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**COMPENSATION REPRESENTATIVES:
A PRUDENT SOLUTION TO EXCESSIVE CEO PAY**

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A PRUDENT SOLUTION TO EXCESSIVE CEO PAY

INTRODUCTION

The issue of CEO pay continues to garner significant attention both in the popular press and among regulators. *The New York Times* alone printed approximately 200 stories dealing with executive compensation in the first seven months of 2006.¹ Moreover, on July 26, 2006, the SEC approved new rules on disclosure of executive compensation.² Prior to approving the new rules, the SEC received more than 20,000 comment letters, prompting SEC Chairman Christopher Cox to comment that “no issue in the 72 years of the Commission’s history has generated such interest.”³ The reason for the intense degree of interest is clear: CEO compensation in the U.S. is extremely high, and is getting higher. In 2003, the average CEO of a large U.S. firm made 500 times that of the average

¹ Culled from a Westlaw search of *The New York Times*, conducted on August 1, 2006, using the search request “ceo or executive w/5 pay or compensation.”

² SEC Press Release, U.S. Securities and Exchange Commission, *SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters* (July 26, 2006), <http://www.sec.gov/news/press/2006/2006-123.htm>. The full text of the rules was not available as of August 7, 2006. *See id.* for a summary of the new rules. *See also infra* notes 55 and accompanying text for a brief discussion thereof.

³ *See* SEC Press Release, *supra* note 2.

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worker.⁴ This compares with 140 times worker salary in 1991.⁵ In absolute levels, the average pay of CEOs in the S&P 500 has risen (in constant 2002 dollars) from \$3.7 million in 1993 to \$9.1 million in 2003.⁶ One study of executive compensation at publicly traded firms with a market capitalization larger than \$50 million found that, during the period from 2001 to 2003, the top five executives received compensation equivalent to 9.8% of the firms' aggregate earnings.⁷

Some have argued that, for the good of society, CEOs should not be allowed to receive such exorbitant amounts.⁸ Others take the narrower position that, irrespective of the impact on the broader society, excessive CEO pay clearly harms shareholders. Not only must shareholders ultimately pay the bill, but to the extent that such pay levels are pervasive throughout the market, it becomes difficult for them simply to sell the

⁴ *CEOs and Their Indian Rope Trick*, *ECONOMIST*, Dec. 11, 2004, at 61, *quoted in* Stephen M. Bainbridge, *Executive Compensation: Who Decides*, 83 *TEX. L. REV.* 1615, 1619 (2005); Janice Revell, *Mo' Money, Fewer Problems: Is it a Good Idea to Get Rid of the \$1 Million Pay Ceiling?*, *FORTUNE*, Mar. 31, 2004, at 34, *quoted in* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1* (2004) [hereinafter PWP].

⁵ PWP, *supra* note 4, at 1.

⁶ Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 *OXFORD REV. ECON. POL'Y* 283, 285 (2005).

⁷ Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: An Overview of the Issues*, 30 *IOWA J. CORP. L.* 647, 652 (2005).

⁸ *See, e.g.*, Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy: The Case for Compensation Discussion and Analysis*, 30 *J. CORP. L.* 675 (2005); Mark J. Lowenstein, *Reflections on Executive Compensation*

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shares of any offending companies. Following the so-called “Wall Street Rule” would force investors to exit the entire equity market, an obviously untenable response.⁹

Still, despite overwhelming evidence that CEO pay is extremely high, it does not follow that CEO pay is “excessive.” A figure can only be considered excessive if it is higher than the “correct” price, and numerous unanswerable questions confront anyone attempting to determine the correct price for the services of a CEO.¹⁰ For example, how many people actually have the necessary skills to be a good CEO? How much better is a given CEO than the other candidates? How much of the company’s success or failure is attributable to the CEO? What is the “fair” allocation of profits as between the CEO and the shareholders?¹¹ In the face of such unknowables, one is left with the market. In short, a fair price for a CEO is what the market will bear. But one can use the market to legitimize ostensibly excessive CEO compensation only if the market is “fair,” in the sense that it has not been manipulated by the participants.

and a Modest Proposal for (Further) Reform, 50 SMU L. REV. 201, 206-07 (1996).

⁹ Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 25-26 (2000).

¹⁰ See Gordon, *supra* note 8, at 677; Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129 (2003).

¹¹ Snyder, *supra* note 10, at 144-46.

Lucian Bebchuk and Jesse Fried, in their seminal book *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, condemn CEO pay for just such manipulation.¹² According to Bebchuk and Fried, boards of directors and CEOs do not engage in real arms length bargaining over CEO pay. Rather, CEOs exert “managerial power” to extract economic rents above and beyond what they could have obtained in an arms length negotiation.¹³ The result is excessive CEO pay, insufficiently aligned with the CEO’s performance. To address the problem, Bebchuk and Fried have proposed granting shareholders greater power vis-à-vis the board of directors. For example, they would allow large shareholders to nominate candidates for the board, and would require the company to pick up the expenses for any proxy fight if the shareholder’s nominee received more than a designated minimum level of support.

