is also more difficult and costly for the board to monitor the firm. The authors hypothesized and demonstrated that the pay of CEOs in such firms is higher because the skills needed are a “scarce and valuable resource”112 and because pay reflects a higher proportion of long-term compensation, indicating the difficulty in monitoring the CEO's performance. These findings suggest that market factors may be operating: firms face a smaller pool of qualified executives and therefore offer a more attractive pay package to attract an acceptable CEO. The captured board story does not explain why companies with complex businesses and organizations pay their CEOs more.

There are other indications that the market is operating. A study of data from 120 firms in 1977-81 disclosed that CEOs recruited from outside of the firms are paid significantly more than CEOs recruited internally.113 We would expect this sort of result in a competitive market. In fact, in the market for professional athletes, the athletes are frequently paid significantly more when they become “free agents.” Another indication that CEOs are not overcompensated comes from a 1985 study of the stock price reaction to the unexpected death of a firm's CEO.114 This study demonstrated that,

110. See Wm. Gerard Sanders & Mason A. Carpenter, Internationalization and Firm Governance: The Roles of CEO Compensation, Top Team Composition, and Board Structure, 41 ACAD. MGMT. J. 158, 158 (1998). The authors also found that the more internationalized firms tended to have larger top management teams and separate CEOs and board chairs. See id. at 172.
111. See id. at 162.
112. Id.
113. See Deckop, supra note 31, at 225.
114. See generally W. Bruce Johnson et al., An Analysis of the Stock Price Reaction to Sudden Executive Deaths: Implications for the Managerial Labor
on average, the market reacted negatively to the news, suggesting that investors view the CEO as adding value to the firm.\textsuperscript{115} If the CEO could be replaced with someone earning less or performing more effectively, we would expect the stock price, on average, to rise. It did not.

Against this empirical research—which does not resolve the question of whether CEOs are overcompensated—I next consider the reforms recommended to deal with the supposed problem. The important inquiry here is whether reforms will accomplish their intended purpose and, if so, at what cost to the corporation.

IV. ATTEMPTS AT REFORM

A. Judicial Activism

The foregoing discussion, which suggests the difficulty of determining whether CEOs are paid excessively, highlights the problem that courts would face were this a litigated issue.\textsuperscript{116} In part for this reason, the courts have shied away from cases alleging excessive compensation, instead deferring to the judgment of the directors under the business judgment rule.\textsuperscript{117} Nonetheless, from time to time, academics have called on the judiciary to play a role.\textsuperscript{118} Professor Detlev Vagts, after describing the roles that directors and shareholders might play in “keep[ing] compensation from getting out of control,”\textsuperscript{119} recommended that, when they fail, the courts should step in and, using “comparative data,” adjust the level of compensation.\textsuperscript{120} The problem with this approach is, of course, that the use of comparative data may be a source of the problem and not its solution.

\begin{footnotes}
\item[115] See id. at 162-64.
\item[116] Indeed, the judiciary long ago recognized the difficulties a court faces in this area. The New York Supreme Court, in a 1941 decision, summarized the difficulties well:

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


\item[119] Vagts, supra note 8, at 275.

\item[120] See id. at 276.
\end{footnotes}
Were courts to rely on such data, they likely would not be comfortable setting compensation and, if they were, they would be deluged with litigation. In any case, judicial involvement in cases involving excessive compensation typically has been limited to cases involving stock option grants, golden parachutes, and pension grants, where the legal issues were limited to consideration or contract interpretation, matters that the courts feel competent to handle.121

A recent example of such involvement was Sanders v. Wang,122 a highly publicized Delaware Court of Chancery case involving Computer Associates. The corporation, in a plan approved by its shareholders, authorized the board to grant up to 6,000,000 shares of the company’s common stock to three key officers of the company if certain performance goals were attained.123 Interestingly, these goals related to the company’s stock price,124 just the sort of incentive plan that pay-for-performance advocates favor. The problem arose because the plan did not provide for an adjustment of the number of shares that might be granted in the event of a stock split, which occurred here.125 The board, acting under a general provision of the plan that authorized it to interpret and administer the plan, increased the stock award to take the splits into account, so that the officers received 20.25 million shares126 worth over $1.08 billion.127

