EXHIBIT “M-8”
Opening Statement of Sen. Chuck Grassley, Chairman
Finance Committee Hearing, "Executive Compensation: Backdating to the Future/Oversight of current issues regarding executive compensation including backdating of stock options; and tax treatment of executive compensation, retirement and benefits"
Wednesday, Sept. 6, 2006

We all know that the American work ethic is unrivaled anywhere in the world. We have always wanted a better life for our children and our grandchildren. That is a part of our heritage that connects all of us together as Americans. Not only do we work harder than anyone else in the world, we also work smarter. Entrepreneurship, innovation, and technological advancement have been hallmarks of the American economy from our colonial times until today. We remember the spirit of invention of our founding fathers such as Benjamin Franklin and Thomas Jefferson down through the generations to Thomas Edison, Henry Ford, and today’s Silicon Valley leaders and pioneers.

It is Americans’ work ethic, coupled with our relentless thirst for innovation, that has led us to be the greatest economy that the world has ever seen. The greatness of our economy and our society also rests on some other fundamental principles. We are a capitalist society that believes strongly in the power of free markets to improve standards of living – not just here, but around the world. We believe in the “American dream” – the idea that we all have an opportunity to achieve as much and advance as far as our ability and our work ethic will take us. Underpinning that concept is the idea of fairness – that an honest day’s work will mean an honest day’s pay. The factory worker who puts in his eight hours (or more in many cases) knows that he will be paid for the hours he works – no more, no less. Similarly, a farmer who has worked hard in his fields all season takes his crop to market and gets paid the market price for that delivery date. He or she doesn’t have the option to say, “I want to sell my crops for the price two months earlier when the market was better.”

This is the concept of an honest day’s work for an honest day’s pay in our free market economy. Our capitalist system creates winners and losers, but it is supposed to do so in a way that is fair to all and from which we all ultimately benefit. These are our American values. And we as Americans also believe in the supremacy of the rule of law as the ultimate enforcer of our American values. When anyone threatens our fundamental principles, we must take it very seriously, or risk losing our greatness as a nation.

Today, we will hear about behavior at some of our largest companies that is such a threat. It is behavior that, to put it bluntly, is disgusting and repulsive. It is behavior that ignores the concept of an “honest day’s work for an honest day’s pay” and replaces it with a phrase that we hear all too often today, “I’m going to get mine.” Even worse in this situation, most of the perpetrators had already gotten “theirs” in the form of six- and seven-figure compensation packages of which most working Americans can only dream. But apparently that was not enough for some.
Instead, shareholders and rank-and-file employees were ripped off by senior executives who rigged stock option programs — through a process called “back-dating” — to further enrich themselves. And as we have found far too often in corporate scandals of recent years, boards of directors were either asleep at the switch, or in some cases, willing accomplices themselves. We will hear today from the Justice Department, the SEC, and the IRS about how they are responding to this unfolding scandal and what we as a Congress can do to aid their efforts. We will also hear about executive compensation issues more generally — both from our panel of government witnesses and from a second panel of experts in the area.

It is important that we defend the American principles of capitalism and free market innovation, and it is also important that we defend the equally important American principles of fairness and the rule of law. These are not conflicting principles. They are the backbone of our nation. And those who violate them need to answer for that.
I thank today's panelists. This has been a very informative hearing. I am a great believer in conducting oversight of the tax code and we need more of it from the press, GAO and the Inspector General. Clearly, we've learned today that 162(m) is broken. The 1993 law – part of a bill that I did not support or vote for, I should make clear – was meant by its advocates to deny tax deductions when there was a great deviation between what executives got paid and what people further down the ladder got paid. It was well-intentioned. But it really hasn't worked at all. Companies have found it easy to get around the law. It has more holes than Swiss cheese. And it seems to have encouraged the options industry. These sophisticated folks are working with Swiss watch-like devices to game this Swiss cheese-like rule.

I want to know what went wrong and consider whether it makes sense to make changes. Modifying the deduction for performance-based pay or at least tightening up the eligibility are possibilities I think members of the Finance Committee will want to consider based on comments made at this hearing. Today's hearing is helpful in sorting through the pros and cons of changing the deduction and possible alternatives. It's challenging for Congress to stay one step ahead of some companies that try to exploit tax loopholes faster than we can close them.

I will be reviewing today's record, submitted material and questions for the record to consider next steps. If we are going to keep this code section, I think a question that needs to be answered is whether it is equitable to treat high salaries of top executives at publicly traded companies differently than high salaries of other individuals.

We've also heard today troubling testimony about the wide disparity of treatment between regular workers and top executives when it comes to deferred compensation, pensions and health insurance. The President's panel on tax reform touched on some of these same issues as well and they deserve our close attention. Workers who make their living paycheck to paycheck have a right to expect fair tax treatment of their earnings, savings and retirement as compared to the boss.

Finally, I fear that we have a new set of problems behind this backdating – all the individuals who supported this illegal activity. This includes the board members, the attorneys, the accountants and the outside consultants who all either blessed or looked the other way when it comes to backdating. In response to this hearing, I intend to write to several major corporations that have been involved in the backdating of stock options. I want these corporations to provide me the board minutes regarding the decision to backdate as well as any and all material from advisors – including
attorneys, accountants and compensation consultants who assisted in these efforts. We need to understand and bring enforcement action against all the actors who were involved with this abusive scandal.
EXHIBIT "M-9"
In the Wilderness of Sinai, when the Children of Israel gathered manna from heaven, the Book of Exodus reports: “[H]e who gathered much did not have too much, and he who gathered little did not have too little.”

Unfortunately, these days, we cannot say the same about executive compensation. We regularly hear reports of executives who gathered much. And we not infrequently hear reports of some executives who gathered much too much.

For example, in 2001, the CEO of Tyco received a compensation package of $36 million. This CEO was later indicted for grand larceny, enterprise corruption, falsifying records, and sales tax evasion.

In 2002, the CEO of Sun received $25 million.

And we can’t forget Lee Raymond, who retired from ExxonMobil in January. In April, we read that he received a retirement compensation package valued at about $400 million.

In 2004, the average compensation for top executives at the country’s largest publicly-held corporations rose to $9.6 million. That’s more than 300 times the wages of the average worker.

From 2003 to 2004, executive compensation increased by about 16 percent. At the same time, compensation for the rank-and-file worker rose by about two percent. And last week’s news reported that wages for working-age Americans declined in 2005.

And the Congressional Research Service found that firms that announce layoffs tend to give their CEOs comparatively larger pay packages and greater percentage raises than firms that did not announce layoffs.
How have companies been able to pay their executives such large compensation packages? That’s what we’re here to talk about today. Today, we address executive compensation and how the tax law treats it.

Now I have nothing against people earning a good living. America is a land of opportunity. America is a place where people can invent the new idea, make the new product, and make a good deal of money doing it. God bless them!

But we are also reading reports that some in corporate America are apparently backdating stock options to boost top executive compensation. We read that the authorities are investigating dozens of companies and executives for this latest corporate scandal. Today we will look into the backdating of stock options.

And today, we will hear about the interplay between the tax rules and executive compensation. Yes, America is a land where people can make a great deal of money. But that’s one of the reasons that we have a progressive income tax. Today, we will talk about whether America’s tax system helps to promote fairness.

Fairness is important. No one wants to pay too much money to the Federal Government - or to anyone else for that matter. Most folks want to pay their fair share.

But some appear to be working to buck the system. Some appear to be spending their time searching for loopholes in the tax laws. These people appear to be working aggressively to avoid paying their fair share of the taxes.

So I am glad that the Finance Committee is looking into the subject of executive compensation. It is high time that we discussed some of the abuses that are taking place. It is high time that we tried to close the loopholes. And it is high time that we focused on the fairness of the tax code. A fair tax code should not be as rare as manna from heaven.

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EXHIBIT "M-10"
STATEMENT

OF

PAUL J. McNULTY
DEPUTY ATTORNEY GENERAL
UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

“EXECUTIVE COMPENSATION:
BACKDATING TO THE FUTURE, OVERSIGHT OF CURRENT ISSUES
REGARDING EXECUTIVE COMPENSATION
INCLUDING BACKDATING OF STOCK OPTIONS; TAX TREATMENT OF
EXECUTIVE COMPENSATION, RETIREMENT AND BENEFITS”

PRESENTED ON

SEPTEMBER 6, 2006
September 6, 2006

Chairman Grassley and Members of the Committee, thank you for the opportunity to be here today to discuss the practice of backdating stock option grants to executives at publicly-held corporations. As you know, this practice received wide-spread publicity when it was initially uncovered, and it is now being investigated by civil regulators and by the Department of Justice.

Let me begin my testimony with a brief description of the mechanics of this practice and then discuss how it can violate the criminal statutes. Options are contractual rights to purchase a share of stock on a future date at a set price (known as the "strike" price”), and they are often granted to corporate employees as part of their compensation package. Under most plans, the employees cannot exercise the options until a vesting period has passed. Typically, the strike price is the market or trading price of the stock on the day the option was granted by the corporation’s board of directors, commonly acting through its compensation committee. The employee can buy the stock at the end of the vesting period at the strike price and realize a profit by selling it when it is trading at a higher price than the strike price. Thus, options are often granted to give employees incentives to work hard – their hard work will theoretically result in more profit for the company and a corresponding increase in the market price of the stock.
Of most concern in the practice of backdating options is that when certain options are granted the options are already “in the money” or show a profit to the option-holder. It might be beneficial to define some of these terms so that in discussing this issue, we are all using a common vocabulary. Let me differentiate between “at the money” and “in the money.” Options with a strike price equal to the current trading price of the underlying stock are referred to as being “at the money” and options with a strike price below the current trading price of the stock are “in the money.” The practice we are investigating involves stock options that are backdated so that they are “in the money” at the time of the grant. Options that are “in the money” give the option-holder a paper profit, since they have a value based on the difference between the strike price and the current higher trading price, even though the employee has not exercised the option and sold the stock. When options are backdated in this way, the strike price is fixed on a certain date when that day’s market price for the stock was lower, but in actual fact, the options were granted at a later date when the share price of the stock was higher. The practice of backdating allows corporate wrongdoers to fix a lower strike price for the options, locking in an immediate gain to the option holder.

Significant accounting, disclosure and tax consequences resulting from grants of “in the money” options provide an incentive for corporate executives to covertly backdate these options. As a result, some corporate executives have engaged in schemes to falsify corporate books and records, to mislead the corporation’s board of directors and outside auditors, to file false reports and financial statements with the Securities and Exchange Commission (SEC), and to mislead shareholders, the investing public and the financial press.
a grant of “in the money” options is treated under accounting principles as compensation to the option holder, and therefore should be treated as an expense by the corporation and be deducted from reported revenue. In contrast, grants of options with an exercise price either above or at the trading price on the real grant date are not considered an expense of the corporation. Thus, if a corporation both backdates options and prices them “in the money” without properly disclosing this fact, the corporation is falsifying its books and records, fraudulently decreasing expenses and falsely inflating profits. Second, backdating of stock options also conceals the fact that employees are being given the right to purchase the underlying stock at a discount from the fair market value on the date the option was really granted – and that misrepresents the employee’s compensation. Finally, the sale of the underlying stock to these favored employees at a discount to the market price dilutes the value of the shares held by stockholders.

Corporations are required to accurately report compensation and other remuneration to officers, including the nature of the compensation. Corporations are also required to accurately describe the stock option plans for which they request shareholder approval. When stock options are surreptitiously backdated, the corporation will file false and misleading reports and financial statements with the SEC and other regulatory authorities. By doing that, the corporation disseminates false and fraudulent information to the investing public. Failing to report the backdating of options misrepresents the true nature of stock option plans and executive compensation and thus, a company obtains shareholder approval for the company’s compensation plans under false pretenses. Grants of backdated options contrary to the terms of shareholder-approved option compensation plans can also be considered an embezzlement of corporate assets because the defendants are misappropriating shares of the company at an
Secretly backdating options to a date with a lower market price may also have tax consequences for the employee and the corporation. If the stock option is a qualifying Incentive Stock Option, the employee can, under certain circumstances, defer tax for many years and pay tax at lower capital gains rates. However, to qualify as an Incentive Stock Option, the option price must not be "in the money" or less than the fair market value at the time of the grant; otherwise, the employee must pay ordinary income tax rates when the option is exercised. Also, corporations may not qualify under the Internal Revenue Code for certain deductions for stock issued under "in the money" options to highly paid executives. Consequently, backdating options may lead to the filing of false tax returns by the corporation and the employee if the true nature of the option is misrepresented.

When this practice was first disclosed, the Department of Justice moved quickly to determine whether it warranted criminal investigation. Many companies had restated their earnings and made public filings to that effect. At the same time, the United States Attorneys' Offices throughout the country, assisted by agents of the Federal Bureau of Investigation, initiated contact with the SEC and began to investigate. In Silicon Valley, where much of this backdating occurred, an organized team approach to assess the criminal implications of backdating was needed. On July 13, 2006, the United States Attorney for the Northern District of California announced the formation of a stock options backdating task force to investigate allegations that corporations and individuals in Northern California had "retroactively changed the grant dates of stock options with the intent to defraud." The Task Force, consisting of personnel from the United States Attorney's Office and the FBI, is investigating companies in
engaged in fraudulent option backdating or related criminal conduct.

To date, there have been two criminal cases filed alleging that backdating of options constituted violations of the federal securities laws and other criminal statutes. In *United States v. Reyes, et al.*, an eight count indictment was filed in the United States District Court for the Northern District of California, charging the former CEO, President and Chairman, and the former Vice President of Human Resources of Brocade Communications Systems, Inc., with conspiracy, securities and mail fraud and falsifying books and records. The allegations involve a scheme from 2000 to 2004 to defraud Brocade, the Board of Directors, its shareholders and auditors, the public and the SEC when the defendants caused the corporation to grant “in the money” options to both new and current employees by backdating documents to make it appear the options were issued at fair market value -- concealing millions of dollars in expenses from investors. The defendants allegedly created false documents such as employment offer letters and compensation committee minutes which purported to document that options were granted to employees earlier and at a lower price than they actually were granted. The government alleges these activities resulted in the creation of false and misleading financial statements, audited reports and other documents and false filings with the SEC.

In *United States v. Jacob Alexander, et al.*, in a Criminal Complaint filed in the Eastern District of New York, the former CEO, CFO and General Counsel of Comverse Technology, Inc., are charged with conspiracy to commit securities fraud, wire fraud and mail fraud for a fraudulent scheme between 1998 and 2002 to grant secretly backdated “in the money” options to themselves and others. It is alleged that they backdated stock option grants to coincide with low
closing prices of the underlying stock. According to the Complaint, two of the defendants also
created a “slush fund” by causing backdated options to be issued to fictitious employees and
later used these options to recruit and retain key employees. Finally, it is alleged that they made
material misrepresentations to Comverse investors, issued false proxy statements, and filed false
reports and financial statements that concealed and misrepresented the results of operations and
expenses of Comverse.

The cases I have just described have only recently been indicted and the defendants are
presumed innocent of these allegations, unless and until proven guilty in a court of law.

Backdating cases that are viewed as appropriate for criminal resolution are being
prosecuted on the theory that the defendants violated the federal securities statutes and other
anti-fraud statutes by (1) falsifying corporate books and records to conceal the fact that option
grants were backdated; (2) causing the preparation of false and misleading financial statements
and other documents; (3) lying to the corporation’s board of directors, and auditors and the SEC;
and (4) misleading investors and the financial press and filing false reports with the SEC. In
other words, our theories of prosecution are concerned with the accuracy and adequacy of
disclosure of material information and, in that respect, they are similar to many other DOJ
prosecutions for corporate fraud. Our corporate fraud indictments typically allege falsification
of books and records, concealment of material information, causing false and misleading
information to be disseminated to the investing public and financial analysts, and filing false
reports and documents with the SEC.

In discussion of this issue, defense counsel and corporate officials have argued that
grating "in the money" options is not per se illegal and may serve a legitimate corporate purpose in attracting and retaining the most competent employees in the industry. Let me emphasize this -- we do not attack the legitimacy of granting "in the money" options if the practice is fully disclosed and shareholder approval is obtained where necessary. Our cases concern falsification of corporate records, concealment and misrepresentation in the way in which the options were granted and priced, and deceptive conduct that may mislead the corporation, its directors, auditors, shareholders, and the investing public. Indeed, in the *Alexander* case the defendants are alleged to have falsely promised institutional investors that the company would not grant "in the money" options at the very same time the defendants were causing the company to grant such options by secretly backdating them.

In addition to the charges I previously mentioned, fraudulent conduct involving backdated options can be investigated and prosecuted under other criminal statutes enacted as part of the Sarbanes-Oxley legislation, such as securities fraud, 18 U.S.C. § 1348; knowingly certifying false statements filed with the SEC, 18 U.S.C. § 1350; destroying, falsifying or altering records in federal investigations, 18 U.S.C. § 1519; and destroying corporate audit records, 18 U.S.C. § 1520. Of course, some of this conduct may predate Sarbanes-Oxley, and in those instances, that legislation cannot be used. These cases may also be amenable to prosecution under criminal statutes relating to obstruction of justice, perjury, and criminal tax violations. Thus, the Department can rely on a number of statutes in charging this conduct. To the extent that the Committee is considering taking action to prevent this practice, the Department has a range of statutory options and it is not requesting any new legislation to deal with this specific problem.
The practice of stock option backdating to conceal information from corporate boards and regulatory authorities can only be seen as a brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders. By fraudulently backdating grants, defendants evade significant accounting, disclosure and tax requirements that flow from granting “in the money” options. Properly accounting for these grants would have reduced reported corporate earnings, created tax liability for option recipients and the company, and obligated the company to inform shareholders that it was offering stock at a discounted price. For some of those companies that have now disclosed backdated grants, corporate reputations have been tarnished and shareholder value has diminished substantially.

Like other forms of corporate fraud, the Department of Justice takes stock option backdating seriously, and we will continue to use our best efforts to uncover criminal conduct where it occurs. While we cannot say at this juncture how many cases we will ultimately investigate or what number will be more appropriately resolved as criminal, rather than as civil matters, we are committed to using the resources of our experienced securities fraud prosecutors and investigative agencies throughout the country to ensure that each matter we open is thoroughly investigated. Moreover, as Chairman of the Corporate Fraud Task Force, I made this issue a top priority during our July 27, 2006, meeting, and there was a productive discussion about backdating with task-force member agencies. In addition to the SEC, the Internal Revenue Service is now reviewing this practice to determine the tax consequences for companies and executives. In short, federal law enforcement agencies are working together to prevent fraudulent stock option backdating practices and to promote transparency in corporate governance whenever we are able to do so. This is a duty we owe to the American people,
whose hopes, dreams and futures are tied more and more to the integrity of our stock markets.

Thank you again for the opportunity to appear before you today, and I look forward to answering the Committee’s questions.
EXHIBIT "M-11"
Good morning Chairman Grassley, Ranking Member Baucus, and the Members of the Senate Finance Committee. It is good to appear before you again to discuss the issue of executive compensation and the Internal Revenue Service’s efforts in administering and enforcing our nation’s tax laws.

It is hard to pick up a newspaper or hear a financial report on the evening news without learning of some new or continued excess in executive compensation. When this excess violates the securities or tax laws, it undermines not only investor confidence and corporate governance, but also tax administration.

This morning, my focus will be on executive compensation issues for corporate executives. I want to discuss our efforts and procedures in this area, what we are finding, and impediments that lie in our way.

The IRS examines corporate returns in two of our business units. Our Large and Mid-Size Business (LMSB) division handles the examinations of corporations with assets greater than $10 million while other companies would fall into the Small Business and Self Employed (SB/SE) business unit.

The Service has, by design, increased the coverage rate of corporations and high income individuals that we audit over the last several years. In Fiscal Year (FY) 2005, we audited over 10,800 corporations with assets over $10 million as opposed to approximately 9500 in 2004. This is a coverage rate of 20 percent in FY 2005, compared to a coverage rate of 16.7 percent in FY 2004 and 12.1 percent coverage rate in FY 2003. Based on year to date data we anticipate we will maintain the same level of audits in FY 2006 and the same coverage rate.

Similarly, for corporations with assets under $10 million the coverage rate has increased as well. In FY 2005, we examined 17,858 small corporations, a coverage rate of 0.79 percent. This is more than double the audit rate in FY 2004 (0.32 percent). We expect our FY 2006 numbers to be similar to the 2005 rates.

We see a similar increase in audits of high income taxpayers, those with incomes in excess of $100,000. In FY 2004, we examined 166,221 high income taxpayers. That number rose to almost 220,000 in FY 2005. Similar increases can also be seen in the
coverage rates. The rate in FY 2004 was 1.25 percent, as opposed to 1.57 percent in FY 2005. The coverage rate for those with incomes over $1 million is 5 percent. Our plan in FY 2006 is to complete 234,000 high income individual audits. We are well ahead of that schedule currently and may reach as many as 240,000 or more.