Bebchuk and Fried’s book has received considerable academic attention, with some commentators taking issue with their conclusion that CEOs are in fact overpaid, and others objecting to their proposed remedies. This paper accepts the fundamental point that the CEO pay-setting process is flawed and that reforms are necessary. Nonetheless, it recognises that

¹² See PWP, *supra* note 4.

¹³ *Id.* at 61-64.

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high CEO pay may be attributable to numerous factors other than managerial power, and it questions whether certain of Bebchuk and Fried's proposed solutions might, by altering the balance of power between shareholders and directors, have unintended negative consequences for matters beyond CEO pay. Therefore, to remedy the process problems identified by Bebchuk and Fried, this paper proposes that large shareholders be allowed to appoint non-executive "compensation representatives" to look after the interests of all shareholders on matters relating exclusively to CEO pay. This paper contends that compensation representatives could address the most significant problems described in Bebchuk and Fried's book, without fundamentally altering the traditional relationship between the shareholders and the board of directors. As such, it would constitute a prudent solution to the problem of excessive CEO pay.

Part I of this paper discusses in detail Bebchuk and Fried's thesis, as well as their suggested reforms. Part II describes and evaluates a number of objections to the managerial power thesis. Part III discusses the many objections to Bebchuk and Fried's proposal to permit large shareholders to place board nominees on the corporate ballot. Part IV introduces the compensation representative approach and outlines its numerous advantages over both the current system and the reforms suggested by

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Bebchuk and Fried. This paper concludes by raising and responding to potential objections to the compensation representative approach.

I. THE MANAGERIAL POWER THESIS

Ideally, say Bebchuk and Fried, boards and CEOs should engage in arms length bargaining over CEO compensation. In such a scenario, boards would vigorously negotiate to receive the best deal for the benefit of the company's shareholders. In fact, argue Bebchuk and Fried, CEOs exert managerial power to ensure that their compensation is superior to what they would receive in an arms length bargain. Bebchuk and Fried point to five major factors that enable CEOs to exert managerial power. First, although most compensation committees are comprised of independent directors, CEOs have significant control over who will serve on the board from which the committee members will be drawn. Although exchange rules no longer permit CEOs to serve on the nomination committee, a nomination committee is are unlikely to propose directors opposed by the CEO. And CEOs are not likely to support a critic of high

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executive pay.¹⁴ As long-time General Electric CEO Jack Welch told an audience of recently appointed CEOs:

Put someone in charge who is nearing the end of their career, so that they're not jealous of a younger CEO, is immensely rich, much richer than you, and enjoys seeing other people get rich. . . . Never, ever make a distinguished academic your compensation committee chair. You'll be a poor man by the end of it.¹⁵

Warren Buffett, a long-time critic of excessive CEO pay, had in mind a similar tendency when he noted that “[t]hough I have served as a director of twenty public companies, only one CEO has put me on his compensation committee. Hmmm . . .”¹⁶ Second, CEOs are in a position to steer benefits to board members, though their ability to do so has been reduced by the 2003 changes to listing standards of the major securities exchanges.¹⁷ Third, social and psychological factors discourage board members from bargaining aggressively with CEOs over compensation. Friendship, loyalty, and team spirit encourage directors to be pliant, often at the expense of the interests of parties, such as shareholders, who are

¹⁴ *Id.* at 26.

¹⁵ See Symposium on Bebchuck & Fried’s Pay Without Performance, *The Media and Executive Compensation: A Panel Discussion*, 30 IOWA J. CORP. L. 795, 796-97 (2005) (statement quoted by Matthew Bishop).

¹⁶ Letter from Warren Buffett to Shareholders of Berkshire Hathaway, Inc. 17 (Feb. 28, 2006), (included in the Annual Report to the Shareholders of Berkshire Hathaway, Inc.) <http://www.berkshirehathaway.com/letters/2005ltr.pdf>.

¹⁷ PWP, *supra* note 4, at 27-28.

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present at the table.¹⁸ Also, board members who are highly paid CEOs in their own right are likely to rationalize high CEO pay as being in the best interests of shareholders.¹⁹ A former SEC commissioner described it more nefariously as the “giraffe effect”:

The compensation committee, composed solely of outside directors who were CEOs of their own public corporations, knew that what goes around comes around. Pushing the pay envelope for the CEO who had selected them for his board was only natural, since they would not want anyone they were associated with to rank in the bottom half of surveys, and getting CEOs’ scale up could only help them when their scales were reviewed by their outside directors.²⁰

Fourth, since board members typically own only a very small fraction of the company’s stock, and since the reputations of directors are unlikely to suffer from approving a CEO’s pay package unless the terms of the package are truly egregious, directors who comply with CEO pay demands will usually not pay a high financial or reputational cost.²¹ Finally, the limits to board members’ time and information all but compel them to rely on the advice provided by the company’s human resources department and

¹⁸ *Id.* at 32.

¹⁹ *Id.* at 31-34.

²⁰ Bevis Longstreth, *A Real World Critique of Pay without Performance*, 30 IOWA J. CORP. L. 767, 769 (2005).

²¹ PWP, *supra* note 4, at 34-36.