Shareholders, in a derivative action, challenged the board’s action as a breach of the plan (which the court characterized as a contract between the board and the shareholders) and a violation of the board’s fiduciary duties.128 The court held in favor of the plaintiffs on the theory that the plan’s terms were plain and unambiguous: it authorized grants of up to 6,000,000 shares and no more.129 Defendants’ arguments that the intent of the plan was to award the participating officers 3.75% of the company’s equity if the performance goals were obtained was rejected by the court.130 Similarly, the court found no inconsistency between the provision specifying the number of shares and the provision empowering the board to administer and interpret the plan.131

The court likely was influenced by the sheer size of the award, noting that “even under the strictest reading of the Plan, the three Participants will together still receive nearly $320 million. $320

121. See Loewenstein, supra note 117, at 215 & n.71.
123. See id. at *1-5-2.
124. See id. at *2.
125. See id. There were three separate “three for two” stock splits. See id.
126. See id.
127. See id. at *4.
128. See id. at *2-9.
129. See id. at *9.
130. See id.
131. See id.
million is no mere bagatelle.\textsuperscript{132} If the size of the award influenced the court, then the outcome is unfortunate. The defendants pointed out that, had there been a reverse stock split, surely the directors would have been obliged to adjust downward the number of shares that might be awarded under the plan, but the court did not think such considerations relevant in light of the plain meaning rule.\textsuperscript{133} While an examination of the plain meaning rule is beyond the scope of this Article, its application often frustrates the intent of the parties, prompting many courts and commentators to view it with skepticism.\textsuperscript{134} The effect of the court’s ruling may be to jeopardize other similar plans where the drafters failed to include an adjustment clause, even if the intent was to protect the beneficiaries of the plan from the adverse effects of a stock split.

Finally, the court’s characterization of the plan as a “contract” between the board and the shareholders is strained.\textsuperscript{135} The plan seems better characterized as a contract between the corporation and the participants under the plan. As such, the board clearly was granted broad authority to interpret and administer the plan to act in place of the shareholders who, having approved the plan, delegated the implementation of the plan to the board on their behalf. In other words, the responsibility of the board with respect to the plan does not differ from its normal responsibilities to manage the business and affairs of the firm in the interests of the shareholders, as the firm’s residual claimants. The courts typically defer to business judgments of the board when it acts in that capacity. By characterizing the plan as something different, the court was able to consider the merits of the board’s decision, which it found lacking.\textsuperscript{136}

My point is not just that Sanders is a questionable decision, although it is that. Rather, my concern is that judicial review of compensation decisions is troublesome when undertaken directly or indirectly. Courts should resist the temptation to weigh in on these issues because doing so jeopardizes other prudential concerns. Sanders may have created an unfortunate precedent under the business judgment rule.

B. Increased Disclosure

Another reform calls for increased disclosure of executive compensation. The Securities and Exchange Commission (“SEC”) has dealt with this issue more than once, most recently in 1992.\textsuperscript{137} The

\begin{itemize}
\item \textsuperscript{132} Id. at *7.
\item \textsuperscript{133} See id.
\item \textsuperscript{134} See, e.g., Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 644 (Cal. 1968).
\item \textsuperscript{135} Sanders, 1999 WL 1044880, at *5-*6.
\item \textsuperscript{136} See id. at *6-*7.
\item \textsuperscript{137} See generally Executive Compensation Disclosure, 57 Fed. Reg. 48126 (1992) (to be codified at 17 C.F.R. pts. 228, 229, 240 & 249) (outlining amendments to executive compensation disclosure requirements intended to make
current rules require disclosure of a good deal of information, as much as any conscientious shareholder is likely to want.\textsuperscript{138} The rules were promulgated in an atmosphere of intense public interest over executive compensation and, thus, may reflect a political attempt at limiting compensation.\textsuperscript{139} Some commentators have speculated that disclosure has caused directors to limit performance-based compensation plans and levels of compensation out of fear that the resulting compensation would generate criticism,\textsuperscript{140} and there is reason to believe that disclosure might have a restraining effect on the level of compensation. With extensive disclosure, shareholders inclined to monitor the firm’s performance will have a lower cost of monitoring. In firms with ownership concentrated in large institutional investors—which are generally the largest firms with the highest CEO compensation—we might expect those investors to pressure the board on compensation issues. Indeed, the California Public Employees Retirement System (“CalPERS”) has gained a reputation for doing so.\textsuperscript{141} This reputation, in turn, increases CalPERS’ ability to influence other firms in which it has invested. Finally, disclosure obligations may encourage compensation committees to exercise particular care in crafting their plans in light of possible public scrutiny. So, disclosure encourages better compensation plans (in terms of aligning managers’ interests with the shareholders’) and restraint on the level of compensation.