While we are doing more, we are not where we want to be or need to be. Compliance by large businesses and high-wealth individuals remain two of the Service’s strategic priorities.

Executive Compensation

When examination teams examine a large corporation, executive compensation issues are required to be considered. There are a variety of issues in the executive compensation arena confronting IRS examiners. These issues relate both to the company and to key executives within the company. Issues include such items as stock-based compensation, (including stock options), parachute payments made when control of the company changes, non-qualified deferred compensation, split dollar life insurance, and various fringe benefits. More recently, we have been confronting the issue of backdating of stock options.

From an overall corporate perspective we need to make sure that the company has complied with section 162(m) of the Internal Revenue Code (IRC), which potentially limits the amount of compensation that the company can deduct.

A Compliance Initiative Project was established for many of these issues and Audit Technique Guides (ATG) have been written and published for the use of our examiners and the public.

As I indicated, as part of our corporate examinations, the examiners not only look at the overall corporate return, but also inspect the returns of executives in the corporation. They then make a decision, or a risk assessment, as to whether they should engage in a full scale examination of any executive’s individual return. This decision is based on a number of risk factors, such as the amount of tax paid by the executive in question, whether there has been proper reporting of all income and fringe benefits known to the examiner through audit of the corporation, the use of tax shelter activities, and the existence of reportable deferred compensation. In general, risk assessments are based on return information, audit history, and public information, including filings before the Securities and Exchange Commission (SEC).

The choice and number of executive returns we inspect in any particular company are determined by the examination team, but the inspected returns generally extend beyond those filed by the top five executives that are relevant to the corporation’s section 162(m) issues. For example, in the largest corporations we would typically inspect 15-20 executive returns. If the inspection on an individual executive’s return does not demonstrate the presence of risk factors, the return will not be subjected to a full examination.
In some cases, the risk factors seen on the individual returns of executives do indicate the need for further examination. In FY 2005, for example, LMSB conducted formal examinations of the individual returns of 90 executives, resulting in adjustments of just over $16 million. For FY 2006, through July, LMSB has examined 95 returns of corporate executives, leading to adjustments of over $84.5 million. It is important to remember these examinations were of only those returns identified by LMSB auditors through an assessment of risk factors they identified in the course of examining a corporate return and an inspection of personal income tax returns from executives of that corporation.

These audits are part of our overall program to increase the examinations of high income taxpayers that I mentioned earlier.

While the number of audits and the audit coverage rates are increasing, they are still too low. We plan to deploy additional resources to the area of high income taxpayer examinations. Some of those resources will likely come from the drawdown of resources now devoted to examining small estates under the estate and gift tax program. It is important to remember that this drawdown will not affect large estates (those in excess of $5 million), where our coverage rate will still be in the range of 28 percent.

For FY 2006, through July there have been approximately 25 corporate executive compensation fraud cases referred for criminal investigation. Of those, 20 were sourced from SB/SE. These referrals deal primarily with the diversion of corporate income to corporate executives, resulting in the underreporting of compensation on the executive’s personal income tax return.

**Tax Administration and Corporate Governance**

It is important to distinguish between tax administration and the oversight of corporate governance. The IRS is, of course, responsible for the former, but does touch on issues of corporate governance with some regularity, while our colleagues at the SEC focus more directly and undoubtedly more often on the latter. It is critical that we work together to the extent possible under existing law.

I have stated publicly before that clearly Sarbanes/Oxley and the post-Enron environment have improved corporate governance, including in the tax arena. It has also increased and improved the contacts between the Service and the SEC, as well as with the Financial Accounting Standards Board. We have had useful and productive discussions on the recent significant changes to FASB Statement No. 109, *Accounting for Income Taxes*, on the implications for certain SEC reporting companies of their participation in real-time tax examinations through LMSB’s Compliance Assurance Process, on the ways in which large corporate examiners, analysts and researchers can best access and understand data filed with the SEC and maintained and made available through the SEC’s EDGAR database and non-SEC sources, and most recently, on the backdating of stock options.
The SEC’s cooperation and willingness to share information about what it is finding from its investigations of options backdating, which is referenced below, are particularly significant for us. The SEC’s authority, expertise and ability to access information on a real-time basis allow us to identify potential options backdating exam subjects more precisely and more quickly than we would be able to do on our own.

From a tax administration standpoint, we sometimes identify issues in the course of an audit of a corporation that surface problems from a corporate governance perspective. But for several reasons, including the relevant reporting periods for tax purposes and the lag time between return filing and return examination, we are unlikely, in many cases, to identify governance issues before they have become known through the media or identified by other organizations, such as institutional shareholders, research analysts, or the SEC. In any event, we are generally precluded from sharing that information with the SEC or other government agencies by section 6103 of the IRC.

In addition, tax provisions that might be expected to have an impact on corporate governance may, for a number of reasons, not always have the impact that had been anticipated when they were drafted. Take section 162(m) of the IRC for example. It is intended to limit the income tax deduction that may be taken by a publicly held corporation for certain compensation in excess of $1 million paid to its chief executive officer and the four other highest paid executive officers unless certain specific requirements are met. Only compensation that is considered “performance-based compensation” is deductible above the $1 million level. The limit applies only to publicly traded corporations.

Section 162(m) is a relatively straightforward section of the IRC that most companies understand and with which they are able to comply. They commonly structure compensation arrangements with their highly paid executives that allow the executives to earn compensation in excess of the $1 million limit in the form of performance-based bonuses, particularly in the form of stock options. As a result, corporations subject to section 162(m) are generally entitled to deduct these performance-based bonuses and we generally find this is not a significant area of noncompliance from a tax administration perspective.

This may be the case even if a company paying substantial or even unsettling amounts of deductible performance-based compensation is actually doing well from an earnings per share or earnings growth standpoint. This development is partially a product of the latitude corporate law grants companies in compensating executives, and partially a product of the use of that latitude by corporate boards. The standards of section 162(m) are no more stringent than the corporate law standards upon which this corporate largesse is sustained.

**Backdating of Stock Options**

One of the issues this hearing is focused on is the backdating of stock options. Company after company is restating earnings upon discovery of proof or indications of backdating
of options for their executives. Such backdating not only raises corporate governance concerns if proper approval was not obtained from the corporation's shareholders and directors, but can indicate tax compliance issues as well.

In general, corporate stock options are granted to employees with an exercise price equal to the market price of the stock on the date of grant. An employee benefits from an option if the market price of the stock on the day the option is exercised exceeds this exercise price. The practice of backdating options allows the use of hindsight to pick a date for the exercise price on which the market price was low. Picking a date on which the stock price was low in comparison with the current price gives the employee the largest potential for gain on the option and makes it possible for the employee to benefit from corporate performance that occurred before the option was granted. While this practice does not guarantee income on the exercise date, it increases the value of the option and makes it more likely the employee will be able to exercise the option at a time when the market price exceeds the exercise price (i.e., at a time when the option is "in the money").

As this simplified description of the practice suggests, backdated options that are in the money do not measure the performance of the company from the date of grant, and as a consequence, may not be treated as performance-based compensation under section 162(m). Thus, for the company, the tax implications are that any deduction of compensation related to the backdated option would be subject to the $1 million IRC section 162(m) limitation and would be disallowed if paid to the chief executive officer or one of the four other highest paid executive officers.

In addition, if an Incentive Stock Option (ISO) is backdated, the option will no longer qualify for preferential ISO treatment and will be reclassified as a nonqualified stock option. The difference between the exercise price and the sales price would be additional wages to the executive and must be included on the employee's Form W-2 in the year of exercise. The executive will lose the deferral and rate benefits associated with ISO qualification, but the corporation may be eligible for an additional wage deduction if IRC section 162(m) limitations are not triggered.

Under new section 409A of the IRC, enacted as part of the American Jobs Creation Act of 2004, serious tax implications can now exist for the executive of a corporation that backdates options. He or she may now be responsible for the payment of tax on income previously deferred until the exercise of the options. In addition, there can be substantial additional taxes under section 409A. This provision applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004.

We are currently in a transition period with the rules relating to section 409A. During the transition, options that were in the money on the grant date can be amended to avoid violating section 409A in either of two ways. The parties can increase the exercise price to equal the fair market value on the original grant date and eliminate any other deferral feature, or the parties can amend the options to provide for a fixed exercise date after
which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised.

In recent months, we have set aside and are reviewing cases identified as involving or potentially involving the backdating of stock options by the SEC, the Department of Justice, or companies announcing that they must restate earnings. We have met with SEC representatives and they agreed to share information regarding ongoing backdated stock options investigations.

This information sharing is critical to our efforts. I mentioned earlier that there are substantial tax implications if the backdating is discovered. The truth is we are not likely to discover something like backdating of options in the course of our ordinary examinations of taxpayers, either corporate or individuals, since backdating is not readily apparent from inspection of the tax return.

Within the IRS we have taken numerous steps to both increase awareness of the issue among our examiners and assist them when cases of backdating are identified. We have:

- approved a Compliance Initiative Project to allow for examination of cases with potential backdating;
- posted a Backdating Issue Alert on our internal web pages;
- issued and posted a proposed backdating Information Document Request Form (IDR); and
- provided Technical Advisor support to teams that have open examinations.

Executive Compensation in the Tax Exempt Arena

Tax exempt organizations also face their fair share of issues related to executive compensation. I know this is an issue of great concern to members of this Committee.

In late 2004, our Tax Exempt/Government Entities (TE/GE) group began the Exempt Organization Executive Compensation Project to explore the seemingly high compensation paid to executives and others who were controlling exempt organizations. We contacted over 1800 organizations. From that number we sent out 1225 compliance letters requesting information on how compensation was set and reported. Roughly 30 percent of those contacted by letter submitted amended returns or schedules as a result of the process and over 170 of the responses to these letters resulted in a full examination of the organization contacted. The balance of the 1800 organizations contacted, over 600, were contacted through an examination. The examinations we have closed to date and the other contacts we have made with exempt entities have shown compliance issues associated with reporting and with loans to executives or other controlling officials. Our examination work continues.

To help combat reporting problems, we have modified the Form 990 in an effort to better capture executive compensation data from the tax exempt community. Executive compensation will continue to be a prime area of focus for our TE/GE group in FY 2007.
For example, we currently have 532 non-profit hospital contacts on executive compensation issues outstanding.

**Challenges Faced In the Area of Executive Compensation**

Many of the challenges faced in the area of executive compensation are similar to those faced in other areas of tax administration – the lack of transparency and the inability to share information with other agencies.

**Transparency**

Despite the fact that we have ramped up efforts in this area in recent years, adjustments on executive and corporate returns as a result of executive compensation issues are relatively infrequent. Our examiners find relatively few indications of executive compensation non-compliance in return information they inspect and the returns they examine.

This is an area where, as we well know, corporations can comply with the law without inordinate risk or expense and still manage to pay their executives handsomely. While there may be non-compliance, we may well not find it reflected on the tax return.

When I testified before this committee on June 13, 2006, I spoke of book-tax differences and how they were growing for corporations. In the area of executive compensation, we estimate from Tax Year 2004 aggregate Schedules M-3 data that the book-tax difference is $47 billion. To a significant degree, this number is made up of the book-tax differences arising from non-qualified stock options. These options are popular with senior management in many public companies because they are a way for the company to offer performance-based pay that is deductible under section 162(m). We anticipate that the recent changes in the accounting standards by the Financial Accounting Standards Board (FASB) will reduce this difference considerably. Many Nonqualified Stock Options that were deductible by the corporation for tax purposes were not required to be expensed for book purposes prior to 2005.

The M-3 is the schedule that corporations with assets of over $10 million must file to reconcile differences between what they report on their books, consistent with generally accepted accounting principles, and what they report to the IRS for tax purposes. The M-3 is critical to our enforcement efforts in that it provides greater transparency over the specific bases for the differences between financial statement income and expense and tax income and expense.

We use the M-3 to guide examiners to potential areas of non-compliance. Our examiners are instructed to pay attention to items on corporate schedules M-3 that are large, unusual or questionable.

The M-3 does not necessarily identify non-compliance, but it does give us an indication of areas that merit further analysis. Together with other aspects of the M-3, however, this
information can be useful. For example, lines 2b and c ask the question: “Has the corporation’s income statement been restated for the current year or any of the five income statement periods preceding?” If the corporation answers yes, it may prompt an examiner to raise additional questions and could lead potentially to the discovery that stock options have been backdated.

With respect to corporate executives, we have no tool similar to the M-3 that would help identify otherwise non-transparent issues on the tax return and in such cases enable us to identify where to ask the right questions with respect to an executive’s compensation. A corporate executive’s 1040 return elicits information with respect to the same line items that are required to be filled in by the assembly line worker or groundskeeper. Without more specific information, we are not well positioned to pick out problematic returns and not bother the compliant executive.

I might compare this dynamic to the situation we faced with respect to the creation and promotion of abusive tax shelters before the disclosure regime was created. Prior to the regime’s establishment, we had no ready mechanism to identify abusive, or potentially abusive, transactions. Much of what we currently have the opportunity to look at was not ascertainable from the return, and consequently went undetected. Now, taxpayers and promoters are required to report, using Form 8886, certain tax shelters and potentially abusive transactions to our Office of Tax Shelter Analysis. This data has been invaluable to us both in terms of better understanding the nature of the potentially abusive transactions and in identifying specific taxpayers that are participating in the shelter and those that might promote them.

**Information Sharing**

I want to thank the Chairman, Senator Baucus and members of this committee for their efforts in allowing us to share data with State Charity Officials under the Pension Protection Act. This provision is an important step in our cooperative efforts with the states in the tax exempt arena. But, unfortunately, this type of information sharing initiative is the exception rather than the rule.

As I indicated earlier, our discussions with the SEC served to remind us of two recurring themes related to our efforts to coordinate compliance efforts with other Federal agencies. First, the IRS and other federal law enforcement agencies frequently gather and analyze information, independent of the other agencies, concerning the same parties and matters. Second, while the other agencies can provide considerable information to the IRS, we are precluded from providing any information from a tax return. We cannot even confirm the existence of many facts relevant to their investigations.

Section 6103 of the IRC broadly states that tax returns and return information are confidential and cannot be shared except for very specific purposes identified in the IRC. This is an important taxpayer protection that should only be modified after careful consideration. We are working with the SEC to determine whether there might be
limited areas in which broader information sharing would be helpful, and will work with this Committee on any proposals that may be developed.

Conclusions

Abuses in the areas of executive compensation are a concern from both a tax administration and a corporate governance perspective. The IRS will continue to prioritize its efforts in the entire area of executive compensation. As I indicated, this is an area where we, in many instances, are unlikely to identify significant noncompliance through our traditional corporate audits. To fortify our ability to identify such noncompliance, greater transparency concerning the details of each executive’s total compensation might be considered. In the meanwhile, we will apply our resources to this area with full rigor.

We will also prioritize our coordination with the SEC and our use of both public and non-public information that may be available to us. We are heartened by the Commission’s collaboration and the utility of the information they are willing to make available to us in the area of backdated stock options.

I appreciate the opportunity to appear before the Committee this morning and I would be happy to respond to any questions.
EXHIBIT "M-12"
Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I. Introduction

Thank you for inviting me to testify today about the tax aspects of options backdating. I am pleased to testify next to Deputy Attorney General Paul McNulty and IRS Commissioner Mark Everson. While each of us has different law enforcement responsibilities, backdating can impact criminal and tax laws as well as the federal securities laws. Because of this, I want to assure the Committee that the SEC's Enforcement staff has been sharing information with the Department and the Service as warranted and appropriate. Recently, in fact, the Commission and the Department of Justice jointly announced the filing of two enforcement actions concerning backdating.

Today, I hope to provide the Committee with an understanding of our law enforcement efforts relating to stock options as they, in turn, relate to your interest in overseeing our tax laws. I realize, however, that your interests may go beyond what I, as Director of the Division of Enforcement, can expertly speak to in my testimony, so I am appending a copy of the testimony being given today in the Senate Banking Committee by my Chairman, Chris Cox, also on the issue of options backdating.

II. Options Backdating Practices

In a simple stock option, a company grants an employee the right to purchase a specified number of shares of the company's stock at a specific price, known as the exercise price. The exercise price is usually set as the market price of the stock on the grant date, or "at-the-money." If an option is awarded at a lower market price, it is said to have been granted "in-the-money." Typically, an employee cannot exercise the option and acquire the underlying stock until the passing of a specified period of time, known as the vesting period. Options generally vest in equal but staggered amounts—for example, 20 percent per year over five years. Once vested, options generally are exercisable until they expire; however, when an employee leaves a company, he or she generally loses any
unvested options and has only a limited period (such as 90 days) to exercise options that have already vested. Such terms are spelled out in a company's stock plan.

Options became more popular after Section 162(m) of the federal tax laws went into effect in 1993, which limited to $1 million the tax deductibility of compensation awarded to certain top executives. This change in the tax law tilted compensation practices away from salary and other forms of compensation in favor of performance-based compensation to which the cap didn't apply, such as stock options.

As the use of options compensation has increased, however, so apparently has its abuse. We have learned that some issuers and their executives abused stock option programs by improperly backdating grant dates. The type of "backdating" I'm referring to is the practice of misrepresented the date of an option award to make it appear that the option was granted at an earlier date – and at a lower price – than when the award was actually made. The intent of backdating option grants is to award disguised "in-the-money" options. This allows the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money."

We have also learned that employees, including executives, may at times have backdated option exercises. This practice involves misrepresented the date an option is exercised to make it appear that the exercise occurred at an earlier date – and at a lower price – than when the exercise actually occurred.

Both of these practices – backdating grants, and backdating option exercises – have tax implications.

**A. Backdating Stock Option Grants**

Under the federal tax laws, grants and exercises of stock options can have income tax consequences to companies and individuals alike. Various tax benefits can arise from stock options, and often with more favorable tax treatment afforded to at-the-money option grants as opposed to in-the-money option grants. Backdating option grants can seriously imperil these benefits and potentially result in underpayment of taxes, and associated interest and penalties. These implications are best seen in the context of the two common forms of employee options—non-statutory stock options, or "NSOs", and incentive stock options, or "ISOs".

When an employee exercises a non-statutory option, the difference between the exercise price and the fair market value of the company's stock on the date of exercise is treated as ordinary compensation and the employee is generally taxed on the gain at his or her ordinary income tax rates. The company incurs employee withholding obligations on this gain, but also is entitled to an
associated tax deduction on the gain. When companies backdate option grants to a lower exercise price, employees can obtain a larger taxable gain upon the exercise of an NSO and companies can obtain a correspondingly larger tax deduction and withholding obligation on that gain.

Unlike the exercise of NSOs, incentive stock options, or ISOs, afford employees favorable tax treatment because any gain at exercise is not taxed as ordinary income, although the gain may be subject to alternative minimum tax. Accordingly, a company does not obtain any corresponding tax deduction (or incur withholding obligations) at the time of exercise. In addition, if an employee holds the stock for the statutory holding period prior to sale—one year after exercise and two years after grant—then the sale is considered a "qualifying disposition" and the entire gain on sale is taxed at favorable capital gains rates. However, among the statutory requirements of ISOs is that they be granted at-the-money. An ISO that is granted in-the-money loses its favorable status and instead is treated under the tax code as a non-statutory option (NSO), including ordinary income recognition by the employee on any gain at exercise and a corresponding tax deduction by the company on that gain. Backdating allows an employee to treat what is in fact a non-qualified option as an incentive stock option, which can result in the employee underpaying taxes while causing the company to lose the tax deduction to which it otherwise would have been entitled.

Finally, backdating implicates a company’s ability to benefit from tax deductions normally available under Section 162(m) of the tax code. Section 162(m) exempts from its $1 million tax deduction cap compensation that is performance-based. Compensation an employee obtains as a result of at-the-money option grants is considered performance-based under this provision, because the compensation ultimately received is based solely on an increase in the value of the stock after the date of the grant. Thus, Section 162(m) generally entitles companies to a tax deduction for the ordinary compensation income that a named executive officer recognizes upon the exercise of an NSO or upon the disqualifying disposition of an ISO. However, when options are in-the-money on their award date, companies lose these tax advantages. Backdating option grants therefore can result in a company unjustly receiving tax deductions it otherwise would not have been entitled to under Section 162(m).

B. Backdating Stock Option Exercises

So far, I've focused on the tax implications of backdating stock option grants. But we have also seen that executives have backdated option exercises. This practice benefits employees at the expense of shareholders.

As I mentioned earlier, when an employee exercises a non-statutory stock option (NSO), the employee is required to pay taxes on any gain at the time of exercise, measured by the amount the company's stock price on the date of exercise.
exceeds the exercise price, and the company receives an associated tax
deduction on this gain. Thereafter, if the stock obtained through the exercise is
then held for at least one year prior to sale, any additional gain to the employee
between exercise and sale is treated as a capital gain under the tax laws.