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the compensation consultants that have traditionally been hired by that department.²²

Bebchuk and Fried argue that existing mechanisms cannot effectively constrain pay in the face of managerial power. Litigation's effectiveness is blunted both by the procedural hurdles placed in front of shareholder plaintiffs and by the extremely high standard applied to challenges to executive compensation.²³ In effect, plaintiffs must either establish that (i) when nominally independent directors approved CEO compensation, they were in fact engaged in a self-dealing transaction for their own personal benefit, or (ii) the compensation scheme constituted "waste," i.e., it was so egregious that no rational person could have approved it.²⁴

The difficulty of using shareholder litigation to challenge extraordinary pay was recently confirmed in the Delaware case *In re Walt*

²² *Id.* at 36-37. As discussed *infra* note 128 and accompanying text, NYSE rules now require that a compensation committee's charter give the committee sole power to retain and fire the compensation consultant. Still, a compensation committee will likely make its decision based in part on the recommendation of the firm's human resources department, which is ultimately responsible to the CEO.

²³ *Id.* at 45-48.

²⁴ The difficulty of prevailing in a waste claim was colorfully expressed thus by the Delaware Court of Chancery: "Absent an allegation of fraud or conflict of interest, a court will not review the substance of corporate contracts; the waste theory represents a theoretical exception to the statement very rarely encountered in the world of real transactions . . . [R]arest of all -- and indeed, like Nessie, possibly non-existent -- would be the case of disinterested businesspeople making non-fraudulent deals (non negligently) that meet the legal standard of waste!" *Steiner v. Meyerson*, Civil Action No. 13139, 1995 Del. Ch. LEXIS 95, at *13-*14 (Del.Ch. July 18, 1995).

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Disney Co. Derivative Litigation.²⁵ In *Disney*, the court was called upon to rule on whether Disney directors had breached their fiduciary duty when, among other things, they approved an employment contract for Michael Ovitz which entitled Ovitz to a \$130 million severance package after a mere fourteen months as President of Disney.²⁶ The court indicated that, prior to Ovitz's termination, "the Disney board had never met to vote on, or even discussed, the termination in full session . . . The Disney directors had been taken on a wild ride, and most of it was in the dark." In describing the boardroom culture at Disney, the court wrote of "how ornamental, passive directors contribute to sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit, especially in the compensation and severance area."²⁷ It described CEO Michael Eisner's relationship with other board members as follows:

By virtue of [Eisner's] Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner is to a large extent responsible for the failings in process that infected and handicapped the board's decisionmaking abilities. Eisner stacked his (and I intentionally write "his" as opposed to "the Company's") board of directors with friends and acquaintances who . . . were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.²⁸

²⁵ 2005 WL 2056651 (Del. Ch. Aug. 09, 2005).

²⁶ *Id.* at *25.

²⁷ *Id.* at *28 n.373.

²⁸ *Id.* at *40.

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Nonetheless, despite board conduct that contained “many lessons on what *not* to do,”²⁹ the Court of Chancery held, in a decision affirmed by the Delaware Supreme Court,³⁰ that the Disney directors had not violated their fiduciary duties.

If litigation provides no real constraint on excessive compensation, what about shareholder voting? Bebchuk and Fried argue that it too is inadequate in the face of managerial power.³¹ It is true that in certain instances, such as the adoption of a stock option plan, the major exchanges’ listing rules require that a corporation submit the plan to a shareholder vote.³² However, the vote does not effectively constrain CEO compensation, since it concerns only general matters, such as the total options that may be issued under the plan, rather than the compensation of any particular executive.³³ It is also true that Section 162(m) of the

²⁹ *Id.* at *39 (emphasis supplied).

³⁰ -- A.2d---, 2006 WL 1562466 (Del. June 8, 2006).

³¹ PWP, *supra* note 4, at 48-51.

³² *See, e.g.*, NASD Rule 4350; NYSE Listed Company Manual 303A.08, <http://www.nyse.com/RegulationFrameset.html?nyseref=http%3A//www.google.com/search%3Fsourceid%3Dnavclient%26ie%3DUTF-8%26rls%3DGGLD%2CGGLD%3A2003-37%2CGGLD%3Aen%26q%3DNYSE+Listed+Company+Manual&displayPage=/listed/1022221393251.html> (last modified Feb. 11, 2004).

³³ PWP, *supra* note 4, at 49. *See also Developments in the Law, Slimming the Fat Cats? Evaluating the New Stock Exchange Listing Standards Requiring Shareholder Approval of Stock Option Plans*, 117 HARV. L. REV. 2205, 2214 (2004).

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Internal Revenue Code disallows deductions for compensation exceeding \$1 million per executive unless it is “performance based,” and one of the requirements for “performance based” compensation is that the material terms of the excess amount over \$1 million be been approved by a majority of the shareholders in a separate vote.³⁴ However, assuming shareholders are knowledgeable enough to vote intelligently on compensation issues,³⁵ they are not presented with any alternative to the plan approved and proposed by the board. Therefore, if the shareholders were to reject the board’s plan before an alternative became available, senior management could resign and throw the company into crisis. To prevent this, a board might simply pay executives the cash equivalent of the rejected plan, since the exchange rules do not require a shareholder vote on cash compensation. But the result could make shareholders even worse off, since cash payments would not necessarily be linked to performance of the stock price. And if shareholders did not approve the compensation, it

³⁴ I.R.C. § 162(m) (2000).