On the other hand, there is reason to believe that disclosure may have the effect of increasing compensation levels.\textsuperscript{142} Remember, one of the intended effects of disclosure is to encourage boards to make pay plans more sensitive to, and thus contingent upon, performance.\textsuperscript{143} Boards or compensation committees negotiating with the CEO are motivated to increase the contingent portion of the compensation disclosure clearer, more concise, and more useful to shareholders).

\textsuperscript{138} See Loewenstein, supra note 117, at 216 for a summary of these rules.


\textsuperscript{140} See Jensen & Murphy, Performance Pay, supra note 5, at 262.

\textsuperscript{141} As a result of the 1992 changes in the federal proxy rules, shareholders have greater freedom to communicate their positions on voting matters. See 17 C.F.R. § 240.14a-1(1)(2)(iv) (1997). As a result, CalPERS has created a web site to announce its votes and policies on voting. See CalPERS, CalPERS Shareowner Forum (visited Feb. 15, 2000) <http://www.calpers-governance.org/forumhome.asp>. Such communications may pressure boards to respond to shareholder demands. See generally Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 Ind. L.J. 59 (1992) (discussing the power of institutional investors to influence compensation plans).

\textsuperscript{142} See Iacobucci, supra note 34, at 490. I have drawn on the work of Professor Edward M. Iacobucci for this theory.

\textsuperscript{143} See id. at 505.
compensation package, possibly at the expense of the fixed, non-contingent portion of the package, but the CEO is likely to be risk-averse. This risk aversion makes the CEO resistant to lowering the fixed portion of his or her compensation to substitute an equally valuable, but more risky, performance-based plan. The result is that disclosure pushes firms to more contingent pay (without a corresponding reduction in non-contingent pay), and the contingent pay, if it does what it is supposed to do, motivates the CEO to manage the firm in a way that increases its return to shareholders. Thus, higher compensation is inevitable and should occur without regard to the "ratcheting effect" discussed above.

Professor Murphy put it well: "[S]atisfying shareholders by increasing pay-performance sensitivities ultimately implies higher, not lower, levels of pay ...." Moreover, as most contingent pay is in the form of stock options, the value of which is reported when exercised, the list of "top earners" is skewed as their compensation reflects options granted and share gains over a period of time. Finally, the effect is enhanced during periods of broad stock market increases like we are currently experiencing.

The possibility that increased disclosure increases compensation levels is an example of the potentially unintended effects of regulation. While the SEC is unlikely to reverse itself and lessen the amount of disclosure, it is clear that disclosure should not be regarded as an effective limitation on compensation.

C. Tax Reform

Tax reform reflects another governmental response to the "executive compensation" crisis. At about the time the SEC increased disclosure requirements, Congress amended the tax code to limit the deductibility of compensation in excess of $1,000,000 paid to executive officers of publicly-held companies unless the excess compensation is paid pursuant to performance-based plans meeting certain criteria. As in the case of disclosure reform, tax reform is unlikely

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144. See id. at 508-09. Risk aversion aside, another factor that makes the CEO resistant to substituting non-contingent pay for equally valuable contingent pay is the "endowment effect." See id. Individuals generally are unwilling to give up something they have for something of equal value, classical economic theory to the contrary notwithstanding. See id.