We have seen that employees may backdate exercise dates to correspond with
low points of the closing price of a company’s stock. In doing so, they are able to
minimize the gain at exercise that they report as ordinary income on their tax
returns, while maximizing the capital gains treatment of any eventual profits by
starting the clock ticking early on the holding period for capital gains treatment.
At the same time, the reduced gain at the exercise of an NSO results in a
corresponding reduction in the tax deduction for the company.

Similarly, backdating exercise dates of incentive stock options, or ISOs, also
starts the holding period early for the favorable long-term capital gains treatment
an employee ultimately can receive at the time of a qualifying disposition.

III. SEC Enforcement Efforts to Address Backdating Issues

With this background, let me describe one of our Enforcement cases that more
clearly illustrates the fraudulent option practices I have described.

**Symbol Technologies**

In 2004, the Commission levied fraud and other charges concerning option
exercises as part of a case that involved various fraudulent accounting practices
to overstate revenues or earnings. In this case, the SEC charged Symbol
Technologies, Inc. and its former general counsel, Leonard Goldner, with
manipulating stock option exercise dates to enable certain senior executives,
including Goldner, to profit unfairly at the company’s expense. The complaint
alleged that rather than use the actual exercise date as defined by Symbol’s
option plans, Goldner instituted, without board approval or public disclosure, a
practice of using a more advantageous date chosen from a 30-day "look-back"
period so as to reduce the cost of the exercise to the executive. The SEC
charged that, to create the false appearance that these exercises actually
occurred on the selected dates, Goldner had his staff backdate the requisite
transactional documents and use the phony exercise dates in the forms on which
the executives reported their acquisitions to the Commission and the public.

According to the complaint, by backdating the exercise to a date when the
company’s stock price was lower, the executives obtained a benefit at the
shareholders’ expense: the executives realized less gain at the date of exercise
and thus reduced their tax liability, while the company, among other things,
received less of a tax deduction for the exercises (by the same amount of the
reduced taxable gain to the executives). The complaint alleged that Goldner’s
regular use of the fraudulent “look back” practice caused Symbol to misstate its
stock option expenses by material amounts—the company's restatement of its improper accounting included a cumulative net increase of $229 million in stock option expenses from 1998 through July 30, 2002. The Department of Justice also filed parallel criminal proceedings against Goldner and another Symbol executive relating to the backdated exercises.

Ongoing Investigations
The SEC's Enforcement Division is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The investigations are being coordinated from our Washington, DC headquarters and are being carried out at our SEC offices nationwide. The companies under investigation are located around the country. They involve Fortune 500 companies and smaller cap issuers. And while a large number of the companies involved are from the technology sector, the companies under investigation span multiple industry sectors.

Because of the importance of these matters and the different laws they implicate, our Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice and the Internal Revenue Service. We continue to be vigilant on the enforcement front.

IV. Conclusion

Mr. Chairman, that concludes my testimony. Thank you again for inviting me to appear before you today on this important subject. I am happy to take any questions you may have.
EXHIBIT "M-13"
Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern.

The economist John Kenneth Galbraith said, "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."

He said that in the 1950's. The primary change since then is the number of zeroes at the end of the figures.

My firm, The Corporate Library, maintains an extensive database on corporate governance in public companies, and that includes a great deal of information and analysis of executive compensation. The data show that the disparity between pay and performance is enormous and growing.

Backdating and spring-loading of options are only the latest in a series of abuses and dodges that have escalated CEO pay to levels that Marie Antoinette would have been embarrassed by. I am particularly outraged by those who suggest that there is nothing wrong with this manipulation. Everything is wrong with it.

The entire justification for options is to align the interests of management with those of the shareholders. The great challenge of capitalism is exactly this issue – how do you keep the managers as committed to creating shareholder value as those who are providing the capital? Options seemed like a good answer, and that was the theory behind 162-M. But, as you know, that well-intentioned provision has had unanticipated perverse consequences.

When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance, two things happened. First, everyone got a raise to $1 million. Second, everyone got boat-loads of options. The very definition of a "mega-grant" had to be changed, so it now can be as much as eight times the CEO's base pay and bonus.

Option grants only work when:

1. The executives make money based on how the company does, not on overall market gains,
2. The number of options is not so excessive that there is a mountain of
pay-out for a molehill of performance, and

3) All information relating to the options is promptly, clearly, accessibly, and comprehensibly disclosed.

The failure of 162-M shows how difficult it is for the federal government to address the issue of executive compensation. Ever since 1789, corporate governance has been a matter of state law. So, at the federal level, our only tools are the tax code and disclosure requirements. The result has been a sort of whack-a-mole game, as every time we slam down one abuse, others start popping up.

Back-dating and spring-loading have been among the most shocking, however, because they so fundamentally subvert the entire justification for option-based compensation. If options are supposed to align the interests of shareholders and executives, then it is monumentally unfair for executives to get a chance shareholders do not to retroactively change the starting of the clock. I can just imagine the reaction if an investor called his broker to say that he'd like to change his mind and move the date of his last purchase of stock to another time, when the share price was lower.

I am appalled by those who suggest there was nothing wrong here. If, in fact, it was not illegal, it is only because it is such an obvious outrage no one thought outlawing it was necessary. Apologists have suggested that it was just a clever way to grant executives more compensation in the pre-expensing days without having to take a hit to the income statement. If that is true, what did they have to hide? Why didn't they disclose it? And why would we want to give executives more compensation if it wasn't tied to performance?

I have also heard the argument that even pre-expensing investors could tell the cost of the options from the disclosures in the financials. This analysis completely ignores the other ways that investors use the information that executives have received in-the-money options. There's informational value in companies' compensation practices, so telling investors that all the options are at-the-money when they are not misleads investors, who could use the information to (1) make decisions about the management team's abilities, (2) decide how to vote the next time an equity compensation plan came up for a vote, (3) decide whether to withhold votes from members of the compensation committee and (4) evaluate whether to sell the stock. In January 2000, I wrote a report noting a problem at one company because it gave the CEO two million options at $10 a share below market. It seemed clear that was a bet that the stock was going to decline in value. I got a lot of criticism; it was the fastest-growing stock in the history of the NYSE. But I was right. That company, Global Crossing, was soon to set another record as the fourth-largest bankruptcy in U.S. history.

If there is nothing wrong with the compensation arrangements, companies should be happy to provide full disclosure to encourage and reassure investors that their
interests are paramount.

Earlier this year, The Corporate Library conducted a special study for our latest CEO compensation survey, designed to test whether the highest compensation increases in the S&P 500 reflected significant long-term improvements in company performance. The results of the study showed that the largest percentage increases in total compensation had very little connection to long-term value creation. This table shows the examples of the greatest disparity between pay and performance:

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>Fortune Rank</th>
<th>Current CEO</th>
<th>Total CEO compensation in last two fiscal years</th>
<th>TCL Rating</th>
<th>5-Year TSR</th>
<th>Performance vs. Peers</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT&amp;T Inc.</td>
<td>T</td>
<td>13</td>
<td>Edward Whitacre</td>
<td>$134,413,596</td>
<td>95</td>
<td>-2.02</td>
<td>Underperformed</td>
</tr>
<tr>
<td>BellSouth Corporation</td>
<td>BLS</td>
<td>57</td>
<td>Chester Adamson</td>
<td>$227,392,738</td>
<td>190</td>
<td>-24.32</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Hewitt-Packard Company</td>
<td>HPQ</td>
<td>17</td>
<td>Mark V. Hurd</td>
<td>$517,046,126</td>
<td>194</td>
<td>-2.04</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Home Depot Inc.</td>
<td>HD</td>
<td>17</td>
<td>Robert N. Nardelli</td>
<td>$57,077,009</td>
<td>759</td>
<td>-4.00</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Lucent Technologies Inc.</td>
<td>LU</td>
<td>249</td>
<td>Patricia Russo</td>
<td>$10,121,737</td>
<td>755</td>
<td>-4.00</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Merck &amp; Co. Inc.</td>
<td>MRK</td>
<td>54</td>
<td>Richard Clark</td>
<td>$160,032,911</td>
<td>194</td>
<td>-2.03</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Pfizer Inc.</td>
<td>PFE</td>
<td>34</td>
<td>Howard A. Weissman</td>
<td>$52,051,978</td>
<td>273</td>
<td>-4.00</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>PG</td>
<td>59</td>
<td>David A. Pointon</td>
<td>$52,051,978</td>
<td>273</td>
<td>-4.00</td>
<td>Underperformed</td>
</tr>
<tr>
<td>3M Co.</td>
<td>MMM</td>
<td>92</td>
<td>chairman</td>
<td>$44,284,538</td>
<td>169</td>
<td>-6.29</td>
<td>Underperformed</td>
</tr>
<tr>
<td>市值通讯社 Inc.</td>
<td>VZ</td>
<td>71</td>
<td>Ken R. Deckerberg</td>
<td>$29,350,391</td>
<td>194</td>
<td>-2.04</td>
<td>Underperformed</td>
</tr>
<tr>
<td>Wal-Mart Stores, Inc.</td>
<td>WMT</td>
<td>11</td>
<td>H. Lee Scott</td>
<td>$377,061,862</td>
<td>194</td>
<td>-2.04</td>
<td>Underperformed</td>
</tr>
</tbody>
</table>

It’s a very small group in the stratosphere of pay: rock stars, movie stars, athletes, investment bankers, and CEOs. Of that group, the first four are in the ultimate pay-for-performance category, with a tiny percentage at the very top making millions of dollars, and with deals that evaporate quickly if a movie, a CD, or a business deal tanks. Their pay is set through tough arms-length negotiations.

CEOs are the only ones who pick the people who set their pay, indeed they pay the people who set their pay. And no matter what “independence” standard we try to impose, the board room culture of congeniality and consensus is so powerful that it makes it very hard to object, especially when the compensation consultant helpfully provides an avalanche of numbers designed to justify pay increases. In the wonderful world of CEOs, like the children in Lake Woebegon, everyone is above average. Even Warren Buffett acknowledges his own failings as a director, particularly in approving excessive compensation: “Too often, collegiality trumped independence.” If Warren Buffett, always a significant shareholder in any company on whose board he serves, does not feel able to oppose excessive pay, something is wrong.

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, Searching for a Corporate Savior: The Irrational Quest for
Charismatic CEOs, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

Disclosure is important. The SEC’s new rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:

1. Accelerated vesting of options
2. Manipulation of earnings to support bonuses
3. Imputed years of service
4. Setting the bar too low (guaranteed bonus)
5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

Until we remove the impediments to a market response from shareholders, we will never be able to address these problems.

I leave you with two key points. First, executive compensation must be looked at like any other allocation of corporate assets. Currently, the ROI for executive pay does not measure up to just about any other use of corporate capital.

Second, the pay-performance disparity is so outrageous, so atrocious that in my opinion it undermines the credibility our system of capitalism. In a global environment, information and the ability to trade in any market at any time will provide our system with the toughest market test in the history of our country. As we compete for capital, we must be able to show those inside and outside our country that we deserve their trust and will provide them with a competitive return instead of shoveling more money into the pockets of the top executives.

Ultimately, as long as the CEOs determine who sits on their board, and, in the overwhelming majority of cases, who sits on the compensation committee, the real mis-aligned incentive we have to worry about is the incentive of the compensation committee members to give the CEO whatever he wants.
We speak of the “election” of directors, but management picks the slate, no one runs against them in well over 99% of the cases, and management counts the votes. Even one vote for a candidate will insure his election. In my opinion, a requirement that board candidates get a majority of votes cast and, as in the UK, the ability of shareholders to vote on CEO compensation are meaningful changes that will be effective in addressing the abuses.

Many thanks, and I will be glad to answer any questions.
EXHIBIT "M-14"
Written Statement of
Professor Lucian A. Bebchuk
Harvard Law School
Before the
Committee on Finance
United States Senate
Hearing on Executive Compensation

September 6, 2006

Introduction

Chairman Grassley, Senator Baucus, and distinguished Members of the Committee, thank you very much for inviting me to testify today regarding executive compensation.¹

The first part of my remarks will focus on the executive retirement plans that I was asked to discuss, and I will then comment on some other issues. My discussion of executive retirement benefits is based on the analysis in a book on executive pay I co-authored with Jesse Fried,² as well as on a subsequent empirical study with Robert Jackson.³

As explained below, executive retirement plans have provided top executives with large amounts of non-performance compensation that were neither salient to investors nor subject to the limitations on tax deductibility established by Section 162(m). The SEC's recent disclosure reform, which I strongly support, would in the future place these types of compensation on investors' radar screen. However, it will still be possible to use executive retirement plans to provide large amounts of non-performance pay without falling within the scope of Section 162(m).

¹ The views expressed herein are solely my own and should not be attributed to Harvard Law School, the National Bureau of Economic Research or any other institutions with which I am affiliated.
Executive Pensions

Because companies have not been reporting a monetary value for executives’ pension plans (as the SEC rules have allowed until recently), standard datasets have not included pension values. My empirical study with Robert Jackson demonstrates that this omission has led public officials, investors, and the media to have an inaccurate picture of executive pay.

The study analyzes the pension arrangements of CEOs of S&P 500 companies who were near the retirement age or left their positions during the period under examination. With respect to the two-thirds of the CEOs who had a pension plan, we found that:
(1) The executives’ pension plans had a median actuarial value of $15 million;
(2) The pension plan of the median CEO was worth twice as much as the aggregate salary paid during his or her service as CEO; and
(3) The value of the median CEO’s pension comprised 35% of the total compensation (including both equity-based and non-equity-based pay) during that executive’s service as CEO.

Explaining the Heavy Use of Executive Pensions

The use of executive pensions might seem natural given that firms offer pension plans to many non-executive employees. However, the plans offered to executives and non-executives differ in two important ways that raise questions about why firms use executive pensions so often.

First, the pension plans used for non-executive employees are designed to capture the benefits from the favorable tax treatment of “qualified” pension plans. However, because of the limits on the amount that can be placed in an employee's qualified pension plan, firms cannot use qualified plans to provide executives with pensions that approach the magnitude of their annual compensation. Instead, firms have been providing pensions to executives mainly through nonqualified Supplemental Executive Retirement Plans (SERPs) that do not enjoy a tax subsidy. Firms that provide SERPs to executives generally do not offer such plans to other employees.

Second, while firms have been moving away from defined-benefit plans for non-executive employees, they continue to offer defined-benefit pension plans to most top executives. Unlike defined-contribution plans, defined-benefit plans shift the risk of investment performance to the firm and its shareholders. However, one would expect the defined-benefit structure to be more valuable to regular employees who – relative to executives – are probably
less able to bear the investment risks associated with defined-contribution plans.

What then could explain why firms have been making a massive use of defined-benefit pension plans for their top executives while moving away from defined-benefit plans for other employees? One possible explanation is based on the fact that firms have not been required to place a monetary value on SERPs and include this value in the summary compensation tables that are publicly disclosed. As a result, SERPs have provided large amounts of non-performance pay without making them transparent to investors.

Because the SEC's new disclosure requirement will obligate firms to make the value of pensions transparent, another possible explanation for the use of pensions is worth stressing. Because Section 162(m) does not apply to payments made after an executive retires, executive pensions have enabled the payment of large amounts of non-performance compensation that is not subject to the $1 million limitation established by section 162(m). For the median CEO in our empirical study of executive pensions, adding the pension value on top of aggregate salary during the CEO's service roughly tripled the amount of the CEO's non-performance pay.

Deferred Compensation Plan

Deferred compensation is another form of compensation that has provided large amounts of performance-insensitive compensation to executives without attracting much shareholder attention or falling within the scope of Section 162(m). The lion's share of firms offer their top executives deferred-compensation programs that permit executives, or sometimes even require them, to defer receipt of compensation until some future date. The deferred compensation "builds" according to a formula devised by the firm, and executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company.

Some deferred compensation plans provide executives with above-market returns. Even when the plan offers only market returns, however, executives can make substantial gains from accumulating investment income tax-free. Depending on the company's tax rate and investment returns, the executive's tax savings come at the expense of the company, the taxpayer, or both.

Because there are limits on how much money can be contributed annually to a 401(k)

4. See, e.g., Clark Consulting, Executive Benefits – A Survey of Current Trends – 2005 Results (reporting that about 90% of public firms surveyed have deferred-compensation plans for executives).
account, firms provide executives with deferred-compensation plans outside the framework of 401(k) plans. Again, as in the case of SERPs, the question arises: Why do firms commonly offer nonqualified deferred-compensation plans to executives but usually not to other employees? If nonqualified deferred compensation is an efficient form of compensation for the executives of certain firms, it should also be an efficient form of compensation for their nonexecutive employees. But firms rarely, if ever, provide nonexecutive employees with the option of participating in nonqualified deferred-compensation plans in addition to their 401(k) plans.

What can explain the massive use of deferred-compensation plans for executives? One possible explanation is that such plans have enabled getting around the limitations on non-performance pay established by Section 162(m). First of all, a firm may give an executive any amount of non-performance compensation, however large, and still not fall within the reach of Section 162(m) — as long as the payment of this amount is deferred until the executive's departure. On top of the original amount deferred, a deferred-compensation plan can provide the executive with additional performance-insensitive gains from a tax-free accumulation of investment returns.

In addition, as in the case of SERPs, deferred-compensation plans have provided large amounts of non-performance compensation that fall below investors' radar screens. Past disclosure requirements have allowed firms to provide little information about executives' deferred compensation plans. Indeed, the information disclosed has been insufficient for outsiders to be able to quantify — as our empirical study did for executive pension benefits — the gains that executives have been making from deferred compensation plans. We do not have even ballpark estimates of these gains.

In the next proxy season, however, the SEC's disclosure reform will require firms to disclose the amounts credited to executives in deferred-compensation plans. These figures will enable outsiders to estimate for the first time the magnitude of executives' gains. Public officials and investors should pay close attention to the figures that come out.

Non-performance Pay through Bonus Plans

Firms can also use bonus plans to make payments that are barely tied to performance yet do not fall within the scope of Section 162(m). Section 162(m) does not apply to bonus payments as long as the bonus plan satisfies certain formal requirements. In particular, as long as the payment of a bonus amount was not certain, Section 162(m) may not apply even if the threshold for getting a bonus amount is sufficiently low as to make the likelihood of receiving one quite high.
Neither stockholders nor public officials are in a position to assess the magnitude of this problem. Firms often do not disclose the specific numerical thresholds used to determine bonus payments. A firm may disclose that bonuses were paid on the basis of earning targets set in advance by the compensation committee but not disclose the precise numerical targets used.

In my view, firms should be required to provide full and detailed disclosure of the numerical thresholds used to determine bonus payments. Opponents of such disclosure argue that it could help the firm's competitors. Even if this consideration were valid, however, it would at most justify delaying such disclosure to a later proxy statement. This information is necessary for outsiders to be able to assess the extent to which a firm's bonus payments have been meaningfully tied to performance.

**Strengthening Shareholder Rights**

I would like to conclude with a remark on shareholder rights. Although reform in this area is not the focus of this committee, the weakness of existing shareholder rights should be noted in any examination of executive compensation.

The SEC's recent disclosure reform, as well as the earlier passage of Section 162(m), might have been partly motivated by recognition that, without some push from the outside, corporate boards cannot be expected to adopt pay arrangements that are sufficiently linked to performance. However, as long as shareholder rights are not strengthened as well, neither disclosure requirements nor tax penalties can by themselves address the problem.

Disclosure by itself is insufficient when investors do not have the power to act on the information they obtain. And tax penalties by themselves can have little influence on compensation arrangements; when shareholders' rights are weak, designers of pay arrangements may not feel sufficient pressure to change these arrangements because any tax penalties will be borne largely by shareholders, not executives.

Indeed, the very need to expand disclosure requirements indicates the limits of shareholders' existing rights. Despite the dissatisfaction of investors, companies have continued to avoid making pay arrangements transparent, something they could have done on their own. Their failure to do so made SEC intervention necessary.

What else needs to be done? To ensure that directors focus on shareholder interests, they must be made not only independent of insiders but also dependent
Shareholders' power to remove directors must be turned from a fiction into a reality. Shareholders should be able to place director candidates on the corporate ballot, as well as to vote by secret ballot. All directors should stand for re-election annually, and should not serve if they fail to get a majority of the votes cast.

Furthermore, shareholders should have more power to influence the setting of companies' governance arrangements. Shareholders' involvement has been limited to the passing of advisory resolutions that boards may (and often do) choose not to follow. We should remove all legal impediments to shareholders' ability to adopt bylaws or even charter amendments. And shareholders should also get to vote on the compensation committee's report, or least get the power to opt into having such a vote.

In the end, executive compensation arrangements reflect the quality of the corporate governance processes that produce them. Problems of executive compensation can thus be fully addressed only by improving these processes. Strengthening shareholder rights would make boards more accountable and attentive to shareholders – and thereby improve corporate performance and enhance shareholder value.