³⁵ In fact, this is not always a valid assumption, given the complexity of the documents and the frequent need to tailor the details of the compensation plan to the specifics of the particular industry. See Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1033-34 (1999).

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would not be deemed “performance based,” and amounts over \$1 million would not be tax deductible.³⁶

Finally, argue Bebchuk and Fried, neither the labor market, the market for corporate control, the capital market, nor the product market constrains executive pay. Thus, the only remaining restraint on inappropriate compensation are “outrage costs,” which Bebchuk and Fried define as outsiders’ negative reactions to unjustified, abusive, or egregious pay practices.³⁷ But even outrage costs can be rendered ineffective, since companies endeavour to camouflage the extent and form of their compensation.

Because perceptions are so important, the designers of compensation plans can limit outside criticism and outrage by dressing, packaging, or hiding – in short camouflaging – rent extraction. . . . [M]anagers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance based than they actually are, and that package pay in ways that make it easier to justify and defend.³⁸

Indeed, the very fact that CEOs feel the need to camouflage their pay (as is not the case with movie stars, athletes, and other highly paid stars) strongly

³⁶ PWP, *supra* note 4, at 49-50.

³⁷ *Id.* at 65.

³⁸ *Id.* at 67.

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suggests to Bebchuk and Fried that most compensation packages are not arrived at by arms length negotiation.³⁹

Examples of camouflage cited by Bebchuk and Fried include long-time managerial resistance to the expensing of options,⁴⁰ the widespread use of tax-inefficient supplemental executive retirement plans or “SERPs,” which do not enable the company to reap tax benefits but may allow CEOs to reap camouflage benefits,⁴¹ deferred compensation arrangements, which permit the CEO to enjoy an undisclosed, above-market rate of return prior to vesting,⁴² and post-retirement perks and consulting compensation, which need not be disclosed because the recipient is no longer CEO at the time he receives the benefits.⁴³ Bebchuk and Robert Jackson conducted a study of the pension plans among the CEOs of the Fortune 500 who either retired during 2003 or the first five months of 2004, or were at or close to retirement age in 2004. Although the companies were not required to disclose the total costs of such plans to shareholders,⁴⁴ they were required to disclose the existence of the plans and the method for determining the

³⁹ *Id.* at 21.

⁴⁰ *Id.* at 150.

⁴¹ *Id.* at 97-100.

⁴² *Id.* at 105.

⁴³ *Id.* at 110.

⁴⁴ New rules approved in July 2006 will require companies to include a pension benefits table disclosing the actuarial present value of each of the accumulated benefits under each pension plan of the CEO and other designated executives.

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annual benefit.⁴⁵ Only by examining each company's proxy materials, 8-k filings, and CEO employment contract, as well as by estimating the likely payout by taking into account factors such as each CEO's tenure at the company, age, and expected life span, were the authors able to estimate the costs of such plans to shareholders. They found that, for recently retired CEOs, the average cost exceeded \$21 million, and for incumbent CEOs between the age of 63 and 67, the average cost exceeded \$26 million.⁴⁶

According to Bebchuk and Fried, unrestrained managerial power, coupled with camouflage, leads to "pay without performance," in which CEOs enjoy extraordinarily high pay irrespective of whether they increase shareholder value. For example, CEOs of companies in the S&P 500 averaged \$2 million in cash salary and bonus in 2002, but the variation in cash pay among the CEOs was not correlated to performance relative to their respective industries.⁴⁷ Although option grants were meant to overcome the alignment problems found in cash compensation, Bebchuk and Fried point out that standard, non-indexed, at-the-money option grants⁴⁸ often provide CEOs with windfall benefits. After all, the rise in a

⁴⁵ Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 IOWA J. CORP. L. 823, 828 (2005).

⁴⁶ *Id.* at 837-38.

⁴⁷ PWP, *supra* note 4, at 122-23.

⁴⁸ In a standard, non-indexed at-the-money grant, the CEO receives the option at any time during a designated period (typically ten years) to purchase shares of the

given company's stock may simply be part of a general rise in the market, resulting from the mere passage of time, or from circumstances beyond the CEO's control, such as a reduction in interest rates.⁴⁹ Although boards could solve much of the windfall problem by "indexing" options so that the exercise price would rise or fall in tandem with a given index, such as the S&P 500, indexed options are rare, a fact that Bebchuk and Fried view as further support for the managerial power thesis.⁵⁰ And while boards do not

company at the market price (known as the "exercise" or "strike" price) prevailing as of the date of the grant. Thus, for example, if the CEO received 100 options at an exercise price of \$20 and five years later, he or she exercised the option when the market price for the stock was \$40, the CEO would reap a benefit of $(\$40 - \$20) \times 100$, or \$2000. An "in-the-money" option would set the exercise price below the market price on the date of the grant, while an "out-of-the-money" option would set the exercise price above the market price on the grant date. If the option were indexed, then the exercise price would rise or fall in tandem with a specific index, such as the S&P 500. In the foregoing example, assuming that the option was indexed to the S&P, and the S&P increased 50% over the five-year period, the exercise price would also rise 50% to \$30. The CEO's gain on exercise would be reduced to $(\$40 - \$30) \times 100$, or \$1000.