145. See id. at 510.

146. See id. at 505; see also Jensen & Murphy, CEO Incentives, supra note 5, at 139 (recognizing that contingent increases in CEO compensation result in potential gains to shareholders because CEOs would probably employ greater effort).

147. Supra text accompanying notes 33-41.

148. Murphy, supra note 32, at 714.


150. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66,
to limit compensation, and it may fuel the increase of compensation. Boards are encouraged to adopt incentive plans tied to stock price. Generally, this means stock option plans with large option grants provide incentives and align executive and shareholder interests. Again, if the plans do what they are supposed to do—motivate management—compensation should rise. Moreover, if these plans are on top of existing compensation plans, compensation may well rise dramatically, particularly if stock prices generally are rising. Indeed, that appears to be the case.\textsuperscript{151}

The law also has another feature likely to cause an increase in compensation. Under the legislation, a plan qualifies as performance-based only if, among other things,\textsuperscript{152} the plan’s performance goals are non-discretionary.\textsuperscript{153} However, IRS regulations permit discretion to reduce, but not increase, a performance bonus.\textsuperscript{154} Consequently, to approximate its pre-legislation discretion, compensation plans may provide a larger bonus pool than they otherwise might have prior to the legislation and then provide that individual awards may, in the committee’s discretion, be reduced. Having created a larger pool, however, there will be pressure on the committee to award the entire pool or, at least, to award more than it would have under prior plans. Thus, compensation may be increased,\textsuperscript{155} and there is some evidence that this is occurring.\textsuperscript{156} In short, Congressional efforts to limit compensation through the tax code are proving to be weak and ineffectual, at best.

D. Shareholder Involvement

Shareholders can express their concern over executive compensation in several different ways. First, they can sell their stock or refuse to invest in companies that, in their view, overcompensate their executives (or any employees, for that matter). Increasingly, however, institutional shareholders are finding this option unattractive. If one believes that excessive pay is pervasive in corporate America, then exiting one company would logically mean exiting the

\begin{footnotesize}
\begin{enumerate}
\item Performance-based plans must meet the following criteria: 1) the goal was determined by a committee of the board of directors comprised solely of two or more “outside” directors; 2) the shareholders approved the goals by a majority vote; and 3) prior to the payment of the performance compensation, the board’s compensation committee verified the propriety of the payment. \textit{See id.} See \textit{generally} Loewenstein, \textit{supra} note 117, at 217-21 (critiquing the amendments); Kevin J. Ryan, \textit{Note, Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary}, 15 VA. TAX REV. 371, 379 (1995) (describing the amendments as they were proposed).
\item \textsuperscript{151} \textit{See Loewenstein, supra} note 117, at 219-20.
\item \textsuperscript{152} \textit{See Omnibus Budget Reconciliation Act of 1993, I.R.C. § 162(m) (1998).}
\item \textsuperscript{153} \textit{See id.}
\item \textsuperscript{154} \textit{See id.}
\item \textsuperscript{155} \textit{See Murphy, supra} note 32, at 739.
\item \textsuperscript{156} \textit{See Loewenstein, supra} note 117, at 218 & n.80.
\end{enumerate}
\end{footnotesize}
market. For institutions whose charter or announced investment policy includes the equities of large U.S. companies, or for individual investors who view the market as an integral part of their investment plans, this obviously is not an option.

Second, shareholders can communicate with their boards or fellow shareholders either directly or through formal proposals. The latter can take the form of proposals under Rule 14a-8 of the federal proxy rules. These proposals would not be self-executing and only constitute recommendations to the board, or bylaw amendments, which would become part of the governance structure of the corporation. Bylaw amendments, especially those dealing with pay issues, are a relatively recent phenomenon. In 1998, the SEC took the view that shareholders could use Rule 14a-8 to propose bylaw amendments related to pay practices. In 1992, the SEC had reached a similar view with respect to non-binding shareholder proposals dealing with senior executive compensation. In each case, the issue was whether such proposals would be excludable as relating to the ordinary business operations of the corporation. Now, depending on the applicable state law and the corporation’s articles of incorporation, shareholders can use either means to affect pay practices.