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EXHIBIT "M-15(a)"
EXECUTIVE OVERCOMPENSATION—A
BOARD-BASED SOLUTION†

CHARLES M. ELSON*

INTRODUCTION

Envy, for better or worse, is a fundamental part of the human condition. Whether we admit it or not, most of us take a keen interest in the financial status of our neighbors. Few aspects of existence in contemporary society create more anger, resentment and dissension than how much we are compensated for our daily toils in comparison to what our fellow workers earn. It is this simple fact, along with distributive justice concerns, that explain the cause of the extraordinary popular attention and fury directed at the seemingly innocuous issue of executive compensation. Within the last several months, both the popular and financial media have devoted much attention to the charge that the executives of America’s largest and most respected public corporations are being grossly overpaid for their services, at the expense of their shareholders, employees and the general public.1 Comparisons are made with historic U.S. compensation levels and the

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amounts executives of foreign competitors receive, particularly in relation to the spread between the salaries of the highest and lowest paid employees. It is argued that U.S. executives are being compensated at an alarmingly high and dramatically escalating rate, despite the fact that domestic corporations may be performing less efficiently and less profitably than similarly situated foreign enterprises. What are the legal ramifications of this executive compensation issue and is there a need for some sort of legal response?

The controversy is not a new one. In the mid-1930s, a similar public debate emerged over what was then considered to be the extraordinarily high compensation levels of certain corporate executives. While acknowledging that a corporate board may be responsible for salaries paid to executives that exceeded compensation for services rendered and thus became actionable "waste" or improper gifts of corporate assets, the courts generally declined to intervene. It was believed that a court was no better at valuing an executive's worth than a properly functioning board, and therefore judicial review would be fruitless. With the judiciary a reluctant venue for compensation reform, Congress attempted to resolve the issue by dramatically raising

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2 In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. In 1980, the average chief executive earned only 42 times the average factory worker's wage. John A. Byrne, What, Me Overpaid? CEOs Fight Back, Bus. Ws., May 4, 1992, at 142, 143. See also ROBERT A.G. MONKS & NEIL MIROW, POWER AND ACCOUNTABILITY 170 (1991) (observing that executive overcompensation has a negative effect on employee morale); Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 Ind. L.J. 59, 69-71 (1993); Jonathan Rowe, CEO Pay Affects Company Morale, CHRISTIAN SCI. MONITOR, Mar. 12, 1992, at 15.

3 Roberto Goizueta, Chairman of Coca Cola, recently received over $80,000,000 in restricted stock for his services to the company. Anthony O'Reilly, the retiring chief executive officer of H.J. Heinz, was paid $75,085,000 in compensation for 1991. And for the same year, Leon Hirsch, chairman of U.S. Surgical Corp., received $23,281,000. See Byrne, supra note 2, at 142. Can any one executive's services be worth that much to the corporation? The tenor of the varied articles discussing the phenomenon suggests not. See supra note 1.

4 See, e.g., Rogers v. Hill, 289 U.S. 582, 591-92 (1933) (ruling that bonus payments to executives which have no relation to the value of services rendered are gifts of corporate property, and remanding to the trial court to determine whether payments constituted a waste of corporate assets); Seitz v. Union Brass & Metal Mfg. Co., 189 N.W. 586, 587-88 (Minn. 1922) (explaining that courts should proceed with caution when determining whether salaries are excessive and unreasonable; courts are not called upon to make a yearly audit and adjust salaries); Gallin v. National City Bank, 281 N.Y.S. 795, 802-03 (Sup. Ct. 1935) (ruling that the magnitude of the total compensation received by officers does not, by itself, entitle plaintiffs to recover, but merely requires an investigation by court as to whether a cause of action exists and leaves the burden of proof on the plaintiffs); Barris, supra note 2, at 81-83; Detlev Vagts, Challenges to Executive Over Compensation: For the Markets or the Courts?, 8 J. Corp. L. 231, 252-55 (1983).

5 Heller v. Boylan, 29 N.Y.S.2d 659, 679-80 (Sup. Ct. 1941) ("Courts are ill-equipped to solve or even to grapple with these entangled economic problems."); aff'd mem., 32 N.Y.S.2d 131 (App. Div. 1941).
the income taxation rates imposed on those receiving the greatest compensation. No legal changes, however, in internal corporate governance procedures were enacted. Following this taxation-based response, the issue basically lay dormant until the perceived salary excesses of the late 1980s revived public interest and debate.

Although some may argue that through efficient market function, either few executives are overcompensated or that market-based forces will act to limit salary excesses, there is a compensation problem today that, for various reasons to be discussed below, is not responsive to a market-based solution. The best way to encourage reasonable compensation without discouraging effective executive performance centers on better internal corporate oversight. Such oversight may come only from an unfettered, unbiased, independent board of directors. This article proposes two reforms in corporate board structure to encourage such independence of judgment that will result in the proper review of executive compensation procedures. First, the outside directors should be compensated solely in company stock. Second, directors' term lengths should be significantly expanded. These internal structural changes will result in a more effective board-level review of executive compensation and should lead to more reasonable compensation schemes.

Unfortunately, as this article will discuss, most commentators examining the compensation issue have not focused on reform of the internal corporate governance procedures that created the problem. Rather, they have proposed externally-based solutions that will either prove ineffective or hinder effective corporate management. Indeed, the regulatory and legislative communities have been quickest to respond, offering varying responses to the overcompensation problem. The Securities and Exchange Commission, probably seeking to stimu-

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late a shareholder response to the issue, has taken a two-flanked approach. The first, adopted in early 1992 during the height of the proxy season, loosened the restrictions on placing shareholder-initiated proposals on compensation issues on corporate ballots.\(^8\) The second, initially released as proposed amendments to the proxy rules and later adopted with some revisions, expanded the amount of disclosure companies must provide to their shareholders on the amounts their top executives are paid.\(^9\) The Congress, on the recommendation of President Clinton, chose an historic tax-based response to the problem. In the Revenue Reconciliation Act of 1993, Congress mandated that corporations may no longer deduct, as a business expense, any compensation to an executive in excess of $1 million per annum that is not related to performance.\(^10\) Additionally, a new "millionaires" surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year.\(^11\)


\(^10\) Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). This bill prohibits publicly held corporations from deducting executive compensation in excess of one million dollars per annum. Id. However, corporations that tie compensation to performance may be able to continue to deduct the entire amount of compensation. In order to qualify for this performance-based compensation exception, corporations must meet five basic requirements: 1) executive compensation must be made according to a previously established performance-based goal; 2) the performance goal may not be altered following its establishment; 3) such a plan must be approved by a board committee that is comprised of at least two outside directors; 4) the material terms of the plan must be disclosed to and ratified by stockholders prior to the payment of compensation; and 5) the committee must certify satisfaction of the performance goals prior to the payment of compensation. Id. Thus, corporations may avoid the deduction limitation by either following these guidelines, shifting a portion of compensation into stock options, "which are generally considered "performance based" or making payments to a qualified retirement plan. Kathryn Jones, Tax Law Expected to Bring Little Shift in Executive Pay, N.Y. Times, Aug. 24, 1993, at CI, C2. Consequently, some commentators and corporate executives have suggested that these new deduction limitations will in actuality have only a limited impact upon most corporate executive compensation schemes. Id.

\(^11\) H.R. 2264. The bill, which both the House and Senate passed by the narrowest of margins, imposes a ten percent surtax upon individuals with taxable income in excess of the applicable threshold of two hundred fifty thousand dollars. Id. See also Jackie Calmes, With Signature, President Will Erase Reagan’s Legacy, WALL ST. J., Aug. 9, 1993, at A4. During the presidential campaign, President Clinton proposed implementing a "millionaires" surtax upon individuals with incomes in excess of one million dollars. See President-Elect Clinton Foresees Change in Plan for Middle-Class Tax Break, 10 DAILY TAX REP. (BNA) D4 (Jan. 15, 1993). However, President Clinton subsequently lowered this ceiling and proposed imposing a ten percent surtax upon
A debate is also occurring within the academic community. Despite the traditional reluctance of courts to involve themselves in compensation disputes, a few commentators have called for increasing judicial activism in reviewing questionable compensation schemes. Given the present interest in both the legal and financial communities in the emerging power of institutional investors, some academics have suggested an institutional investor-based solution to the problem. Should the institutions eschew their traditional passivity and take a greater interest in the management of the companies in which they invest, they may act as a powerful force in preventing executive overcompensation.

Although each of these approaches is not without some merit, this article will argue that they are "solutions" that will either cause more harm than good, or effect little change in the present state of affairs which, given the level of public discontent, cannot be ignored. The problem of executive overcompensation is best dealt with not at the regulatory or even shareholder level, but by focusing on that body traditionally charged with responsibility for corporate oversight—the board of directors. It is the board which must approve all executive compensation. Thus, it is the board which must act to rein in overzealous and overcompensated management. Some commentators have suggested that only by strengthening the power and independence of the board's compensation committee will the issue be successfully resolved. Such tampering, however, is not the solution. In large publicly-traded companies, where the compensation crisis is most manifest, no major shareholder or group of shareholders controls the activities of individuals with incomes in excess of two hundred fifty thousand dollars per annum. Under the new tax code, the effective tax rate for individuals with incomes in excess of two hundred fifty thousand dollars per year has risen to 39.6 percent. H.R. 2264.


14 See Lance Berger, New Initiatives for the Compensation Committee, DIRECTORS & BOARDS, Winter 1985, at 33; James W. Fisher, Jr., Crafting Policy for Performance and Rewards, DIRECTORS & BOARDS, Winter 1986, at 26. See also Alison L. Cowan, Board Room Back-Scratching?, N.Y. TIMES, June 2, 1992, at C1 (noting that the leaders of various companies often sit on each others' compensation committees and, as such, set pay for one another). Some large institutional investors are proposing that shareholders be allowed to vote on the selection of compensation consultants used by boards to set executive compensation. Gilbert Fuchsberg, Investors May Seek Vote on Executive Pay Consultants, Wall St. J., Aug. 27, 1992, at B1.
of the enterprise because of the sheer size of the operation and atomistic shareholding patterns. Rather, corporate management controls the business. The board is not representative of any one shareholder or shareholder group, but is picked by and responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome. In a captured board, the directors, responsible for oversight, are generally either the officers themselves (inside directors); participants in enterprises retained by management, such as law firms, and investment banks (inside "outside" directors); or social or business acquaintances of the top executives, most likely the top officers of other corporations, on whose boards the chief executive officers may sit ("outside" directors). Although such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Even if the compensation committee (which determines compensation levels) itself is composed exclusively of "outside" directors, both economic and psychological ties to management exist that preclude exercise of truly independent judgment. Theoretically, the threat of legal liability should ensure unencumbered judgment, but, as a matter of practice, the protection afforded by the business judgment rule and concomitant reliance on "captured" outside consultants counters any potential prophylactic effect. A compensation committee is only as effective as its members. If the outside directors comprising it are beholden in any respect to management, whether by economic or psychic ties, the committee will not function as the panacea.

The solution lies in loosening the outside directors’ ties to management and recreating a vital and independent board, which will engage in active oversight, not passive agreement. A way must be found to reinvigorate the outside director who traditionally acted in the shareholders’ interests by directing management. Some commentators have argued that this may be accomplished by placing representatives of the corporation’s major institutional shareholders on the board.17

16 See Avery S. Cohen, The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation, 34 Wash. & Lee L. Rev. 837, 837 (1977) (classifying directors as "inside directors, non-independent outside directors, and independent outside directors"); Corporate Director’s Guidebook, 33 Bus. Law. 1595, 1619–20 (1978) (describing directors as management and non-management directors); but see Principles of Corporate Governance § 1.29 (A.L.I.) (Tentative Draft No. 11, 1991) (abandoning the use of labels, but defining when a director has a "significant relationship" with a company’s senior executives).
17 See Jayne W. Barnard, Shareholder Access to the Proxy Revisited, 40 Cath. U. L. Rev. 87 (1990) (arguing that the proxy rules should be modified so that it is easier for shareholders to elect...
They reason that because these individuals attained their board positions as a result of their relationship to the shareholding institutions and not to management, they will act in the shareholders' best interests, independent of management. This approach is problematic in one major respect. It assumes that the institutions will bond together to elect their representatives and that the institutions possess sufficient voting power to place enough directors in office to gain control over the board.

There is, however, a much simpler and more effective way to reposition the board to act as a counter-force to management, and resolve the perceived compensation crisis. The outside directors must be made to consider management proposals from the perspective of the equity-holders to whom they are legally responsible, and not from the viewpoint of one engaged by and beholden to management. After all, they were elected to their positions as the representatives of the shareholders, not the officers. The best way to create this perspective may be to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Frequently, however, outside directors do own stock in the corporations on whose boards they sit. Yet, they are still subject to management capture. Why? It is because their equity positions in the companies are insubstantial compared with the monetary and reputational compensation they receive for serving on the board. Financially, it is far better to side with management and not risk failing to be renominated and receiving the compensation and prestige a board seat brings, than to act independently and face removal. If, however, one's personal financial interest in the corporation's stock exceeded the annual compensation and prestige value of board membership, one would be less willing to side automatically with management. Self-interest is obviously tied to board behavior, and if a director's self-interest is aligned with the equity-holders, as opposed to management, then the compensation problem, and maybe even the whole issue of management capture, might be solved. But how do we place significant equity positions in the hands of the outside directors?

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outside directors); Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811 (1992) [hereinafter Black, Agents] (arguing that regulations should be relaxed so that particular institutions may be permitted to own 5–10% of certain companies). See also Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863 (1991) (calling for institutional investors to organize a core of professional directors).

18 Black, Agents, supra note 17, at 842–44.
This article proposes that corporations should pay their directors their annual fees in restricted company stock. In a few years, each outside director will have accumulated a reasonably substantial portfolio and, therefore, will possess a powerful financial incentive to act more independently of management. Additionally, directors' term lengths must be significantly expanded both to ensure that their equity positions (or potential positions) will reach the levels necessary to influence their decision-making and to mitigate the chilling effect of a management threat not to re nominate that frequent elections create.

Of course, the linchpin to the effectiveness of this approach is the assumption that stock ownership has a salutary impact on individual behavior—that significant stock ownership does make for a director less susceptible to management capture. An empirical examination of the voting behavior of boards comprised of outside directors with substantial stock holdings, compared with boards with outside members who do not, should confirm the validity of the approach. This article undertakes such an examination. In the realm of executive compensation, it appears that companies with boards composed of outside directors with significant shareholdings are less susceptible to the charge of executive overcompensation than companies without such boards. In fact, an apparent relationship exists between the way companies are regarded by the financial community in terms of the fairness of executive compensation, and the levels of outside director stock ownership. Those companies that are viewed as having high levels of executive compensation tend to have fewer outside directors with significant holdings in the business. On the other hand, those businesses with levels of executive pay considered to be in line with services rendered tend to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with management, through the development of substantial equity holdings which results in more effective oversight, would explain this phenomenon. Director stock ownership may not prove the comprehensive cure to the overcompensation controversy and related captured board syndrome—but it may have a strong salutary effect and certainly would be a good beginning.

Part I of this article examines the question of overcompensation. Are U.S. executives overpaid, and, if so, can the market itself act to correct any imbalances? For reasons to be discussed, I think the market cannot. Part II considers the various solutions proffered, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation.
committees. These approaches are critiqued as either ineffective or causing more harm than good to ultimate shareholder and national interests. Part III focuses on stock ownership and lengthened board terms as the preferred response to the problem of overcompensation. Finally, this article examines the link between substantial equity holdings and better oversight and proposes that companies create such holdings in their outside directors. This proposal should eventually result in more effective board oversight, reasonable market-based compensation schemes, and healthier, more competitive corporations.

I. THE OVERCOMPENSATION PROBLEM

A. Is There Overcompensation?

Before embarking on a quest to determine an appropriate solution to a perceived inequity, it must first be determined that a problem exists which requires an active response. In other words, are U.S. executives overcompensated and, if so, is extraordinary action necessary to remedy the situation? The problem with examining compensation is that the entire inquiry begs the question—for what is the true value of the deployment of human capital? Unlike determining the cost of providing a physical good based upon known variables, there is really no mechanistic process for quantifying the value of human labor. If it were merely the cost of the basic human needs of food, clothing and shelter, we would all be compensated similarly. However, we are not. Although human effort is in one sense easily quantifiable by being limited to the physical capacities of the human being and the time limitations of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain an advanced economy are extraordinarily varied and require vastly different skills. Some skills are seemingly more valuable to society than others and, as a result, are compensated at higher levels. What those levels may be are determined through the routine function of the market.

How much individuals are compensated for their labors is the

19 As Karl Marx and Fredrich Engels stated:
The average price of wage labor is the minimum wage, i.e., that quantum of the
means of subsistence which is absolutely requisite to keep the laborer in bare
existence as a laborer . . . . We by no means intend to abolish this personal appro-
priation of the products of labor . . . . All that we want to do away with is the
miserable character of this appropriation . . . .

Manifesto of the Communist Party, in Marx & Engels, Basic Writings on Politics & Phi-
result of an implicit or explicit bargaining process. One party has labor
to offer and another has a need for the skill. The resulting compensation
is the product of the matching of expectations—what one expects
to receive and what the other is willing to give. These expectations,
created through routine market function, determine compensation
levels. What others are giving or receiving for similar tasks produces
the expectations that determine particular compensation levels for
particular skills. The “value” of a particular skill is not implicit in the
skill itself but, rather, is simply the result of this bargaining process. In
this regard, there is really no such thing as an implicitly “fair” salary—
only one that is acceptable to both parties.

This is the real problem with discussions concerning “overcom-
pensation,” for if a salary is the result of an active bargaining process
can such compensation ever be considered excessive? Because there is
no truly objective standard for valuing human capital other than
through the operation of the market driven by active bargaining, the
reasonableness of a particular compensation arrangement is objec-
tively indeterminable. Reasonableness is the product of the bargain.
For example, who can say that an employee is overcompensated if two
willing parties agree that the efforts of one of them are worth one
million dollars? If one is voluntarily willing to part with capital to obtain
a particular service, that is the value of the service. The compensation
is thus reasonable. Compensation becomes unreasonable when it is not
the product of balanced bargaining. Where one party to a bargain, due
to external pressures, is unable or unwilling to bargain effectively to
maximize self-interest, then the resulting agreement may be unreason-
able.

In the corporate setting, the executive bargains with the corpora-
tion for compensation. The executive possesses managerial skills that
the corporation desires. The corporation possesses capital that the
executive desires in exchange for services rendered. How much capital
will be parted with for these services is the result of bargaining. The
resulting salary may be problematic where effective bargaining does
not take place because one party does not attempt to maximize its own
self-interest. This is the crux of the overcompensation dispute. Executive
salary arrangements are the products of negotiation between the
executive and the company’s board of directors who represent the
interests of the company and its owners, the shareholders. If the board
is reluctant to bargain effectively with management because, despite
its fiduciary obligations, it believes itself to be more closely allied with
management than the shareholders, then the product of such a “bar-
gain” may be no bargain at all to the corporation and its owners.
Alliances between bargaining parties may result in acquiescence rather than bargained-for agreement. Salary arrangements that result from such a one-sided bargaining process may be susceptible to charges of excess.

Although the popular media focuses simply on the large executive salaries themselves as proof of the existence of an overcompensation problem, the problem actually involves the process by which these salaries were determined and not the dollar amount. A lucrative salary, either standing on its own or in comparison with other salaries paid within the organization, is not in and of itself proof that the recipient has been overcompensated. As long as the compensation was the product of an active, good-faith bargaining process between the board and the executive, the salary cannot be characterized as unreasonable. Negotiation, motivated by self-interest on both sides, assures proper compensation. There is really nothing improper about an executive’s compensation if a board determines that the services rendered are highly valuable to the corporation and offering a high salary is the only way to retain that executive.

Compensation amounts do become problematic, however, when a board, beholden to a particular executive, agrees to a salary package upon demand, in the absence of self-interested bargaining. The failure to actively negotiate an executive’s compensation request is most likely to occur in corporations where the directors are not obligated to any particular shareholder or shareholder block, but gain and maintain their board seats because of executive largesse. This situation generally exists in companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.

In such businesses, the boards of directors generally consist of management and those appointed by management. In these situations, it is unwise for the outside directors to actively challenge the executives who have placed them in office. Such directors have little incentive, other than fiduciary duty (which for reasons to be discussed has proven ineffective...
in creating incentive), to bargain actively with management over compensation.

Many of the largest U.S. public corporations have shareholding ownership patterns that dispose them to such potential management capture and attendant compensation problems. It is these companies which have traditionally paid their executives the largest salaries and are currently the target of popular scrutiny. A large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture, may be indicative, because of its size, of a failure by the directors to have bargained effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the U.S. and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.