⁴⁹ PWP, *supra* note 4, at 138-39. Warren Buffett has pointed out another method by which CEOs can ensure that, over time, the value of un-indexed stock options will increase – consistently withholding dividends and buying back company stock. Buffett imagines a Company called Stagnant Corporation, which has granted a ten year, at-the-money option to its CEO, Fred Futile, to purchase 1% of the company. During the ten year period Stagnant Corporation enjoys no growth, each year earning \$1 billion on \$10 billion net assets, equal to \$10 per share on each of its outstanding 100 million shares. If, rather than paying any dividends, Fred uses the \$1 billion to repurchase shares, and the shares continue to sell at 10 times earnings, the shares will have appreciated 158% over the ten years. "That's because repurchases would reduce the number of shares to 38.7 million by that time and earnings per share would therefore increase to \$28.50. Simply by withholding earnings from owners, Fred gets very rich, making a cool \$158 million, despite the business itself improving not at all." Buffett, *supra* note 16, at 16.

⁵⁰ PWP, *supra* note 4, at 141-43. There may be good reasons, however, not to index option grants. For one thing, suppose Company A's board indexed CEO

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index options upward, they do often re-price them downward when the shares drop deeply out of the money, essentially providing CEOs with a gift, despite the poor performance of the company's shares.⁵¹ An even more egregious practice, which has come to light since the publication of Bebchuk and Fried's book, has been the widespread use, particularly among high technology companies, of backdated options. Options actually granted on a given date are made effective retroactively, as of a date when the stock price was lower. This decreases the exercise price of the option and enables executives to reap a larger benefit from the option grant. Despite the claim that stock option grants incentivize executives to increase the company's stock price in the future, backdating rewards

options to the movement of the S&P 500. If the S&P dropped 10 % while Company A shares stayed flat, shareholders might complain that Company A's CEO is being unfairly rewarded for the fall in the price of other shares. Or imagine the CEO of Big Oil, Inc. As a result of rising oil prices, the S&P plummets as Big shares rise spectacularly. Big's CEO would be doubly rewarded for events beyond his control. In order to avoid the problem of sectors whose stocks move counter to a broad index, Big's stock options could be tied to the "energy sector." But defining the sector could be difficult, and it could open the way to manipulation *ex ante*. Query: was Enron in energy or financial services? If, in order to avoid definitional problems, Big indexed options to the stock of a few companies in its peer group, the pay to Big's CEO could vary wildly simply as a result of a large scandal at, or a large windfall to, a competitor. Even a perfectly designed index could present new problems. Saul Levmore has suggested that indexing options might encourage CEOs to take on excessively risky projects, since they will receive the same payout (zero) from their options whether they index returns or take a big risk that fails spectacularly, but will receive a huge payoff if their gamble succeeds. See Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1922-23 (2001).

⁵¹ PWP, *supra* note 4, at 165-67.

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executives merely for short term volatility in the recent past. SEC investigations into the practice have only just begun, but one academic study using statistical analysis of 7,774 companies' stock option grants between 1996 and 2005 has found that an estimated 29.2%, or 2,270 companies, at some point manipulated stock grants.⁵² Even in those companies that do not engage in backdating, Bebchuk and Fried point out that CEOs can often blunt the risks (and alignment of interests) associated with stock options by selling their shares promptly upon exercise of the underlying options or by hedging against the performance of the shares, thereby protecting themselves against future drop in the company's stock price.⁵³

Bebchuk and Fried indicate that their primary goal is to call attention to the problem of executive compensation, rather than to propose solutions. Nonetheless, they do suggest several specific reforms. First, they advocate steps to enhance transparency, such as expensing options, placing a monetary value on all compensation, and disclosing what fraction of executives' option gains resulted from performance that was superior to that of its industry peers.⁵⁴ These suggestions are relatively

⁵² Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, J. FIN. ECON. (forthcoming).

⁵³ PWP, *supra* note 4, at 176-79.

⁵⁴ *Id.* at 192-94.

priced options, and large severance payments.⁵⁸ Second, they would grant shareholders more say in the appointment and reappointment of directors. Currently, while shareholders have the right to elect directors, they generally may not nominate them. Bebchuk and Fried would permit any shareholder who for one year has held, say, 5% of the shares to gain access to the corporate ballot for board elections. Instead of the existing rule, which requires a shareholder to pay its own costs in any proxy fight,⁵⁹ Bebchuk and Fried would require the company to cover the costs of proxy campaigns that garner significant support.⁶⁰ Third, Bebchuk and Fried would give shareholders the power to initiate changes to the corporate charter.⁶¹

⁵⁸ *Id.* at 195-98.

⁵⁹ Currently, Rule 14a-8, pursuant to which a shareholder can shift the costs of a proxy proposal by compelling a corporation to place it on the corporate proxy, is not available for disputes over the election of particular board members. *See* 17 C.F.R. § 240.14a-8 (2005). Rule 14a-8 is discussed further *infra* notes 106-113 and accompanying text.