Whether as bylaw amendments or non-binding recommendations, shareholder proposals in this area generally have not fared well. The Investor Responsibility Research Center tracked ninety-two shareholder proposals dealing with compensation issues, including director compensation, in 1998. For present purposes,


158. Shareholders can also express their concern over executive compensation policies by voting against management-sponsored proposals, such as those seeking approval of stock option plans or voting against management’s slate of directors in a so-called “Just Vote No” campaign. Negative votes on stock option plans have increased in recent years, prompting management to avoid seeking shareholder approval, if possible. See Wagner & Wagner, supra note 65, at 10-11. See generally Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 STAN. L. REV. 857 (1993) (regarding the “Just Vote No” approach).


161. See id. at 79,337, 79,338; General DataComm Indus., Inc., supra note 159, at 78,475, 78,473.


only three categories of proposals are of particular interest. These categories deal with the amount or manner of payment of executive compensation: proposals that restrict executive compensation, proposals that require approval of executive compensation, and proposals that would restrict repricing of options without shareholder approval. The average vote for these proposals was 9.2%, 13.6%, and 27.6%, respectively. Except for the third category, dealing with repricing of options, the average vote indicates that shareholder concern about the level of executive compensation is not high. The paucity of proposals among shareholders also is reflective of a general malaise; there were only fifteen proposals to restrict executive compensation, down from twenty-nine proposals in 1997.

While the repricing issue reflects some shareholder concern, there were only three proposals raising the issue, and they may have related to situations in which repricing was particularly abusive, at least in the eyes of activist shareholders.

The apparent inconsistency between the outrage expressed in the popular press and the lack of shareholder voice may have several explanations. The obvious explanation is that, except for a few instances in which poorly performing companies repriced the stock options of their executives, shareholders generally are pleased with the compensation policies of their companies. Alternatively, one might argue that shareholders are apathetic and often fail to open their proxy materials, much less take the time to complete a proxy card and mail it back to the company. Thus, one should not infer much from the low vote totals or the lack of proposals. While there is truth to this explanation—public companies often struggle to get a quorum at their meetings—there is also reason to doubt the explanation. Some corporate governance proposals frequently are proposed and well received. For instance, there were seven proposals in 1998 recommending the repeal of classified boards, receiving, on average, a 47.3% approval. There were thirteen proposals to repeal or vote on poison pills, receiving, on average, 57.4% approval. This suggests that, when shareholders perceive an issue as affecting the value of their investment, they will take the time to express their preferences even if, as is the case in shareholder proposals, their preferences are not binding. If true, this means that shareholders

165. See INVESTOR RESPONSIBILITY RESEARCH CTR., supra note 163, at 2.
166. See id. at 2.
167. See id.
168. See id.
169. See Newbury, supra note 164, at 3.
170. See id.
171. See id.
do not perceive executive compensation issues as affecting share values.

I have recommended elsewhere that shareholders should vote annually on CEO pay, in the form of a non-binding advisory vote. The concept is that much of the speculation of shareholder discontent can be confirmed or denied if there is a shareholder vote. While the sparse data available, as noted above, suggests that shareholders are not discontented, this proposal would provide more convincing data. My guess is that shareholders understand the relationship between pay and performance and will not vote against a package that provides the right incentives, irrespective of the potential size of the proposal. If shareholders do vote not to ratify, then a significant message is sent to the board, which would be difficult to ignore. This is especially so if, as a matter of practice, shareholders generally ratify the package. If the shareholders fail to ratify what is otherwise a sound plan, in the sense that it provides the right incentives to management, then they will bear the burden of their decision.

In any event, there is some reason to believe that management pays attention to shareholder votes on compensation matters. A recent article by Randall S. Thomas and Kenneth J. Martin examined the effect that shareholder votes on compensation proposals had on future compensation practices. They found that companies targeted with compensation proposals tend to increase CEO pay the following year much less than comparable firms not receiving proposals. This suggests that boards are sensitive to shareholder concerns and that an annual advisory vote might influence corporate policies.