The difficulty with attempting to measure the adequacy of compensation is the highly subjective nature of the entire matter. This is why the courts have traditionally been reluctant to open their docket to salary disputes. There are too many ways of measuring compensation and related performance. What by one standard is excessive, may

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Id.; see also Herman, supra note 20, at 30-48; Monks & Minow, supra note 2, at 75-79; Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 607-39 (1982); Gilson & Kraakman, supra note 17, at 873-76 ("All too often outside directors... turn out to be more independent of shareholders than they are of management."). This situation may be changing. In October 1992, the outside directors of General Motors fired their CEO in response to the company's lackluster performance. See Paul Ingrassia, Board Reform Replaces the LBO, Wall St. J., Oct. 30, 1992, at A14. See also Jay W. Lorsch, Pawns or Potentates: The Reality of America's Corporate Boards 17-31 (1989) (noting that while the CEO still controls the director nomination process, boards are beginning to have greater participation in the process); Thomas A. Stewart, The King is Dead, Fortune, Jan. 11, 1993, at 84 (discussing recent firings and forced resignations of company CEOs); Stuart Mieher, Firms Restrict CEOs in Picking Board Members, Wall St. J., Mar. 15, 1993, at B1 (reporting survey which indicates that many companies now prohibit corporate insiders from nominating new directors).

22 See Herman, supra note 20, at 70-85.

23 See, e.g., Monks & Minow, supra note 2, at 166 (explaining that in 1989, the average CEO at top 200 companies received $2.8 million in salary and bonuses); Arch Paxton, Those Million-Dollar-a-Year Executives, in Executive Compensation: A Strategic Guide for the 1990s 43, 44 (Fred E. Foulkes ed., 1991) (noting that executive pay in the 100 largest publicly-owned corporations increased by an average of 13.7% in 1983); Executive Compensation Scoreboard, Bus. We., May 4, 1992, at 148-62 (rating executive pay among 500 largest U.S. companies).

24 See supra note 2. See also Monks & Minow, supra note 2, at 166-67 (noting that U.S. executive pay significantly outpaced inflation, wage, and profits rates from 1977 to 1987 and that American CEOs in billion-dollar companies receive two to three times the pay of comparable executives in Europe and Japan).

25 Statistics describing compensation levels do not give a complete picture of an executive's compensation package. In addition to salary and incentive awards, executive compensation often
be by another perfectly reasonable. This is what accounts for the tremendous division within the financial community over who is being overpaid and who is not.26 The only way to judge a compensation package objectively is through the same process by which businesses themselves are assigned value—through the operation of routine market forces, characterized by active bargaining. Given the potential for subdued bargaining and coincident overcompensation in the largest corporations, coupled with rapidly accelerating salary scales in the face of a national economic recession, it is not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness, the great potential for abuse mandates the formulation of a prophylactic response.

B. The Inadequacy of a Market-Based Response

Some argue that even if an overcompensation problem does exist, no external response need be forthcoming. The ordinary operation of the markets themselves will provide the solution. If the compensation scheme in a particular company is unreasonable, then market forces will punish that enterprise in the form of a lower stock price. The lessened equity value will, in turn, force the board to bargain more effectively for reduced salary levels to avoid revolt and replacement by enraged shareholders. Under this model, a market-induced decline in share values will encourage shareholder rebellion sufficient to compel a traditionally management-allied board to reconsider its compensation bargaining strategy. As a result, no externally-based approach to the compensation problem is necessary. The situation will take care of itself.

This approach may be seriously flawed despite its strong logical appeal. It is based entirely on the problematic assumption that unrea-
sonable executive salary levels will result in lower equity prices. Although high salaries may indicate a lax bargaining environment between the board and the company's top executives regarding compensation practices, the harm to the company itself may appear insignificant in a macro view. To a multibillion dollar corporation, a few million more dollars paid to its top management than may actually be necessary to retain their services has little bearing on that business's overall profitability. In this sense, the alleged overcompensation may be statistically insignificant. To a business earning $250,000,000, a million dollar overpayment to an executive, while a spectacular windfall to that individual, is insignificant in evaluating the company's earnings.27

Many techniques are used to value a business. Analysts consider such factors as price/earnings ratios, debt to equity computations, projected earnings streams, resale value, and break-up potential, among others, to determine the going equity value of an enterprise.28 While an executive's compensation is of major concern to that individual, in a large organization it has little impact on any of the common valuation methods because of its small relative scale. The actual effect of an excessive salary on the company's earnings or even its total asset base is likely to be minimal, if not minuscule.29 Therefore, even if an executive has been grossly overpaid, the impact on the company's stock price will be negligible because the market places its heaviest emphasis in valuation on "the bottom line," whether that may involve earnings, assets or liabilities.30 For a "market-based" solution to the compensation

27 But see Debate, supra note 1, at 133 (Michael S. Kesner, National Director on Compensation and Benefits at the accounting firm of Arthur Andersen, states that "(A) $5 million CEO pay package on the bottom line of a $2 billion sales company is clearly not the issue."). As former Illinois Senator Everett M. Dirksen remarked, "A billion here, a billion there, and pretty soon you're talking about real money." Respectfully Quoted 155 (Suzy Platt ed., 1989).

28 Analysts use four main methods to value companies. Discounted cash flow analysis ("DCF") essentially states that the value of a company is reflected in the profits the company will earn over a projected period of time. With the comparable company method, analysts compare the business to be valued with companies possessing similar financial and operational profiles. With the comparable acquisitions method, the value of a business is based on the cost of acquiring similar businesses. Liquidation analysis determines the company's value based on the prices the company's assets could be sold for in an orderly manner. Analysts apply combinations and variations of these methods when valuing a company. Robert L. Kohn, Investment Banking 97-125 (1990). See also Brian H. Saffer, Touching All Bases In Setting Merger Price, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing the strengths and weaknesses of the four methods).

29 Most valuation analyses do not separately address the executive's compensation. See supra note 28.

30 See Brownstein & Panner, supra note 7, at 29 ("The question is not 'Are executives paid too much?' The real question is 'Are shareholders getting their money's worth from their executives?'").
problem to be effective, overcompensation must have a reasonably
significant impact on the equity value of a company to force a board
response.

The market functioning alone will provide no certain remedy,
because the problem seems to merit little market attention. Still, a
response is warranted. Even if an executive is overpaid only a single
dollar, that dollar rightfully belongs to the shareholders, not the ex-
ecutive. In our system of criminal justice, the amount that an individual
takes wrongfully is unimportant in adjudging potential criminal re-
ponsibility. The mere fact that an unlawful gain occurred is the basis
for action. So must a response in the corporate arena be similarly
forthcoming? While an unreasonable compensation scheme may, in
and of itself, have little impact on overall corporate performance, it
may also indicate a much broader problem that should demand an
immediate response. An overcompensated executive is indicative of an
inattentive board whose neglect may result in far more dire conse-
quences for corporate profitability than a simple excessive salary
scheme. Inattention to this problem will ultimately result in a runaway
management which may lead to corporate disaster. By the time com-
pany profits have decreased to such a level as to warrant a market-based
response, the damage to the business and shareholder wealth will have
already been done. If the loss to the corporation of its market share
and reputation are severe enough, the damage may be irreversibly
crippling and perhaps even fatal to the enterprise. An active, non-mar-
ket-based response is therefore required.

II. A CRITIQUE OF CURRENTLY PROPOSED SOLUTIONS

As the controversy over compensation has grown, proposals to
solve the problem have proliferated as well. The governmental and
legal communities have offered several dramatically differing solutions.
These well-intentioned approaches miss the mark. They appear to

31 Compensation commentator Graef Crystal concedes that a CEO’s pay package does not
significantly influence stock values, but argues that investors should consider both the amount
of an executive’s pay as well as the mechanisms by which he is paid in order to make an intelligent
32 The consequences of an inattentive board and the resulting benefits of an activist board
are best illustrated by the recent turmoil at General Motors. Throughout its history, the GM board
was typically beholden to GM management, with board meetings being little more than social
gatherings in which the CEO’s agenda was approved. After a long, steady decline during which
GM’s share of the American car market dropped from 52% to 35%, the GM board finally took
affirmative steps to improve the company’s performance, steps which included firing GM’s CEO,
attack the manifestation of the problem without targeting its root cause—passive bargaining resulting from inactive boards. These proposals will either prove ineffective or may even act to compound the damage to corporate health that overcompensation creates.

A. Heightened Disclosure

The Securities and Exchange Commission (the "SEC") has developed a two-tiered approach to the issue. This approach involves a reexamination of the way the proxy rules deal with executive compensation questions and it will have about as much effect on the problem as aspirin provides for the common cold. It may make us feel a bit better, but the offending virus remains. First, the SEC has liberalized its stance on permitting shareholders' resolutions regarding executive compensation onto the annual meeting ballot. Traditionally, such proposals were excluded as a matter of policy. Under Rule 14a-8(C)(7) of the Securities and Exchange Act of 1934, resolutions that dealt "with a matter relating to the conduct of the ordinary business operations of the registrant" were excludable.33 Resolutions relating to compensation were said to fall within this category. In early 1992, however, the SEC amended its policy and announced that it would no longer permit the wholesale exclusion of such proposals, as long as they targeted top executive compensation and not ordinary managerial compensation policy. 34 At least ten shareholder proposals calling for compensation

Recently, a number of formerly passive boards have become increasingly active and have removed from office managers who were previously untouchable. For example, Paul E. Lego, the Chairman and CEO of Westinghouse, resigned his post in response to mounting charges of inadequate corporate financial performance and growing concern about management effectiveness amongst the company's directors. Stuart Mieher, Westinghouse's Paul E. Lego Resigns as Chief, WALL ST. J., Jan. 28, 1995, at A5, A6. IBM's CEO and Chairman John F. Akers was forced into retirement as the company saw its stock price lose half of its value within a six-month time frame: the corporation was forced to make a 55% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Michael W. Miller & Laurence Hooper, Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed, WALL ST. J., Jan. 27, 1993, at A1, A5.

In the past 18 months, 13 Fortune 500 corporate CEOs have either resigned, been fired, or been asked by their directors to prepare for departure. Prominent among Lego's and Akers' colleagues: Nicholas J. Nicholas, Jr., Time Warner; Tom H. Barrett, Goodyear; James D. Robinson III, American Express; Kenneth H. Olsen, Digital Equipment; Joseph R. Canion, Compaq Computer; and James L. Ketelsen, Tenneco. Stewart, supra note 21, at 34, 35-36, 40.

33 17 C.F.R. § 240.14a-8(c)(7) (1992). Rule 14a-8(c)(7) states:

(c) The registrant may omit a proposal and any statement in support thereof from its proxy statement and form of proxy under any of the following circumstances:

(7) If the proposal deals with a matter relating to the conduct of the ordinary business operations of the registrant.

limitations were allowed onto proxy ballots. None, however, was ultimately successful.\textsuperscript{35}

The second tier of the SEC’s response to the compensation issue involves increased public disclosure of executive salary arrangements. In June, 1992, the SEC proposed sweeping changes in the type and amount of disclosure that must be made to the public by reporting corporations in the executive pay area. The reasoning behind the proposals was ostensibly “to improve shareholders’ understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance.”\textsuperscript{36} Three new disclosure requirements were proposed. First, all compensation paid to certain senior executives was to be reported to the public in the form of a “Summary Compensation Table” which would “show both annual and long-term compensation in a single, comprehensive overview.”\textsuperscript{37} Second, the board’s Compensation Committee would be directed to prepare a report “on the corporate performance factors that it relied on in making specific compensation awards for reporting executives, as well as describe the general policies of the committee in determining senior executive compensation.”\textsuperscript{38} Third, the reporting corporation would be required to prepare an annual “Performance Graph”\textsuperscript{39} to aid in shareholder evaluation of the effectiveness of corporate performance in relationship to compensation practices. This graph would set forth the cumulative total return to shareholders of the registrant over a period of at least the previous five years, together with the comparable return to

\textsuperscript{35} The ten proposals and the percentage of shares voted in favor of each motion are: IBM: improved disclosure of officer pay, 16.7% shares; Baltimore Gas & Electric: cap executive pay at 20x average worker’s salary, 12.2% shares; Eastman Kodak: disclose executive severance packages, 15.9% shares; Equimark: tie executive severance pay to company performance, 16.5% shares; Bell Atlantic: end management short-term bonus plan, 10.9% shares; Black Hills Corp.: eliminate director’s retirement plan, 36.9% shares; Chrysler: disallow revaluing of stock options, 5.6% shares; Aetna: cut director’s pay for failure to attend board meetings, 7.5% shares; Battle Mountain Gold: cut executive pay 30% and end stock options until profit recovers, not on ballot; Reebok: establish compensation committee of independent directors, 19.2% shares. Executive Compensation Disclosure, Exchange Act Release No. 6940, 57 Fed. Reg. 29,582, 29,583 (July 2, 1992); REEBOK INT’L LTD., MAR. 30, 1992, PROXY STATEMENT (1992); Battle Mountain Gold Sees Possible Loss, Reuters, Apr. 21, 1992, available in LEXIS, Nexis Library, Reuters File; Salwen, supra note 34, at A12. See also Judith H. Dobrzynski, A Ground Swell Builds for ‘None of the Above’, Bus. Wk., May 11, 1992, at 34 (observing that many shareholders are withholding proxy votes in an effort to remove directors from company boards).


\textsuperscript{37} Id. at 48,126–27.

\textsuperscript{38} Id. at 48,127.

\textsuperscript{39} Id.
shareholders for the stocks included in (i) the Standard and Poor's 500 Composite Stock Price Index ("S & P 500"); and (ii) any recognized industry index (e.g., the Dow Jones Transportation Average) or a group of peer companies selected by the registrant. Following substantial public comment and debate, the SEC adopted the proposals with some changes made in the amount of information to be disclosed. A number of the proposed tables were either revised or dropped "to eliminate redundant information and to improve the clarity of information presented." Despite these changes, the increase in the amount and type of information to be reported under the new rules as compared with the material disclosed under the old regime was substantial.

It is clear from these changes that the SEC has settled on a disclosure-based approach to the compensation controversy. In the SEC's view, the solution to overcompensation lies with an informed and empowered shareholdership, informed as to exactly how much the executives are earning and how that figure relates to performance, and empowered to vote both on compensation resolutions and, if thoroughly dissatisfied, on ultimate board replacement. SEC Chairman Richard C. Breeden has summarized the Commission's theory behind its actions by stating that:

The proposals would give the shareholders more information and then make it reasonably possible for them to do something about that information . . . . The philosophy that underlies the proposals is that the people in the best position, if a company is deteriorating or stagnating, to do something about it are the people who own it. For too long, the Wall Street rule has been that if you don't like what's going on, sell out. That has made it difficult and expensive for shareholders. These proposals make sure the information is out in the open and remove the restraints so shareholders can do something.

This approach, although not without some visceral appeal (for who can argue with a better-informed public), is basically ineffectual. Indeed, in its very premise can be found the source of its primary

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40 Id.
41 57 Fed. Reg. at 48127. The SEC received more than 900 letters of comment concerning the proposal. Id.
42 Id.
weakness. The whole concept relies on the idea that an outraged and invigorated shareholding public will provide the solution to the perceived corporate malaise. Shareholder activism will result in more accountable and productive management. The best way to create this necessary activism is through the prodding effect of heightened disclosure. Additionally, the more excessive a salary structure appears, the more likely that full disclosure will embarrass management into correcting the situation.

Although it is certainly true that as the owners of the enterprise, shareholders have the power to engage effective and accountable managers, it is equally clear that this ability does not always translate into results. Indeed, it was the same shareholders who permitted the creation of that management capture that has led to the entire controversy. Shareholder passivity created the problem, and it is unlikely that disclosure will provide the solution. This irksome passivity is not the result of a lack of information, but, rather, a growth in the size of the typical public corporate entity. The larger the corporation became, the more likely its ownership took on an atomistic quality, with no one shareholder or shareholding group exercising control. Moreover, as the size of proportionate shareholding fell, individual shareholders, who no longer held controlling or particularly significant amounts of stock, lacked the incentive to take an active role in the corporation’s affairs. Management then filled the vacuum. Increased disclosure will have no effect on this situation. As Professor Bainbridge has observed:

Basic financial economics tells us that most shareholders prefer to be passive investors. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs. Given the length and complexity of SEC disclosure documents, the opportunity costs are quite high and very apparent. In contrast, the benefits aren’t at all clear because most shareholders’ holdings are too small to have any significant effect on the vote’s outcome. For most shareholders, therefore, the investment of time and effort necessary to make informed voting decisions remains a game not worth playing. . . . What then will shareholders do with the enhanced disclosure required by the commission’s present proposals? They will do what they always do

45 Id. at 141.
with corporate disclosure: ignore it and simply vote for management’s director slate and management compensation proposals.46

What about the institutional investors whose growing ownership presence in the largest public corporation presents, according to many scholars, so much potential for effecting positive change in corporate governance? Will increased disclosure motivate this group to pursue more reasonable compensation practices? Probably not. First, for reasons to be developed later in this section,47 it is unlikely that institutional investors, even if awakened from their current economic slumber, will ever achieve the substantial control position in a corporation necessary to direct the affairs of the business. Second, it is unclear that the compensation disclosure now mandated by the SEC will inform institutional investors (or individual investors, for that matter) of anything that they do not already know. As a result of the heightened media attention to the issue, much information on compensation programs in a dizzying variety of corporations (based on past disclosure requirements) has flooded the market-place. Various popular financial publications feature annual performance profiles of numerous public companies detailing compensation practices and how they relate to overall performance.48 There is no shortage of information available to the individual investor on corporate compensation. Moreover, the performance comparisons the SEC has now required reporting companies to make are well within the analytical capabilities of even the most inexperienced financial analyst and may be available to all investors through periodic brokerage house reports. Indeed, the SEC’s new disclosure regime will only serve to create more fodder for potential Rule 10b-5 mis-disclosure actions.49 The end result may be an

46Stephen M. Bainbridge, Executive Pay: Who Listens?, LEGAL TIMES, Aug. 10, 1992, at 23. See also Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. LAW. 461, 525 (1992) (observing that shareholders are not effective monitors of a company’s board of directors and that prominent features of corporate law actually make it difficult for shareholders to hold the board and managers legally responsible).

47See infra notes 90–100 and accompanying text.


49See Bainbridge, supra note 46, at 22 (commenting that disclosure rules only benefit plaintiffs’ lawyers who will bring lawsuits and defense lawyers who will defend them). To avoid this potential liability, companies have started to hire a variety of different advisors, including law firms, compensation consultants, public relations firms, accountants, investment banks, computer software makers, and publishers of electronic data. Thus, company shareholders must pay for increased disclosure in the form of fees the company pays to these advisors. Joann S. Lublin &
increase in official information available, but with little corresponding benefit. Increased required disclosure will do little to arrest the traditional cause of shareholder passivity and will have an insignificant impact on overcompensation.

B. Increased Taxation

The second major response to the compensation controversy has come from the legislature. In early August, 1993, the Congress, upon the recommendation of the President, enacted legislation that placed a one million dollar limit on the deductibility of executive compensation. Under a provision contained within the Revenue Reconciliation Act of 1993, corporations are no longer able to deduct, as a business expense, compensation payments to executives that exceed one million dollars per annum that are not performance-based. Additionally, a special surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year. The theory seems to be that by removing the deductibility of high salaries, and increasing the taxes due by the recipients of sizeable compensation, corporations and the individual recipients will find it too costly to negotiate excessive compensation packages. The benefits of high compensation to the recipient will be taxed out of existence and the corporation itself will find it twice as expensive to pay such large salaries. Moreover, by setting the taxation tripwire at one million dollars, Congress seems to have concluded that salaries over this level are per se excessive.

Although this approach will certainly “solve” the compensation problem and simultaneously produce heightened revenues for a tax-

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50 Indeed, the new disclosure requirements may even have the deleterious effect of deluging the investor in “data-overkill.” Joann Lublin, Executives Grumble About SEC Plan to Require More Pay Data, WALL ST. J., Sept. 21, 1992, at B1. The new disclosure requirements, however, appear to have increased institutional investor scrutiny of the compensation practices of at least one company. The Wisconsin public pension fund is seeking to remove the outside directors of Paramount Communications who approved the company’s executive compensation plan. The fund is basing its action on charts, required by the SEC, which show that, although Paramount’s stock has underperformed both the Standard & Poors 500 stock index as well as peer group stocks, Paramount executives continued to receive bonuses. Susan Pulliam, Paramount Is Targeted by Pension Fund Due to Weak Stock Price, Executive Pay, WALL ST. J., Mar. 4, 1993, at A4.


starved treasury, it will have no favorable impact on corporate health in general. This response is akin to removing a splinter by amputating the limb. The splinter is gone, but at enormous cost. Similarly, this tax-based "cure" may result in more harm to the patient than the initial problem.