⁶⁰ PWP, *supra* note 4, at 210-11.

⁶¹ *Id.* at 212-13. Bebchuk and Fried also suggest companies should link CEO pay more closely to performance by indexing options, limiting executives' ability to unwind holdings, and avoiding "soft landings" in which unsuccessful CEOs are given generous severance payments upon departure. *See id.* at 190-91.

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II. OBJECTIONS TO THE MANAGERIAL POWER THESIS

The managerial power thesis has drawn considerable criticism among commentators. Some have claimed that CEO pay in the U.S. is not in fact excessive. They argue that high CEO compensation is justified by the size and complexity of large organizations. One commentator has pointed out that asset managers, who would seem to have less complex duties than CEOs, typically receive a higher percentage of “assets under management” than CEOs do, even after accounting for the asset managers’ costs of doing business. Surely, he argues, CEOs are entitled to pay on par with that of asset managers.⁶² As for international comparisons, one commentator has posited five possible explanations for the relatively high pay of U.S. CEOs.⁶³ Perhaps, he argues, U.S. CEOs are paid more because they contribute more to their firms’ value than do foreign CEOs; or because the tournament to become a U.S. CEO is bigger, due to the greater power U.S. CEOs wield, compared to their foreign counterparts; or because U.S.

⁶² Joseph E. Bachelder, *Comments on Pay without Performance*, 30 IOWA J. CORP. L. 777, 781-82 (2005).

⁶³ This international compensation differential may be shrinking. See Geraldine Fabrikant, *Gilded Paycheck: American Export. U.S. Style Pay Deals for Chiefs Become All the Rage in Europe*, N.Y. TIMES, June 16, 2006, at A1 (noting that the differential between U.S. and European CEOs is declining as European CEOs demand pay in line with that of the U.S.).

executives are more mobile and can change companies in order to receive higher pay; or because of the presence of poison pills and the absence of control shareholders in U.S. companies, which has shifted bargaining power to management.⁶⁴

Others have argued that even if CEO pay is high, it can nonetheless be justified since, over time, U.S. shares have performed better than those of markets where CEOs are paid less.⁶⁵ Certainly, rational shareholders would prefer to pay an extra \$1 million to CEOs if that would lead to an additional shareholder return in excess of \$1 million.

Still others have pointed out that increased CEO pay is part of the larger labor market phenomenon known as the superstar effect. As organizations get larger, even slightly better management can cause a dramatic increase in total shareholder value.⁶⁶ This increased value may justify a proportional increase in pay for the CEO. Other types of stars, such as pro baseball players, have been enjoying similar pay increases as the amount of money in professional baseball increases, although baseball

⁶⁴ Randall S. Thomas, *Explaining the International Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1176-80 (2004).

⁶⁵ John Core, Wayne Guay, & Randall Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1165-66 (2005); Ian T. Kay, *CEO Pay for Performance: The Solution to "Managerial Power"*, 30 IOWA J. CORP. L. 785 (2005).

⁶⁶ R. Glenn Hubbard, *Pay without Performance: A Market Equilibrium Critique*, 30 IOWA J. CORP. L. 717, 718 (2005).

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players cannot manipulate the negotiation process.⁶⁷ Not all the rise in CEO salaries can therefore be attributed to managerial power.

Bebchuk and Fried have also been faulted for failing to distinguish between the legitimate bargaining power of talented people and the illegitimate manipulation of the negotiation process.⁶⁸ One study of CEO compensation during the years 1992 to 2000 indicated that externally hired CEOs, who do not tend to have power over the existing board, made on average 96% more compensation than CEOs hired from within the corporation.⁶⁹ This finding implies that the high salaries of outsiders at least result from their strong, but legitimate, bargaining power.⁷⁰

Other commentators concede that boards and CEOs do not engage in idealized arms length bargaining over CEO salaries, but deny that the arms

⁶⁷ Snyder, *supra* note 10, at 155-59.

⁶⁸ *Id.* at 152-55.

⁶⁹ Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 853-54 (2002).

⁷⁰ Bebhuk and Fried attempt to address this point by arguing that the directors would still have a strong incentive to please the new externally-hired CEO, since he or she would have influence over the director's re-election prospects. The directors may also be disinclined to bargain with the CEO candidate over pay, since they "want to get things off to a pleasant start." PWP, *supra* note 4, at 40. Yet this hardly explains why the pay of externally hired CEOs would be *higher* than that of internal hires. A better argument might begin by pointing out that managerial power distorts the market price for all CEOs. Since an externally hired CEO is often either the CEO of another firm or an executive who has the possibility of one day becoming CEO, a firm wishing to hire externally would need to compensate the candidate for the forgone opportunities in his current role. In that sense,

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length negotiation model is the correct standard by which to judge the negotiations.⁷¹ They claim that the relationship between the CEO and the board (or company) would be best described as a long term relational contract. In such contracts, parties tend not to fight for every advantage, but recognise that a given negotiation is only part of a broader relationship.