CONCLUSION

A review of the now voluminous research on executive compensation suggests a number of unresolved conundrums:

1. Do the empirical studies of CEO compensation establish that CEOs are overpaid, or is the market functioning?

172. See Loewenstein, supra note 117, at 221-23.
173. Indeed, the Computer Associates plan, though controversial in its implementation, received shareholder approval. See supra notes 122-36 and accompanying text.
174. Thomas & Martin, supra note 162.
175. See id. at 1022. The authors also found that targeted firms tended to shift CEO compensation more toward cash and less in terms of long-term incentive compensation. See id. If true, this may mean that boards shy away from performance-based compensation presumably because it can result in such large payoffs for executives. If so, this might be an unfortunate consequence of shareholder activism, as Jensen and Murphy predicted. Jensen & Murphy, Performance Pay, supra note 5, at 262 (hypothesizing “that political forces operating both in the public sector and inside organizations limit large payoffs for exceptional performance”).
2. Does the relatively higher pay of U.S. CEOs, in comparison to their foreign counterparts, reflect an economically efficient solution to the agency problem?

3. Does greater disclosure of executive compensation result in an increase or decrease in compensation?

4. Does correlating CEO pay to accounting goals add to long-term shareholder wealth more effectively than correlating pay to share prices?

5. If CEOs exercise undue influence over their boards, why are these same boards capable of removing poor performing CEOs, but incapable of compensating them within reasonable limits?

6. Do tax laws that encourage performance-based pay provide the proper incentives for their participants?

7. Have performance-based plans shifted too much equity to management?

8. If CEO pay is excessive, why do shareholders, when given the opportunity, fail to express dissatisfaction?

The controversy that accompanies each of these problems indicates both that further research is in order and that governmental solutions are not. While many empirical studies that I reviewed in preparing this Article had suggestions for further empirical studies, none suggested that the principal actors be interviewed to determine what boards were trying to achieve with their compensation plans, why they chose the plans that they did, and how they tested the effectiveness of their plans. What seems to be lacking in this area is an anthropological type of study, in which researchers would study the firm from the inside, discussing with the compensation committee and other directors how they arrived at their decisions, examining what sorts of negotiations took place, and how various performance measures influenced pay decisions.

Some theories are only, or at least best, verified by such research. For instance, some researchers have speculated that boards set CEO compensation very high to create a "tournament effect." The theory is that to motivate lower level managers, CEO pay is set disproportionately high in relation to the next tier of managers. The chance of winning the "lottery," that is, the CEO pay, motivates managers and is an efficient means to address the agency problem. Researchers tested this theory by hypothesizing that, if the tournament effect explained compensation, then one would expect that the

176. See Edward Lazear & Sherwin Rosen, Rank-order Tournaments as Optimum Labor Contracts, 89 J. Pol. Econ. 841, 841-42 (1981) (delivering one of the early statements of the theory); O'Reilly et al., supra note 87, at 260 (conducting an empirical test of the tournament theory).

177. See O'Reilly et al., supra note 87, at 260.
larger the number of vice presidents in a firm, the greater the difference between average CEO and vice president pay levels. The hypothesis was easily tested, using data on executive compensation. While one can doubt the soundness of the hypothesis, the very nature of the problem seems to compel an entirely different sort of methodology. Asking compensation committees about the extent to which concepts like the tournament effect influenced their thinking would seem to be far more revealing than an empirical study of pay differentials.

There is some precedent for this type of work; two legal anthropologists studied how pension funds make investment decisions, in part to test the conventional wisdom that money managers were short-term oriented. Their work was interesting and valuable. Unhappily, this type of research, which can lead to valuable insights, is not only ignored, but terribly out of fashion. Indeed, the trend in corporate law is heavily in the direction of empirical work, and law reviews increasingly are looking like quantitative management journals. The area of executive compensation is one, however, that would benefit from the use of other means of analysis, as traditional tools are unable to tell us the extent to which comparative tables or tax considerations influence compensation decisions, or resolve many of the other questions in this area. I suggest here one such tool for further research.

178. See id. at 261.

179. The hypothesis seems to ignore the typical salary structure, in which relatively high pay to the top tier of vice presidents may provide incentives to the next tier, and so forth. The “prize” is thus not just the CEO pay, but possibly other levels within the corporation.