First, there is nothing inherently wrong with a salary over one million dollars. An executive who produces substantial increases in corporate profitability that results in large profits for the shareholders, may be worth paying more to retain in the competitive labor market place. The salary is only problematic when it has not been fairly bargained for. Second, a salary not only provides compensation for an individual's efforts, but also acts as an incentive for future activity. Companies compensate both to reward past activities and to encourage greater productivity in the future. The idea emanates from the classic carrot-stick parable. It is not the stick that compels productive labor, but the carrot as incentive. The larger the carrot, the greater incentive to increase productivity. While a large salary may certainly be viewed as a wasteful expenditure of corporate assets if one assumes that wages were simply created to compensate solely for work produced, from a different perspective, heavy compensation may be beneficial to the corporate enterprise as a powerful incentive for heightened management creativity and effort. The larger the proffered salary, the greater effort potentially to be expended. To limit arbitrarily the amount of compensation will effectively eliminate any incentive for the kind of executive productivity necessary to keep our large corporations competitive.

The term compensation itself is a bit of a misnomer, for compensation is not merely a reward for past services, but also acts as an incentive for future efforts. As pointed out earlier, a large salary is not in and of itself pernicious; it is only when it has not been bargained for and is a simple toll paid to the ineffective that it becomes troublesome. To solve the perceived problem of overcompensation by summarily taxing out of existence salaries over one million dollars per year

53 See CRYSTAL, supra note 31, at 159-78 (arguing that high-paid CEOs of Reebok, Walt Disney, and H.J. Heinz are properly compensated due to the risk they take and the returns they generate for their shareholders).
54 See LLOYD G. REYNOLDS et al., LABOR ECONOMICS AND LABOR RELATIONS 183-94 (1966). See also Burchman, supra note 25, at 189-211 (discussing ways to create proper incentives through executive compensation). This "carrot" theory of compensation is evidently in operation as IBM searches for a new CEO. Despite IBM's well-publicized problems, it has had little difficulty finding accomplished candidates for the lucrative position. Michael W. Miller, IBM's Search for New Leader Appears Ahead of Schedule, WALL ST. J., Feb. 24, 1993, at B1.
55 See infra notes 113-16 and accompanying text.
would stifle the crucial incentives created by the prospect of high, and perhaps seemingly excessive, salary levels.

C. Judicial Activism

While some have sought to curtail compensation through heightened disclosure or tax-based legislative limits, one group of commentators has focused on a judicially-based approach. They maintain that active judicial review of executive compensation structures may serve to limit executive salaries. Professor Vagts has argued that while judicial evaluations of “the excessiveness of compensation are not easy to make, they are not impossible. . . . [C]ourts can and should carefully scrutinize compensation that is substantially out of line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them.” This approach to the compensation issue is not without some appeal but it may prove to be as ineffective today as it was when the problem first emerged in the mid-1930s.

Board compensation decisions are generally protected by the business judgment rule. Provided that there has been an informed deci-
sion-making process and no self-dealing, a board’s compensation award will be judicially unassailable, with one exception. Where compensation to an executive simply bears no relation to the services that individual has rendered, it will be considered a waste of corporate assets and thus actionable. This standard was initially promulgated by

acted on an informed basis, in good faith and in the honest belief that the action was in the best interest of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted). The American Law Institute—in its Principles of Corporate Governance has defined the rule in the following manner:

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

(1) he is not interested in the subject of his business judgment;

(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and

(3) he rationally believes that his business judgment is in the best interest of the corporation.


The Delaware Supreme Court, in Beard v. Elster, explained the rationale behind the application of the business judgment rule to compensation decisions:

We have before us a [stock option] plan which, in the judgment of a disinterested Board, is adequately designed to further the corporate purpose of securing the retention of key employees' services. It is theoretically possible, we suppose, that some businessmen could be found who would hold the opinion that options exercisable at once were improvidently granted, but, on the other hand, there are businessmen who would hold a favorable view, as this board of independent businessmen in fact did. At most, therefore, we find ourselves in the twilight zone where reasonable businessmen, fully informed, might differ. We think, therefore, we are precluded from substituting our uninformed opinion for that of experienced businessmen who have no personal interest in the outcome, and, whose sole interest is the furtherance of the corporate enterprise.

160 A.2d 731, 735 (Del. 1960), aff'd sub nom. Eister v. American Airlines, 167 A.2d 231 (1961). Section 5.08 of the ALI Principles of Corporate Governance provides in part that a court may not invalidate a compensation arrangement if it is "authorized in advance or ratified by disinterested directors . . . in a manner that satisfies the standards of the business judgment rule."

PRINCIPLES OF CORPORATE GOVERNANCE, supra note 16, § 5.08(a)(2). Where directors have a personal interest in the fixing of executive compensation, the business judgment rule does not apply and the directors must prove that the transactions were fair to the corporation. Cohen v. Ayers, 596 F.2d 783, 789–90 (7th Cir. 1979) (citing Kerbs v. California Eastern Airways, 90 A.2d 652 (Del. 1952), reh'g denied, 90 A.2d 652 (1952); Gottleib v. Heyden Chemical Corp., 90 A.2d 660 (Del. 1952)).

Even disinterested directors and shareholders cannot ratify waste. Rogers v. Hill, 289 U.S. 582, 591–92 (1933) ("If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority."). Courts usually define "waste" in terms of the adequacy of consideration the corporation receives from the employee in return for the
the Supreme Court in 1933 in *Rogers v. Hill*,\(^{60}\) which remains the seminal compensation case.\(^{61}\) Following disclosures made in the 1930s of substantial compensation paid to executives immediately prior to and during the Great Depression, a number of shareholder actions were brought challenging these compensation practices.\(^{62}\) The *Rogers* decision determined the approach for judicial review of these claims.

While the "waste" standard articulated by the *Rogers* Court was seemingly simple to comprehend, problems arose in its actual application. The difficulty was, of course, in determining when exactly compensation was unrelated to services rendered. The oft-cited language of a New York State Supreme Court Judge in the legendary *Heller v. Boylan*\(^{63}\) decision highlights the difficulty of determining what constituted actionable waste:

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 of human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing this compensation paid by the corporation. See, e.g., Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984) (holding that stock option plans must contain conditions or surrounding circumstances must be such that the corporation may reasonably expect to receive the contemplated benefit from the grant of options); Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (ruling that the court's examination is limited to discovering whether what the corporation has received from the employee is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation paid). Courts have held that boards have not wasted corporate assets when the boards canceled existing stock option plans and reissued new options to executives at a lower exercise price when the company's stock price declined. See *Cohen*, 596 F.2d at 741-43.

The United States Court of Appeals for the Eighth Circuit, in *International Ins. Co. v. Johns*, ruled that in determining whether a corporation receives "adequate" consideration for payments to an executive, a court must inquire into whether the compensation an executive receives bears a "reasonable relationship" to the services rendered. 874 F.2d 1447 (1989) (citations omitted). The court further stated that to find a reasonable relationship, a court must answer three questions. First, did the corporation benefit from the services rendered? If the corporation received no benefits in exchange for the payments, the compensation plan is waste. Second, was the compensation so disproportionate to the benefits received that a reasonable person would think that the corporation received no quid pro quo? If no quid pro quo resulted, the payments would constitute corporate gifts. Finally, did the services rendered trigger the payments? If some other occurrence triggered the payments, the plan is invalid because it cannot assure performance. *Id.* at 1461-62 (citations omitted).

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60 289 U.S. 582 (1933).
61 Barris, *supra* note 2, at 84.
corporation than its stockholders?

Yes, the Court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.

If comparisons are to be made, with whose compensation are they to be made—executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province.64

For these reasons, courts have been highly reluctant to involve themselves in compensation disputes. A compensation decision is not really capable of mechanistic review. It is essentially a business judgment and the same rationale that mandated the creation of the business judgment rule lies behind judicial reluctance to characterize certain payments as “waste.” A court is hardly in a better position than an informed, impartial board to determine an executive’s worth.65 Furthermore, the liability that would result from such judicial second-guessing would seriously compromise a board’s effectiveness and its ability to recruit prospective members. Thus, since the Heller ruling, there have been few reported cases dealing with the compensation levels of executives of large publicly-traded corporations. In those cases, the courts have reached similar results, “either appl[y]ing the business judgment rule and endors[ing] the compensation practice, or simply throw[ing] in the towel and refus[ing] to deal with the problem.”66

Despite judicial reluctance to decide compensation questions in-

64 29 N.Y.S.2d at 679-80.
65 Barris, supra note 2, at 82. See also Vagts, supra note 4, at 254-55.
66 Barris, supra note 2, at 82. See infra notes 67-69 and accompanying text. See also Barris, supra note 2, at 86-88; Vagts, supra note 4, at 255-57.
EXECUTIVE OVERCOMPENSATION

volving large, public corporations, the same reticence is not evident in numerous cases regarding compensation disputes in smaller close corporations. Courts regularly pass on salary fairness, or lack thereof, in this area. In addition, in the tax arena, both tax court and U.S. District Court judges frequently review executive compensation packages to determine the appropriateness of specific corporate deductions for "reasonable" compensation expenditures under § 162 of the Internal Revenue Code. Commentators argue that if the courts have no problem determining the reasonableness of compensation in the close corporation and tax settings, they should extend the same "judicial aggressiveness" to the large corporation compensation cases.

This call for judicial activism, in the face of escalating compensation packages, will remain as unheeded by the courts in the future as it was when initially issued by Professor Vagts more than ten years ago. Although courts have indeed manifested a willingness to review compensation in certain limited contexts, Professor Vagts' call to action underestimates the critical differences between compensation disputes in the close corporation or tax cases and those involving large corporations. The close corporation compensation cases are not disputes about compensation at all. Rather, they are grounded in the attempted oppression of minority shareholders by a controlling shareholder or group of shareholders. In actuality, these cases involve attempts by

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68 The Internal Revenue Code states generally that a trade or business deduction shall be allowed for all ordinary and necessary expenses, a provision which includes a "reasonable" allowance for salaries and compensation for services actually rendered. I.R.C. § 162(a)(1) (1988). Factors used by the courts include: the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexity of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable position in comparable concerns; the salary policy of the taxpayer as to all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in recent years. Mayson Mfg. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949). See generally William E. Palter, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 215-20 (2d ed. 1981); David E. Hoffman, Heeding Significant Factors Improves the Odds for Reasonable Compensation, 50 J. Tax 155 (1976).

69 Barris, supra note 2, at 87; Vagts, supra note 4, at 276. See also Charles M. Yablon, Overcompensating: The Corporate Lawyer and Executive Pay, 92 Colum. L. Rev. 1867, 1896-1906 (1992) (reviewing Graf S. Crystal, In Search of Excess (1991)) (suggesting that easing the legal standard from "waste" to "reasonable in relation to the corporate benefits expected" will create the possibility of litigation with attendant uncertainty which will result in incentive for restraint by CEOs seeking substantially above-average compensation).

70 All of the close corporation cases Professor Vagts cites to support his proposition that courts
the controlling shareholders to steer large portions of the corporate profits selfward rather than sharing the fruits of corporate success proportionately with their fellow equity-holders. Instead of dividing the profits evenly through dividends, the controlling individuals enrich only themselves through large compensation packages, leaving fellow shareholders out in the cold, deprived of the benefits of equity ownership.\footnote{\textsuperscript{71}}

Whether effected through simple greed or as part of some nefarious “freeze-out” scheme,\footnote{\textsuperscript{72}} this manifestly unfair sharing is the type of self-dealing that courts, from an equity standpoint, are eager to remedy. It is not the size of the compensation that provokes a judicial response, but the attempt to divert profits from the minority holders. These shareholders really have no other remedy besides judicial intervention. Because of their minority status, they cannot win a board or shareholder vote on the practice, nor is there any market for their shares. The only potential purchaser is the oppressing majority. In such circumstances, it is a relatively appealing task for a court to intervene and find the compensation unjustified, either forcing a proper sharing of corporate profits with the minority, or a majority buy-out of their shares at an acceptable price. This explains judicial willingness to engage in compensation review in this area. Such judicial involvement is not really about compensation; rather, it involves clear and remedi-
able self-dealing. Without the protection of the courts, few investors would be willing to accept minority status in a small corporation, and such enterprises would be deprived of necessary investment capital.

This is not the case in the large public corporation setting where excessive executive compensation deprives shareholders of a relatively small portion of profits and is effected by a group without the kind of absolute control possible in the close corporation arena. In small businesses, it is not uncommon for a control group to possess over 50% of the corporation's stock and effectively block any kind of minority response to unwelcome actions. In the large public corporation, management controls a relatively small amount of stock and can always be outvoted by an outraged shareholdership. This is obviously not an easy task but it is not a numerical impossibility, as is often the case in the close corporation setting. Thus, judicial involvement seems less necessary, as the problem appears less drastic and other remedies are available. Concerns about judicial competence to review compensation reemerge and stifle intervention.

Judicial activism in the taxation cases is also easily distinguished from the ordinary compensation dispute. The general object of any kind of tax litigation is not the punishment of some overreaching executive, but the production of additional revenue for a tax-starved federal treasury. The objective is revenue generation and any judicial

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73 See Donahue, 328 N.E.2d at 511 (defining a close corporation as a corporation typified by "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in management"). Holders of a majority of a company's stock have the ability to elect and control a majority of the company's directors and thus have the power to employ a variety of techniques to deprive minority shareholders of the value of their interests in the company. Some examples of these techniques include a refusal to declare dividends, payment of exorbitant salaries to majority shareholder officers, refusal to employ minority shareholders, and sale of corporate assets to majority shareholders at inadequate prices. O'NEAL & THOMPSON, supra note 70, § 3.02.

74 Due to the disparity in size of earnings between a small close corporation and a large public corporation, it is usually easier for a court to determine whether an executive's salary is excessive in the close corporation. For example, a $1 million salary for an executive in a Fortune 500 company is insignificant in relation to the company's bottom line, whereas in a small close corporation, the same salary could constitute a significant percentage of the company's earnings for a given year and thus substantially reduce dividend payments to the company's shareholders. See Vagt, supra note 4, at 255-56.

75 The executive compensation cases in this area generally deal with close corporations in which company executives are also controlling shareholders. Section 162 of the Internal Revenue Code is designed to prevent these owner-managers from distributing sums in the guise of salaries (which are deductible by the corporation) that are actually non-deductible dividends and thus subject to corporate-level taxation. Id. at 257. Thus, in this area, courts do not focus solely on the reasonableness of an executive's compensation. They are equally, if not more, concerned with a company's dividend policy. See, e.g., McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970) (finding compensation reasonable, yet disallowing deduction because the corporation
concern about second-guessing a board is secondary to the process. With this in mind, courts review compensation in this arena not with the objective of limiting unreasonable salaries, but to determine the legitimacy of income deductions that reduce tax revenues. The business judgment concerns that accompany judicial review of ordinary compensation actions are simply not present in this area and thus do not create the same judicial reluctance to become involved.

The problem of judicial involvement in large corporation compensation disputes, like that raised in Heller, is as valid today as it was fifty years ago. Courts neither feel comfortable nor particularly well-qualified to substitute their business judgment for that of an informed board of directors. Nothing has changed in the past five decades to enable courts to determine with any better precision what part of a salary has been earned and what part constitutes “waste.” The Judiciary’s discomfort and consequent reticence remain and will continue. There simply is no mechanism available to compute with precision an executive’s worth and any judicial resolution of the matter involves a judgment call of the type courts have typically avoided. Unless a plaintiff can introduce some kind of evidence of fraudulent or collusive behavior on the part of a board in its compensation decision-making process, misconduct which would provide for easy judicial resolution, it is highly unlikely that the courts will abandon their traditional passivity in compensation cases. Judicial activism is simply not a realistic solution to the overcompensation dilemma.

D. Institutional Shareholder Activism

Another proffered solution to the compensation problem involves institutional shareholder activism. It is argued that institutional inves-
tors, who increasingly constitute the largest shareholders in many of the largest public corporations, possess tremendous potential to effect positive change in the operation of these businesses by becoming more active "monitors" of corporate management. The size and financial sophistication of institutional investors make them uniquely positioned to take the lead in promoting corporate productivity. Increased institutional investor activism will result in more effective shareholder oversight of both boards and managers and may prove a solution to corporate inefficiency by stimulating more productive and responsive management. Indeed, much scholarly attention has been devoted to the "promise of institutional investor voice."

The positive potential of active monitoring may also carry over to the compensation area. Professor Black has suggested that despite "systemic shortfalls in corporate performance... institutional oversight, either directly or through stronger boards of directors, could correct these shortfalls... Institutional investors could add value by... establishing a more arm's-length process for setting CEO pay." As a corporation's largest shareholders, institutions may have the clout to force a board to bargain impartially and effectively with senior management to produce reasoned compensation arrangements. Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would

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78 By the end of 1990, institutions owned 53% of the equity in U.S. companies. In addition, institutions have begun to concentrate their assets in specific companies. Jayne W. Barnard, Institutional Investors and the New Corporate Governance, 69 N.C. L. Rev. 1135, 1140 (1991) (observing that the top twenty pension funds plus the ten largest U.S. money managers hold more than 16% of the shares in the 10 largest U.S. corporations) (citing William Taylor, Can Big Owners Make a Big Difference?, HARV. BUS. REV., Sept.-Oct. 1990, at 70); Black, Agents, supra note 17, at 827. See also Carolyn K. Brancato, The Pivotal Role of Institutional Investors in Capital Markets, in INSTITUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3-33 (Arnold W. Sametz & James L. Bicksler eds., 1991); Barris, supra note 2, at 89.


be strong enough to convince otherwise passive directors to act more effectively.

To encourage this seemingly positive form of monitoring, a number of commentators have proposed various reforms in the legal rules regulating institutional conduct in order to give institutional investors more freedom and incentive to engage in active oversight of corporate activities.\(^1\) In addition, they have formulated numerous techniques for institutional investors to use in their attempts to exercise corporate control.\(^2\) These proposals include: amending various SEC regulations to permit more communication and coordination between institutions;\(^3\) altering regulations governing institutional investment strategy to restrict portfolio diversification to discourage investor “exit” and encourage investor “voice;”\(^4\) creating activist shareholders’ advisory committees to make management more aware of institutional concerns;\(^5\) placing representatives of the institutional investors on the corporate boards themselves;\(^6\) or even creating a cadre of professional directors who would serve on corporate boards to demand effective management.\(^7\)

\(^1\) See, e.g., Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990) (describing the complex web of legal rules and cultural factors that prevent institutional shareholders from becoming more active monitors); Coffee, supra note 79 (suggesting that an incentive for institutional monitoring be created by restricting portfolio diversification, requiring fund managers to price investment and monitoring services separately, and authorizing incentive compensation for fund managers); Conard, supra note 79, at 176–78 (calling for, among other things, greater access to company proxy statements and the removal of the threat of “controlling person” liability); Dent, supra note 79, at 907 (proposing that a committee of a firm’s 10 or 20 largest shareholders be given authority to use corporate funds to solicit proxies). Cf. Rosenbaum, supra note 79 (contending that changes in the proxy rules are unnecessary). See also Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991) (observing that U.S. financial institutions cannot reach their full potential as monitors due to a variety of legal prohibitions designed to prevent them from gaining too much power).

\(^2\) See Black, Agents, supra note 17, at 830–49, for a discussion of the variety of methods institutional investors could employ to affect corporate performance.


\(^4\) Coffee, supra note 79, at 1351–66.

\(^5\) Participation in a “shareholders’ advisory committee” is the most commonly proposed role for the institutional investor. In general, these committees would be composed of representatives of a company’s largest shareholders and would be appointed by the board of directors for one-year terms. The committee would advise the board on matters of concern to the company’s shareholders and submit proposals from time to time. See Barnard, supra note 79; Rock, supra note 79, at 49. Professor Barnard argues that shareholders’ advisory committees will be ineffective monitors of corporate performance and suggests that institutions should place representatives on the board itself, rather than on some “shadow committee.” Barnard, supra note 79, at 1168–73.

\(^6\) See Louis Lowenstein, What’s Wrong With Wall Street: Short-Term Gain and the Absentee Shareholder 209–10 (1988); Barnard, supra note 79, at 1168–79; Dent, supra note 79, at 907.

\(^7\) Gilson & Kraakman, supra note 17, at 883–92.
It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active agitators for change in corporate policy and personnel. Most recently, a number of the large institutions have played a major role in forcing changes in management and policy at such prominent corporations as IBM, Sears Roebuck, American Express, and even General Motors.88 Despite this activity, it is unclear whether these groups will either be able, or even desire to be a primary force in effecting change in executive compensation practices.89 There are a number of reasons why sole reliance on institutions to resolve the compensation controversy would be a mistake.