The directors' perception that they should support the CEO, their reluctance to override substantive decisions except under unusual circumstances, and their desire to be part of the "team" are not necessarily abdications of authority but may instead reflect the board's view that the long term interest of the corporation is furthered by cooperation and team building.⁷²

As a senior consultant for TIAA-CREF and former board member succinctly put it, "[b]oards have to be tough. They have to be collegial at the same time, though."⁷³ Or, to use the words of a former SEC Commissioner, "[m]oney may be 'left on the table.' And, yet, the best interests of shareholders may have been served."⁷⁴

externally-hired CEOs may be indirect beneficiaries of the widespread exercise of managerial power in the market for CEOs generally.

⁷¹ See, e.g., Snyder, *supra* note 10, at 149-52; Longstreth, *supra* note 20, at 767-68.

⁷² Snyder, *supra* note 10, at 151. See also Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797, 810 (2001) (suggesting that collegiality is necessary to enable mutual commitment and to make consensus-reaching practical).

⁷³ Kenneth West, *Pay without Performance: An Executive's Perspective*, 30 IOWA J. CORP. L. 791, 792 (2005).

⁷⁴ Longstreth, *supra* note 20, at 768.

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Turning to the specific pay practices criticized by Bebchuk and Fried, such as non-indexed at-the-money options, Kevin Murphy claims that there is a better explanation than managerial power for their widespread adoption. Boards may simply have considered such options a “cheap” form of compensation, since they require no immediate cash outlay and, until recently, they did not need to be treated as an expense for accounting purposes.⁷⁵ On the other hand, risk averse and undiversified managers discount the value of high risk options, and demand large option grants in lieu of cash.⁷⁶ In short, boards’ and managers’ respective assessments of the cost and value of such options may explain their increased use better than does managerial power alone. As evidence of this, one study found that nearly 80% of the options granted in S&P 500 Industrials, S&P 500 Financials, and New Economy firms in 2000 were granted to executives and employees below the top five, presumably employees without significant power over the board.⁷⁷

III. REACTIONS TO BEBCHUK AND FRIED’S PROPOSED REFORMS

⁷⁵ Murphy, *supra* note 69, at 859-60.

⁷⁶ *Id.* at 859.

⁷⁷ *Id.* at 857.

Given the controversy surrounding Bebchuk and Fried's diagnosis of the problem of CEO pay, one could expect similar reaction to their proposed solutions. And in fact, while commentators have not objected to their proposals to increase transparency, they have raised numerous objections to proposals to allow shareholders to appoint nominees to the board and to initiate changes to the corporate charter. For the most part, critics have expressed concern that, once empowered, shareholders would either fail to use their new power, or if the shareholders did use it, would do so to the detriment of the corporation.

Critics have pointed out that institutional shareholders are often unwilling to become engaged in the internal matters of corporations in which they invest, since their costs in time and liquidity would likely exceed the expected benefits.⁷⁸ Rational institutional investors would rather sell the shares of companies that destroy shareholder value (either through inappropriate payment practices or otherwise) than hold on to under-performing shares long enough to effect the necessary improvements.⁷⁹

⁷⁸ Stephen M. Bainbridge, *Director Primacy and Shareholder Empowerment*, 119 HARV. L. REV. 1735, 1751-52 (2006).

⁷⁹ *Id.* See also Olin Kramer, *Pay without Performance: The Institutional Perspective*, 30 IOWA J. CORP. L. 773, 774-75 (2005); Thomas & Martin, *supra* note 35, at 1034; Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 629-33 (2006).

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Moreover, they note, one cannot assume that those shareholders who are willing to become engaged in corporate governance issues will necessarily promote the financial interests of all of the shareholders. Delaware Vice Chancellor Strine makes the point as follows: “Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest.”⁸⁰ For example, a large union pension fund might threaten to mount a proxy fight for the election of board members who would accede to the union’s wage demands. Indeed, some have argued that such a scenario was at the heart of the decision by CalPERS (a former president of which was the regional director of the United Food and Commercial Workers) to withhold support for the election of the Safeway CEO, following a strike at Safeway.⁸¹

It has also been pointed out that, even assuming shareholders do not pursue non-economic agendas, differing types of shareholders could have widely divergent interests. For example, a hedge fund with a short term investment horizon might clamour for policies that sacrifice long term

⁸⁰ Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006); *see also* Bainbridge, *supra* note 78, at 1754-55.

interests for short term gain. Similarly, diversified shareholders (who have eliminated firm-specific risk) might advocate the implementation of projects that would be too risky to suit the preferences of undiversified shareholders.⁸² How do companies generally attempt to reconcile these divergent interests? By placing the authority to make decisions on behalf of the corporation into the hands of the board of directors. Courts facilitate this centralization of authority when they apply the business judgment rule⁸³ to insulate most board decisions from shareholder challenge.⁸⁴ Granting shareholders greater power might enhance board's accountability, but only at a cost to board authority.⁸⁵ To exacerbate matters, Bebchuk

⁸¹ Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. REV.* 561, 590 (2006).

⁸² *Id.* at 577-92.

⁸³ The business judgment rule has been characterized by the Delaware Supreme Court as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Smith v. Van Gorkam*, 488 A.2d 858, 872 (Del. 1985). Absent a showing of fraud, overreaching, lack of good faith, or being uninformed, a court will defer to the business judgment of the directors, and will not substitute its judgment for that of the board. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).