The first set of problems with institutional action is general in nature. There are several fundamental reasons why institutional investors, as currently constituted, may never be able to monitor corporate activities in the manner envisioned by their supporters. The first concern has to do with investment strategy. Professor Coffee has argued that there is an inherent preference among many institutions to structure their investment portfolios in such a manner as to provide maximum liquidity. Investments are arranged by type and size to provide for quick and easy disposition in the event that conditions warrant. Thus, investments that are not readily saleable are avoided. Such liquidity, the ability to easily exit an investment, effectively eliminates

88 As its financial outlook has deteriorated, IBM has faced increased shareholder agitation from groups such as the United Shareholders Association (USA). USA plans to press at IBM's annual meeting for the passage of four proxy proposals which deal with management performance, oversight, and compensation. Catherine Arnst & Joseph Weber, IBM After Akers, Bus. Wk., Feb. 8, 1993, at 22. Sears Roebuck's Edward Brennan relinquished several leadership roles and the company agreed to divest itself of certain business lines in the face of growing shareholder threats. Stewart, supra note 21, at 35. Despite the fact that American Express Chairman James C. Robinson III initially persuaded his board to keep him in power in the face of disappointing results, institutional shareholder agitation eventually led to his resignation. J. P. Morgan, joined by Alliance Capital and Putnam Management, was highly influential in forcing Robinson's removal. Leslie Wayne, Shareholders Exercise New Power with Nation's Biggest Companies, N.Y. Times, Feb. 1, 1993, at A1. It was institutional shareholder pressure that was instrumental in convincing the board of General Motors to demand the resignation of its chief executive, Robert C. Stempel. Id. See Stewart, supra note 21, for a list of companies that have responded to investor pressure by changing leadership. See also Black, Agents, supra note 17, at 828–29.

89 See infra note 100.
any incentive to exercise a meaningful voice in corporate affairs. The institutions

have considerable reason to remain 'rationally apathetic' about corporate governance and little reason to become active participants. Why? [A] tradeoff exists and must be recognized between liquidity and control. Investors that want liquidity may hesitate to accept control . . . [A] preference for liquidity chills the willingness of institutional investors to participate in the control of major corporations . . . .

Coffee suggests several structural reforms to lessen the bias towards "exit" and encourage the exercise of "voice"—such as "a restricted diversification strategy which would discourage institutional investors from diversifying beyond the limits of their monitoring capacity." Unless such reforms are implemented, however, the continued predilection towards liquidity lessens the incentive to monitor, which suggests a continuing passivity among the institutions.

The second concern involves size and communication. Although institutional holdings are substantial, particularly in dollar terms, each institution's ownership interest in the various corporations in which it invests is likely to be proportionately quite small. This reflects a preference for liquidity and portfolio diversification as well as legal restraints. As a result, even if a company's stock is held primarily by institutions, these holders, individually, control very little of that company's overall equity. To exercise "control," therefore, a number of institutions would have to agree to form a coalition. This may be problematic. First, each institution may have varying goals regarding its investment in a particular company and its own general investment strategy. No two institutions are precisely alike insofar as participant composition and investment goals are concerned. Consequently, each

90 Coffee, supra note 79, at 1281.
91 Id. at 1338.
92 For example, even the nation's largest state employee pension fund, Calpers (California Public Employees' Retirement System), only owns 6% of Westinghouse's outstanding shares. Miecher, supra note 32, at A5, A6. Indeed, despite its stock portfolio totaling $25 billion, Calpers has limited its holdings to just under a 1% ownership interest in more than 1,000 large U.S. corporations. George Anders, Restless Natives: While Head of Calpers Lectures Other Firms, His Own Board Frets, WALL ST. J., Jan. 29, 1993, at A1, A9.
93 See Coffee, supra note 79. See supra notes 90-92 and accompanying text.
94 See Brancato, supra note 78, at 7-13 ("Institutional investors are not a 'monolithic' group and have widely divergent investment and risk objectives, as well as varying attitudes on their appropriate role in corporate governance."). One commentator argues that public pension funds, which have the greatest power to influence management, are not well-equipped to do so effec-
would likely respond to varying control issues with differing levels of concern. Where interests diverge, coalitions and consequent power may disappear. Second, as some commentators have observed, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations, including the proxy rules, however, such communication may be restricted. Although changes have been suggested and some, in fact, promulgated, it remains to be seen how easily institutional investors may be able to solicit each other's votes or consent so as to act as a group without running afoul of various SEC requirements.

While these problems generally act to restrict institutional activity, another set of difficulties exists that may also limit institutional investor effectiveness in the compensation area. The first concern involves the benefits to be achieved by active compensation review. As discussed earlier, the actual impact on corporate earnings that an excessive salary represents is not likely to be particularly significant. Given the costs in terms of reputational capital expended in a compensation challenge and time required for organization of opposition among the
tively because of their politically-minded leadership. In contrast, private institutions, such as mutual funds, are run by individuals with greater financial expertise, but who have little inclination to influence management. Taylor, supra note 78, at 72. See infra notes 98-99 and accompanying text. See also Anders, supra note 92, at A1 (reporting that the head of Calpers is facing pressure from his board, which is composed mostly of state officials, to limit his efforts in influencing poorly performing companies and to concentrate instead on the management of the pension fund itself).

SEC regulations define "proxy" and "solicitation" very broadly so that virtually any statement of opinion to security holders is subject to costly and time-consuming filing requirements. Rules 14a-1(f), 14a-1(l), 14a-6, 17 C.F.R. §§ 240.14a-1(f), 240.14a-1(l), 240.14a-3(a), 240.14a-6 (1992). In addition, all solicitations are subject to antifraud rules which may chill communications in a highly-contested proxy fight. Rule 14a-9a, 17 C.F.R. § 240.14a-9(a) (1992). Black, Disclosure, supra note 83, at 53-57. See infra note 96 for a discussion of recent changes to these rules. See also Black, Agents, supra note 17, at 820 n.9; Coffee, supra note 79, at 1342-45; Conard, supra note 79, at 161-62.

The SEC recently eased the rules governing communications among shareholders. The changes include: An exemption from the proxy rules for communications with shareholders where the person soliciting is not seeking proxy authority and does not have a substantial interest in the subject matter of the vote. 17 C.F.R. § 240.14a-2(b) (1992) (amendment to Rule 14a-2(b)). The definition of "solicitation" has been changed so that shareholders can publicly announce how they intend to vote and provide reasons for that decision without having to comply with the proxy rules. 17 C.F.R. § 240.14a-1(b) (1992) (amendment to Rule 14a-1). Solicitations conveyed through the public media are not subject to the proxy rules so long as a definitive proxy statement is filed with the SEC. 17 C.F.R. § 240.14a-3(f) (1992) (amendment to Rule 14a-3). In certain transactions, companies must furnish shareholders with lists of all company shareholders. 17 C.F.R. § 240.14a-7 (1992) (amendment to Rule 14a-7). Regulation of Communications Among Shareholders, Exchange Act Release No. 31826, 57 Fed. Reg. 48,275, 48,276 (Oct. 22, 1992).

See supra notes 27-30 and accompanying text.

See Yablons, supra note 69, at 1893.
various stockholders, it may be that the potential benefit of slightly increased earnings due to lower compensation costs, particularly when diluted among many holders, may not appear worth the effort. Indeed, it would seem more expedient to expend one's energies challenging management on the issues that have a more substantial and fundamental impact on the company's business prospects, such as expansion, asset disposition or even general labor policy, than championing an issue with limited impact on the company's "bottom line."

The second concern involves the interests of those managing the large institutions. As Professor Yablon has pointed out:

Financial institutions are also run by corporate executives who may be receiving, or be interested in receiving, compensation at levels or in forms not very different from those that are under attack from the various shareholder groups. Such executives are unlikely to mount or join challenges to executive compensation plans because they may feel . . . that the compensation offered to their fellow executives is perfectly appropriate.\textsuperscript{99}

Thus, the management structure of some of the institutional investors, may itself serve to limit active compensation oversight.

There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. For the various reasons discussed, however, they may never prove as effective in providing either compensation oversight or even a more general monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this "voice" may not bring as much positive change as earlier envisioned, particularly in the compensation arena.\textsuperscript{100}

E.\textit{ Strengthened Compensation Committees}

A final approach that has been offered to resolve the compensation controversy involves a change in the internal functioning of the corporation's board of directors. It has been suggested that there be a reformulation of the way in which the board's compensation committee,
appointed to "review, analyze, and approve or revise compensation proposals," operates to assure independent and effective oversight. If this committee could be strengthened and made more independent of management, then excessive compensation programs could be defeated before they even reach the full board for consideration. This approach is laudable but ultimately unworkable. The problem lies not in the functioning of this committee, but in the composition of the board itself.

Compensation decisions by a board are generally protected by the business judgment rule. As noted earlier, such decisions are immune from attack if made by disinterested directors following an "informed" decision-making process. As one way of satisfying this requirement, most publicly-held corporations have formed compensation committees, traditionally comprised of several outside directors (those who are not employees of the business) to examine and consider proposals for executive compensation. These committees theoretically evaluate the performance of senior management and make recommendations on compensation formulas to the full board. Frequently, a company's management engages compensation consultants to study the subject company's executive salary scheme and to advise its committee on its appropriateness. These outside advisors examine compensation scales at companies of similar size, similar profitability and in similar industries to determine the reasonableness of each proposed plan. The

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101 Barris, supra note 2, at 75. See also Crystal, supra note 31, at 242-45 (arguing that compensation committees hire their own independent compensation consultants and establish more formal procedures for determining compensation); James W. Fisher, Jr., The Role of the Compensation Committee, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 366, 369-71 (Fred K. Foulkes ed., 1991) (suggesting that compensation committees should, among other things, establish a charter which clearly designates the committee's responsibilities and its relationship to management); Lance Berger, New Initiatives for the Compensation Committee, DIRECTORS & BOARDS, Winter 1985, at 33 (detailing how compensation committees can become more proactive and link payment strategy and performance of the company). Cf. Frederick W. Cook, Executive Pay and the Board, DIRECTORS & BOARDS, Spring 1992, at 43 (arguing that compensation committees should not hire their own consultants).

102 See supra notes 58-62 and accompanying text.

103 Id.

104 Recent studies indicate that between 84 and 99 percent of large publicly-held corporations have compensation committees. See Fisher, supra note 101, at 366 (citing J.E. Richard, Compensation Committee Issues, 1989, DIRECTOR'S MONTHLY, June 1989, at 5); PRINCIPLES OF CORPORATE GOVERNANCE, supra note 16, at § 3A.05. Compensation committees should be composed entirely of outside directors. Id.

105 The American Law Institute recommends that large publicly-held corporations establish compensation committees to provide oversight on compensation issues. The committees should actively review existing compensation programs and recommend methods that ensure that payments are reasonably related to executive performance. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 16, § 3A.05. Traditionally, however, compensation committees have been relatively
presence of only outside directors on such committees and the abstention of interested officers from compensation voting removes any self-dealing taint from such decisions and eliminates any challenge on self-dealing grounds. Moreover, the retention of independent consultants to advise the compensation committee and the committee's recommendations to the full board following extensive discussion with the consultants assure that the informed decision-making process required by the business judgment rule has been met and that the board's compensation decisions will thus be protected.

If compensation committees functioned in the truly independent fashion envisioned in their origination, then there would be little controversy over excessive compensation. The outside directors comprising the committees, bolstered by the efforts of independent compensation consultants, would bargain effectively with management to produce compensation packages that were the result of serious negotiation and not simple acquiescence on demand. Unfortunately, for reasons inherent in present board composition and structure, this is unlikely to occur. As noted earlier, many larger public corporations, due to atomistic shareholding patterns and ineffective communication among shareholders, are subject to management capture.\(^\text{106}\) No one

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\(^{106}\) See supra note 20 and accompanying text.
shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership.\textsuperscript{107} The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management.\textsuperscript{108}

Serving on such boards are the officers themselves, individuals performing various professional services for the corporation, such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.\textsuperscript{109} The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group (from which the membership of the compensation committee is recruited) will rarely challenge management prerogative either, although there have been recent exceptions.\textsuperscript{110} Such board members are usually selected either by the chairman or other senior management and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.\textsuperscript{111} These directors are often officers of other public corporations\textsuperscript{112} and frequently ask their counterparts, whom they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.\textsuperscript{113}

There are three problems with such arrangements that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult

\textsuperscript{107} See \textit{id.}

\textsuperscript{108} See \textit{supra} notes 15-16 and accompanying text for a discussion of the distinction between "inside" and "outside" directors.

\textsuperscript{109} See \textit{supra} notes 21 and 32.

\textsuperscript{110} See \textit{supra} note 21 and accompanying text. See also \textit{CRYSTAL, supra} note 31, at 224-30; \textit{Gilson & Kraakman, supra} note 17, at 884. But see \textit{Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors}, 58 U. Ch. L. Rev. 187, 247 (arguing that directors need not have an adversarial relationship with management to be effective).

\textsuperscript{111} \textit{Barris, supra} note 2, at 76.

\textsuperscript{112} \textit{Id.} at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by \textit{Directorship}, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the boards' compensation committees. \textit{Cowan, supra} note 14, at 81. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. \textit{Id.}
to engage in necessary confrontation. It is always tough to challenge a friend—particularly where the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, where one owes one's board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which, given the large fees paid to directors and great reputational advantage to board membership, may function as an effective club to stifle dissension. Such realities hinder effective oversight by a corporation's outside directors. Because the compensation committees are peopled by such outside directors, it is highly questionable whether, on compensation matters, these individuals possess the kind of independence from management necessary to function as effective bargainers for the corporate interest.

Indeed, because of these relational realities, compensation matters are particularly susceptible to management influence. The single most sensitive issue to an employee relating to his employment is compensation. Few issues cause as much excitement or resentment as how much one is to be paid. A confrontation with a manager over compensation has the potential to breed more ill-will towards a complaining director than any other kind of policy dispute. Given the outside director's personal ties to management and the lucrative nature of a board seat, there is very little incentive to engage in a dispute with an executive over salary. Such a confrontation will breed tremendous resentment and may result in that director's failure to be renominated at the next board election. Furthermore, considering that

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For example, non-employee directors receive annual compensation in the amount of $35,000 at Exxon, $55,000 at IBM, $48,000 at American Express, and $35,000 at General Electric. Moreover, these non-employee directors usually receive a fee of between $1,000 and $2,000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between $3,000 and $5,000 per annum. American Express Co., Mar. 14, 1991 Proxy Statement, at 7 (1991); Exxon Corp., Mar. 6, 1992 Proxy Statement, at 5 (1992); International Business Machines Corp., Mar. 16, 1992 Proxy Statement, at 10 (1992); General Electric Co., Mar. 3, 1992 Proxy Statement, at 15 (1992). See also Barris, supra note 2, at 78 n.114, 79.

In addition, most compensation committee members do not have the expertise to evaluate compensation packages proposed by consultants properly. They are, for the most part, not very adept at statistics and corporate finance, and they may not be able to follow the consultant's sophisticated reasoning. Further, they have no counsel of their own to tell them that what the consultant is saying is or is not true. So they may either fall asleep or look repeatedly at their watches in such a way that the consultant will not fail to notice. Crystal, supra note 31, at 50.

Id. at 226-27; Barris, supra note 2, at 79.
Executive compensation has little bearing on a large company's overall profits, why would an individual risk a lucrative board seat on an issue sure to inflame passions but also certain to have minimal impact on corporate performance? Finally, because many outside directors are also officers of other large corporations, it is not in their own self-interest to object too strenuously to generous compensation, for the higher their peers' compensation tends to be, the richer their own packages may become.\textsuperscript{116}

This reality makes it extraordinarily difficult for an outside director in a management-dominated enterprise to engage in the sort of active bargaining with executives over compensation that will result in reasonable salary arrangements. Despite the existence of a compensation committee theoretically comprised of "independent" outsiders to monitor compensation, the very composition of most boards in the large public corporation setting limits the effectiveness of that supposedly independent body. A compensation committee is only as independent as its members, and in the typical management-captured corporation, given the predilections of most outside directors, that independence is likely to be minimal.

Despite these problems that may lead to the ineffectiveness of a compensation committee and the full board for that matter, in issues relating to executive compensation, each director is still subject to legal requirements as to conduct that should theoretically compel effective action. Unfortunately, the threat of legal liability has little impact on director behavior or effectiveness. Ideally, a director should carry out his or her responsibilities "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."\textsuperscript{117} This would seem to compel circumspect and diligent conduct in executive salary negotiations. Under the business judgment rule, however, a director may be found to have met this duty of care, if in making a specific business decision, he or she has acted without self-interest, in an informed manner and with a rational belief that the decision is in the best interests of the corpora-

\textsuperscript{116}\textsuperscript{116}Barris, supra note 2, at 78. \textit{See also} CRYSTAL, supra note 31, at 227-28 (observing that a CEO can ensure high compensation by placing other company CEOs with pay packages rivaling his own on the compensation committee).

\textsuperscript{117}\textsuperscript{117}PRINCIPLES OF CORPORATE GOVERNANCE, supra note 16, § 4.01(a). Approximately 37 states have adopted statutory duty of care provisions; the rest have a common law duty of care. \textit{Id.} at 200. Most states have adopted a reasonable care standard. \textit{Id.} at n.15. \textit{See also} 2 MODEL BUSINESS CORP. ACT ANN. 3d § 8.30, at 934 (1990); CAL. CORP. CODE § 309(a) (West 1990); N.Y. BUS. CORP. LAW § 717 (McKinney 1985); Graham v. Allis Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); \textit{but see}, e.g., KY. REV. STAT. ANN. § 271B.8-300(1) (Baldwin 1989) ("A director shall discharge his duties . . . [i]n a manner he honestly believes to be in the best interests of the corporation.").
A director who so acts in reaching a business decision is then protected from any legal liability to his or her shareholders. This standard of care is not very difficult to satisfy, particularly in the compensation area. Provided that the directors are to receive none of the compensation they are voting on and the decision is not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements have been met. Most challenges to a particular board decision involve the third requirement, that an informed decision was made. How exactly does one demonstrate that a decision was informed? The Delaware Supreme Court's landmark ruling in *Smith v. Van Gorkom* created a number of important guideposts to informed decisionmaking. In addition to requiring that a board spend a proper amount of time making a particular decision, the court also suggested that the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement. Consequently, a compensation committee's decisions may be labeled "informed" and, thus, protected, upon a showing that the committee has no actual interest in the salary recommendations it is considering, has spent a significant amount of time discussing compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a particular salary package. And, in due course, the full board itself is entitled to rely upon the recommendation of its compensation committee when approving a salary proposal in order to meet its own obligations under the business judgment rule and, thus, reduce any threat of shareholder liability.

The retention of an independent compensation consultant insu-

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118 *PRINCIPLES OF CORPORATE GOVERNANCE*, supra note 16, § 4.01(c). Where a director has not made a business decision, such as in cases of omission, the business judgment rule does not apply and the director should be judged under the reasonable care standard. *See* Aronson *v.* Lewis, 473 A.2d 805, 813 (Del. 1984).

119 *PRINCIPLES OF CORPORATE GOVERNANCE*, supra note 16, § 4.01(c) cmt. f.

120 488 A.2d 858 (Del. 1985).

121 Id. at 874 (holding that the board of directors was grossly negligent when it approved the sale of the company with only two hours of deliberation).


123 *See*, e.g., *International Ins. Co. v. Johns*, 874 F.2d 1447, 1460 (11th Cir. 1989) ("When a board's enactment of a course of action merely effectuates the plans of a disinterested directors' committee, the board's action is prima facie subject to the protections of the business judgment rule."). *See* supra notes 58–59 and accompanying text. When a compensation plan is not approved by a majority of disinterested directors, the burden of proof shifts from the shareholder challenging the plan to the directors, who must prove that the plan was fair to the corporation. *Cohen v. Ayers*, 596 F.2d 733, 739–40 (7th Cir. 1979).
lates both the compensation committee and the full board from liability. Theoretically, the use of a third-party advisor would help to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant/corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation. Thus, there is a powerful disincentive for recommending a salary structure that management would consider inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lie in the offering.

Second, compensation structuring is not a precise art or science. It is based on comparisons with what other business are paying. There is tremendous subjectivity involved in deciding with what businesses the client’s compensation structure will be compared. The consultant may look at companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture—the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is also completely up to the advisor. The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above, have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporation that has retained them. As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence neces-
sary to assure a compensation package reasonably related to an executive’s professional contributions. This compensation consultant “for hire” phenomenon, particularly when combined with compensation committees comprised of outside directors who may be unwilling to challenge management results in compensation arrangements that are acquiesced to and not bargained for, and, thus, are potentially unreasonable. 128 Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, administered by a judiciary reluctant to involve itself in compensation disputes. 129

Although a board’s use of a compensation committee comprised exclusively of outside directors has the theoretical potential to create reasoned compensation schemes, this solution is entirely predicated on finding outside directors who are unwilling to compromise their objectivity in the face of management capture. This potential may never be realized given the current state of the outside directorship in the typical large public corporation and the ready availability of possibly corruptible outside compensation consultants. How, then, can a compensation committee be made more effective? The solution does not lie in making the consultants more independent of management—their desire for future retention and the subjectivity inherent in the analytic process have rendered this a most difficult goal. Rather, an approach must be found to promote independent and responsible behavior on the part of the outside directors. Simply mandating that compensation decisions be made exclusively by outside directors will accomplish little; only if these directors are truly independent in motivation, will the dispassionate bargaining requisite to reasonable compensation ever occur. 130 Strengthening the compensation committees will have negligible impact, unless those who comprise these bodies are given sufficient motivation to act effectively. This seems unlikely to occur under the current scheme of director appointment and retention.

F. Summary

The various proposals for attacking the problem of executive overcompensation, whether involving heightened disclosure, tax-based

128 See CRYSTAL, supra note 31, at 214-40; but see COOK, supra note 101, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).
129 See supra notes 58-66 and accompanying text.
130 CRYSTAL, supra note 31, at 224-28; Barris, supra note 2, at 77-78. See supra notes 112-16 and accompanying text.
remedies, judicial involvement, institutional shareholder activism or strengthened board compensation committees will ultimately prove ineffective and, worse still, may even jeopardize corporate well-being. Although they may attack the problem from various angles, these proposals fail to strike at the heart of the issue. The real solution to overcompensation lies with stimulating effective board oversight. This must take place from within the boardroom itself. Solutions that attempt to change board behavior through external pressure may effect some positive results, but they do not tackle the problem that created the overcompensation issue in the first place. The board must act as its own motivational force. External pressure will have an impact only so long as it continues to be applied. Once the pressure is reduced due to public apathy, the problem will resurface. The only long-term solution is to create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force both as to compensation and general corporate affairs for which it was originally created.

III. THE EQUITY-BASED APPROACH

The overcompensation controversy is the result of unchecked self-interest on the part of management and passive indifference by the corporation’s board of directors. Because personal greed created the problem, a similar appeal to individual interest may resolve it. Externally-based pressure on a board to bargain effectively with management overcompensation, as noted earlier, is an ineffective approach. There is a much simpler and efficacious method to reposition the board as a counter-force to management in the compensation area.

A. Stock Ownership

The outside directors must be made to consider executive compensation proposals from the viewpoint of the company’s stockholders to whom they are legally obligated instead of from the perspective of ones beholden to management. It is the stockholders who stand to lose the most from unreasonable compensation arrangements. Thus, it is crucial that the company’s outside directors re-align their interests and thinking with those of the shareholders. The most effective way of creating such perspective is to appeal directly to these directors’ personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director’s personal capital is potentially affected by an excessive compensation package, that director is much less likely to acquiesce to such a proposal. It is easy to spend other people’s money
freely; it is always much more difficult to be inattentively lavish with what one considers to be one’s own funds.

By becoming equity-holders, the outside directors would assume a personal stake in the success or failure of the enterprise.131 Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with distant legal requirements, or vaguely understood pressures from outside institutions, but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably. In addition to the consideration that the active monitoring of management may lead to eventual replacement, an outside director must also consider that the failure to exercise effective oversight may also result in the diminution of that individual’s personal wealth. Under such an arrangement, it would not be quite so easy to simply acquiesce to the demands of management.

Nowhere would the positive effect of a personally-motivated outside directorship be more evident than in the area of executive compensation. Overcompensation is the result of ineffective bargaining.

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131 The benefits of outside director stock ownership have been well-documented. See, e.g., Mace, infra note 15, at 61–65 (outside directors who own substantial amounts of stock in their company are more likely to ask discerning questions than non-stockholding outside directors); Louis Fernandez, Tax Deferral, Capital Gains, DIRECTORS & BOARDS, Spring 1985, at 51 (discussing tax advantages of stock payments); James J. Fitzsimmons, A Better Approach to Director Pay, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (directors paid in stock are more closely aligned with shareholders and are in a better position to ensure that top management is paid based on its performance); Edmund W. Littlefield, A Stake with Restricted Stock, DIRECTORS & BOARDS, Spring 1985, at 51, 52 (“Paying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders.”). See also Pearl Meyer, The Rise of the Outside Director As an Equity Owner, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned large amounts of stock and that companies may be returning to this compensation strategy).

Brown Brothers Harriman’s Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly one million dollars, described that group as a “board that pays attention, . . . I’ve never seen pocket calculators come out so quickly in my life.” FINANCE, INVESTOR’S BUSINESS DAILY, July 7, 1995 at 4.
People without great incentive to press for position rarely do. Equity ownership would align the position of the outside director with that of the group most disadvantaged by unreasonable compensation, the shareholders. It would provide an incentive to bargain not out of a sense of duty to some indistinguishable mass of stockholders, but duty to one's own interest. Given the fundamental fact of human nature that all are susceptible to the vice of envy, no one delights in providing a financial windfall to another, most especially when it comes out of one's own pocket. It is galling enough to see someone overpaid for their efforts; it is all the more galling to be the vehicle for such overpayment, particularly when the ill-gotten gain results in the perceived diminution of one's own wealth. This dynamic would set an appropriate tone for compensation negotiations between management and equity-holding outside directors, and, in turn, create the sort of active bargaining that would lead to more reasoned compensation.

B. Lengthened Director Terms

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors' stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock.132

132 For example, the holdings of a few noted outside directors at several larger public corporations are as follows:

<table>
<thead>
<tr>
<th>DIRECTOR</th>
<th>SHARES</th>
<th>DIRECTOR</th>
<th>SHARES</th>
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<tbody>
<tr>
<td>Bank of Boston</td>
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<tr>
<td>Donald Monan</td>
<td>0</td>
<td>Philip Morris</td>
<td>400</td>
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<tr>
<td>Thomas B. Wheeler</td>
<td>236</td>
<td>Richard Parsons</td>
<td>500</td>
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<tr>
<td>Alfred M. Zeien</td>
<td>500</td>
<td>Sears Roebuck</td>
<td>450</td>
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<td>IBM</td>
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<td>Mandell de Windt</td>
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<tr>
<td>Harold Brown</td>
<td>321</td>
<td>Norma Pace</td>
<td>400</td>
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<tr>
<td>Nannerl Keohane</td>
<td>321</td>
<td>Nancy G. Reynolds</td>
<td>454</td>
</tr>
<tr>
<td>Richard Munro</td>
<td>421</td>
<td>Ralston Purina</td>
<td>200</td>
</tr>
<tr>
<td>Mobil</td>
<td></td>
<td>David Banks</td>
<td>200</td>
</tr>
<tr>
<td>Donald Fites</td>
<td>200</td>
<td>Francis Ferguson</td>
<td>556</td>
</tr>
<tr>
<td>Disney</td>
<td></td>
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</tr>
<tr>
<td>Robert Stern</td>
<td>0</td>
<td></td>
<td></td>
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<tr>
<td>Stanley Gold</td>
<td>250</td>
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<tr>
<td>Samuel Williams</td>
<td>450</td>
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<td>Gary Wilson</td>
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Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position involving the attendance of only a few meetings a year.\textsuperscript{133} In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered in the business community, leading to other opportunities for financial benefit.\textsuperscript{134} Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.\textsuperscript{135}

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and benefits of the contemplated strategy. When an outside director makes a decision that challenges management prerogative, that director, in a management-controlled enterprise, risks retribution from the dominant executives that might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director

\textsuperscript{133} Remuneration for non-employee directors often exceeds $40,000 including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. See supra note 113. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each non-employee director at Eastman Kodak is covered by group term life insurance in the amount of $100,000. Non-employee directors at American Express, who have served at least five years, are eligible to receive $30,000 per annum upon their retirement from the board. These payments continue for a number of years equal to the time served on the board or until death. Similarly, General Electric's non-employee directors, who have served at least five years, are over 65 years of age, and retire directly from the board, are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. American Express, Mar. 14, 1991 Proxy Statement, at 7 (1991); Eastman Kodak Co., Mar. 18, 1991 Proxy Statement, at 8 (1991); General Electric Co., Mar. 5, 1992 Proxy Statement, at 13 (1992). See Bruce Overton, Remuneration of Outside Directors, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 383 (Fred K. Foulkes ed., 1991).

\textsuperscript{134} See MACK, supra note 15, at 87-91; Overton, supra note 133, at 383.

\textsuperscript{135} See BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE 97-98 (Harper Perennial 1991). At the time of the LBO, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, supra note 133, at 388.
will, consciously or not, weigh the various benefits such a decision entails, with any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that a director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership but substantial ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decision-making process. An outside director's shareholding position must be large enough that, in deciding a particular course of action, concern about how that decision will positively affect equity value will subsume traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decision-making process than fee maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fee in company common stock. As compensation for the exercise of oversight as a board member, it seems only natural that each director should be rewarded with an interest in the business itself. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.\footnote{To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.}
Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. As noted earlier, to have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director’s yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director’s term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve for five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an immediate equity stake and, without yearly re-election concerns, the promise of a fixed number of future stock grants. Five years’ worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.\textsuperscript{137} Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, have recently advocated such a change in board structure, along with a host of other major governance reforms.\textsuperscript{138} They suggest that the creation of a five-year fixed term of office will create a corporate “long-term view” highly beneficial to corporate “vitality.”\textsuperscript{139} The main goal of their proposal, however, involves the creation of a corporate governance model “that will lead managers and stockholders to work cooperatively towards the corporation’s long-term business suc-

\textsuperscript{137}For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

\textsuperscript{138}Lipton & Rosenblum, supra note 110, at 187. The quinquennial election of directors is one part of Lipton and Rosenblum’s proposal for comprehensive reform of the present corporate governance system. Their proposal would also bar nonconsensual changes in control between elections; provide major shareholders with access to corporate proxy materials relating to elections of directors; require a detailed five-year report on the company’s performance and a prospective five-year plan; and tie management compensation awards and penalties to the corporation’s performance against the plan. \textit{Id.} at 190.

\textsuperscript{139}\textit{Id.} at 216.
cess." Their arguments advocating term expansion focus primarily on creating a management/shareholder “long term” cooperation relationship, rather than corporate productivity through active director oversight. Despite this goal, their call for a longer range perspective on company affairs, an obvious by-product of five-year director terms, is a laudable and desirable result. Who can really argue with management and boards of directors making decisions with the long-term health of the enterprise in mind? Some of Lipton’s and Rosenblum’s other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. They should not detract, however, from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity-holders in the executive compensation area.

There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish, and second, they could lead to the possible entrenchment of ineffective or even disloyal directors. These problems are not as dramatic as they would appear at initial glance. First, shareholders always have the right to remove a director for cause, a power which should resolve the problem of the disloyal or inattentive director. Second, provision could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear so necessary to compel effective management. Moreover, the “long view” perspective such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in its favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong returns over the long term, even though they may have a negative impact on profitability in the short-run. The five-year term has, thus, great potential.

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140 Id. at 189.
141 Id. at 224-52.
142 See, e.g., Campbell v. Loew’s Inc., 154 A.2d 652 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954). Some state statutes have modified the common law rule and allow shareholders to remove directors without cause. See, e.g., CAL. CORP. CODE § 303(a) (West 1990); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); N.Y. BUS. CORP. LAW § 706 (McKinney 1986). See also CARY & EISENBERG, supra note 44, at 153-54.
C. Potential Costs

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact an equity-based approach may entail. One difficulty that increased equity-ownership may create involves the possible chilling of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individual’s personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize, because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear. It assumes that the commitment of a large portion of one’s assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk and their stockholdings encouraged still greater risk because of the potential to share in the larger returns such risk brings. What about those in business who are not entrepreneurial in spirit, but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking, rather

Although some individuals are risk-averse by nature (and, indeed, the presence on a board of such persons may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors’ fees in cash encourages risk-positive behavior. As noted earlier, in the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk-averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be the exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity (these individuals could easily convert their cash payments into company stock). This argument misses the point. It was the payment of fees in cash that, in the management-captured enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.\footnote{One commentator states that he will not serve on public company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial }
compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a non-cash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders they were elected to serve by taking an equity position in the enterprise is a corporation's best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity. And reasoned executive compensation will be a beneficial by-product of this approach.

D. The Empirical Evidence

Central, of course, to the effectiveness of an equity-based solution to the compensation dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to succeed, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the executive compensation voting behavior of boards composed of outside directors with substantial stockholdings, compared with boards whose outside members do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

*Business Week* magazine, in conjunction with Standard & Poor's Compustat Services, Inc., conducts an annual survey of 500 of the nation's largest publicly-traded corporations in an attempt "to measure how closely" executive compensation by those companies "matches performance." The study uses two separate approaches to rate performance. The first compares an executive's compensation package with the business's total return to shareholders in stock appreciation and dividends over a three-year period. The second measures compensation against corporate profitability for the same time period. The survey is conducted by assigning each company examined to one of nine industry groups. A comparison is made among those companies in each group based on how their individual compensation programs compared with shareholder return and company profit. A "performance rating" is then assigned to each company surveyed for each of the two categories examined. Each business is thus rated on a scale of 1 (indicating the best performance) to 5 (indicating the poorest). "The return as well as decreases the chance of lawsuits from other shareholders. William A. Sahlman, *Why Some People Shouldn't Serve on Public Boards*, Harv. Bus. Rev., May-June 1990, at 26.

145 Byrne, *supra* note 2, at 148.
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146 Id.

each of these selected corporations were then reviewed to ascertain how much company stock was held by each of the companies' outside directors. This study then compared the stockholdings of outside directors serving on the boards with the worst ratings (indicating overpaid executives) with the holdings of outside directors on the boards of companies with the best ratings (indicating reasonably paid executives). This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that pay their executives in a "reasoned" manner are more likely to have substantial equity holdings in those companies than outside directors on the boards of companies with "overpaid" executives. It was then determined how many companies in the two groups were run by boards in which outside directors with individual holdings valued in excess of $10,000\(^a\) constituted a majority of the full board and thus theoretically controlled that institution. This procedure was repeated for holdings valued in excess of $25,000, $50,000, $100,000, $125,000, $150,000 and $200,000.

The results, presented in Table I, tend to confirm the initial hypothesis on the relationship between equity holdings and effective compensation oversight. The greater the value of outside director holdings, the more likely it was that the corporation surveyed would be managed by "reasonably" compensated executives. In the group of companies with overcompensated executives, as the value of the stockholdings of the outside directors increased, the number of companies with directors holding such equity positions decreased dramatically. At the $10,000 level, 83.1% of the companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped substantially to 42.2%, and at the $100,000 level, the percentage fell to 18.2%. Finally, in the $200,000 category, the highest level surveyed, only 6.5% of the companies in the overcompensation grouping had outside director equity holdings at that value level.

The results for those companies in the "reasonable" compensation category differed significantly. To be sure, there was, as the dollar criteria grew, a decline in the numbers of companies meeting the standards at each level. The decline, however, was not nearly as steep or dramatic as in the overcompensation model and bottomed out at a significantly higher base percentage. At the $10,000 level, 75.3% of the

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\(^a\)The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of July 9, 1992. \textit{Wall St. J.}, July 9, 1992, at C3-5.
### TABLE I

**Total Number of Companies in Survey:** 158  
**Number of Companies with overcompensated executives:** 77  
**Number of Companies with reasonably compensated executives:** 81

**Number of Boards controlled by directors who own substantial amounts of company stock:**

<table>
<thead>
<tr>
<th>Overcompensated</th>
<th>Percentage of total companies in overcompensated grouping</th>
<th>Reasonably compensated</th>
<th>Percentage of total companies in reasonably compensated grouping</th>
<th>Deviation Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$10,000</td>
<td>64</td>
<td>61</td>
<td>75.3%</td>
<td>.906</td>
</tr>
<tr>
<td>&gt;$25,000</td>
<td>50</td>
<td>45</td>
<td>55.6%</td>
<td>.857</td>
</tr>
<tr>
<td>&gt;$50,000</td>
<td>33</td>
<td>39</td>
<td>48.1%</td>
<td>1.121</td>
</tr>
<tr>
<td>&gt;$100,000</td>
<td>14</td>
<td>26</td>
<td>32.1%</td>
<td>1.764</td>
</tr>
<tr>
<td>&gt;$125,000</td>
<td>11</td>
<td>22</td>
<td>27.2%</td>
<td>1.902</td>
</tr>
<tr>
<td>&gt;$150,000</td>
<td>9</td>
<td>19</td>
<td>23.5%</td>
<td>2.009</td>
</tr>
<tr>
<td>&gt;$200,000</td>
<td>5</td>
<td>15</td>
<td>18.5%</td>
<td>2.846</td>
</tr>
</tbody>
</table>
companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped to 48.1%, and at the $100,000 level, the percentage stood at 32.1%. Finally, in the $200,000 category, 18.5% of the companies in the “reasonable” compensation grouping had outside director equity holdings at that value level.

While at the lower levels of stockholdings, $10,000-$50,000, the results in both groups were rather similar, it was when the base holdings reached the $100,000 level that the two groups diverged significantly and the effect of equity ownership on compensation patterns appeared to have the greatest impact. At the $100,000 level, only 18.2% of the companies in the overcompensation grouping met the equity-holding criteria; at $150,000, only 11.7%, and at $200,000, just 6.5%. This differed significantly from those companies in the “reasonable” compensation grouping where, at the $100,000 level, 32.1% met the criteria, at the $150,000, 23.5%, and at the $200,000 level, 18.5%. As the stockholding levels grew, the spread between the two groups increased significantly. At the $100,000 level, there were almost twice as many companies with “reasoned” compensation schemes than those overcompensating their executives. And at the highest level, the spread between the two grew to almost three times in number.

What, then, do these numbers demonstrate and how do they relate to an equity-based solution to the overcompensation problem? The results of this survey suggest that at lower levels of outside director equity ownership—that is, less than $50,000—the impact of equity ownership on director behavior seems inconsequential. But as the value of director holdings increases, the two groups experience substantial divergence in result. Substantially fewer of the corporations that are overpaying their executives, at least by the standards of the Business Week study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses—that is, greater than $100,000 per director. Many more of the companies that are reasonably compensating their directors have boards numerically controlled by outside directors with large stockholding positions. At the $200,000 level, there are almost three times as many companies that “reasonably” compensate their executives as those in the overcompensation category. Although this is obviously not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity-ownership and more effective compensation oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to reasoned compensation. This
fact gives support to the theory that the creation of substantial equity positions in the outside directors may lead to more effective compensation oversight.

Missing, of course, from an interpretation of the results of the study, is any indication of the effect of a five-year board term on director behavior. None of the 158 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact not simply of stock ownership, but of substantial stock ownership. The key to more effective compensation monitoring, then, is to create in each outside director a substantial equity position in the business itself. The payment of director fees in stock, in combination with five-year terms of office, will create such holdings. As noted earlier, implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit appears to begin.

The empirical evidence yielded by this study, does suggest that in the realm of executive compensation, companies with boards composed of outside directors with significant shareholdings, are less susceptible to the charge of executive overcompensation than those companies that do not. Fewer of those companies that are believed to overcompensate their executives, have outside directors with significant holdings in the business than those enterprises with levels of executive pay that are viewed as proportionate to services delivered. An alignment of the directors’ interests with those of the shareholders, rather than with management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based approach to the compensation controversy seems potentially helpful and warranted.

IV. CONCLUSION

Executive overcompensation is a serious problem that weakens the corporate enterprise and undermines public confidence in the management of our largest institutions. It is primarily the result of ineffective monitoring and bargaining on the part of corporate boards of directors. Unlike a number of governance issues, it is not susceptible to effective solution through the normal operation of market forces. Overcompensation is not merely a problem in and of itself. Rather, it is symptomatic of a more serious problem within the corporation—that

\[149\] See supra note 137 and accompanying text.
of a management unresponsive to shareholder welfare because it is unchecked by appropriate monitoring and oversight by an active and involved board. Such self-interested management, motivated primarily by personal gain, may create the kind of ineffective corporate enterprise that will result both in diminished shareholder profit and lessened overall societal wealth. Eventually, when corporate productivity declines sufficiently to provoke a market-based response to the situation—the wholesale replacement of management—the problem of overcompensation will be remedied. But by the time this occurs, the damage to the enterprise that ineffective management brings will already have taken place and, in the highly competitive world market, may prove fatal to the enterprise. Thus, in practice, a market-based solution may come along too late to save the enterprise, and is an ineffective remedy to the problem.

This destructive result need not occur. The key is to prevent the problem from ever developing, not to “solve” it once it has manifested itself and lessened shareholder value. A number of solutions to executive overcompensation have been proffered including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation committees. Several of these approaches attempt to eliminate the problem without attacking the root causes, thus creating the potential for its eventual reemergence. All, unfortunately, will ultimately prove ineffective, and some even potentially harmful to corporate well-being.

The most effective solution lies in stimulating effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The only real long-term solution to the compensation controversy is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity-ownership on the part of the outside directors. To create the sizeable shareholdings that may achieve such positive monitoring, directors should be paid their annual fee in company stock. To ensure that the holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove the comprehensive cure to the overcompensation problem, but the costs of this approach are minimal and it is a good beginning. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.