⁸⁴ *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 *BUS. L.J.* 461 (1992). "The business judgment rule can only be understood as intended to protect the authority of the board and thus to promote the value of Authority. . . . [T]he power to hold a party accountable is the power to interfere and, ultimately, the power to decide. Thus, affording shareholders the right to demand frequent judicial review of board decisions has the effect of transferring decision-making authority from the board to the shareholders." *Id.* at 470.

⁸⁵ Stephen Bainbridge describes the dichotomy between authority and accountability as follows: "A complete theory of corporate governance . . . requires balancing the virtues of discretionary fiat against the need to ensure that such power is used to further the interests of shareholders. Because the power to

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and Fried's proposal could end up making directors more accountable, not to shareholders generally, but simply to those shareholders that attempted to assert their new-found power; and, as demonstrated above, there is no guarantee that the assertive shareholders' interests are always aligned with those of other shareholders.⁸⁶

In short, commentators have pointed out that Bebchuk and Fried's proposed reforms could entail great costs. Thus, they should only be undertaken if they would bring shareholders even greater benefits.

Turning to the putative benefits, critics have argued that they would be rather small in comparison to the costs described above. After all, they argue, there is evidence that, despite the absolute size of CEO pay,

hold to account differs only in degree and not in kind from the power to decide, fiat and accountability also are antithetical." Bainbridge, *supra* note 78, at 1747. Or, as he states elsewhere in the same paper: "There are limits on one's ability to reduce agency costs without undermining the centralization of fiat that makes the modern corporation work." *Id.* at 1741.

⁸⁶ Commentators have pointed out a number of other unintended consequences that might arise if shareholders had the power to nominate board members. For example, perfectly independent board members who significantly improve compensation practices might nonetheless be unqualified to fulfil other more important tasks, such as selecting good projects and making good investment decisions. The net result could be negative for shareholders. See Core et al., *supra* note 65, at 1162-63. A similarly negative result could occur if a board comprised of capable people, under excessive pressure from the company's shareholders, felt compelled to adopt an overly adversarial attitude towards the CEO. In response, the CEO could simply withhold information from the board members, thereby rendering the board less effective. See Bengt Holmstrom, *Pay without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 711-12 (2005).

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the amounts involved may not be material to shareholders.⁸⁷ If shareholders really felt that CEO pay was a material concern, one would expect that they would often reject option plans submitted for shareholder approval. In fact, a study of shareholder voting on stock option plans during the 1998 proxy season found less than 1% failed to receive the approval of shareholders.⁸⁸ One former SEC commissioner put the materiality point forcefully as follows:

The Chartered Financial Analysis Institute, representing more than 70,000 money managers, investment advisers, and Chartered Financial Analysts (CFAs), teaches CFAs how to study a corporation and how to determine what matters and what does not matter in assessing the buy, sell, or hold decision. It even teaches CFAs about the voting decisions and how, with professional confidence, to reach conclusions on which many will rely. The CFA represents the best of the breed. When and if they start to attribute telling importance to executive compensation arrangements in deciding what to recommend, this matter will become important to investors . . . Until this time comes, the issue, by definition, lacks materiality.⁸⁹

⁸⁷ See Loewenstein, *supra* note 9, at 11 (referencing a study that indicated that, had the CEOs of the 1000 largest US corporations worked without compensation in 1992, shareholder returns would have increased by only 0.06%).

⁸⁸ Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 58 (2000).

⁸⁹ Longstreth, *supra* note 20, at 770-71. But another explanation for CFAs' apparent apathy is that, to the extent that the excessive compensation is endemic to publicly traded US corporations, CEO pay is not material for determining *relative* returns. If, however, CEO pay were to decline or to become better aligned with actual performance, material benefits would accrue, especially to the diversified investor. See *infra* p. 46.

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IV. COMPENSATION REPRESENTATIVES: A PRUDENT APPROACH

The controversy can now be summarized as follows: Bebchuk and Fried have pointed out numerous defects in the process for determining CEO pay, and have demonstrated how the process falls short of the ideal of the arms length negotiation. They have argued that the defects have led to excessive CEO pay, largely de-linked from CEO performance. To address the problem, they have suggested, among other things, making boards more responsive to shareholders, by empowering shareholders (i) to specifically approve certain “suspect” forms of compensation, (ii) to nominate directors, and (iii) to initiate changes to the corporate charter.⁹⁰ Critics have responded by arguing that CEO pay may not, in fact, be excessive, and that CEOs may simply be using their legitimate bargaining power to command high pay. They have justified mega option grants by noting that options are viewed by the corporation as inexpensive and by CEOs as risky. As for Bebchuk and Fried’s proposal to increase shareholder power, they have argued, in effect, that the proposed cure is worse than the

⁹⁰ For other proposed reforms, *see, e.g.*, Charles M. Elson, *Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (proposing that all directors be paid only in stock of the relevant corporation); Lowenstein, *supra* note 10 (proposing that shareholders be allowed an advisory up or down vote on CEO pay); Holmstrom,

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disease, especially since the amounts involved may not be material to investors.

The arguments of both sides to this debate appear to have merit, but can they be reconciled? To a certain degree, the answer is yes. On the one hand, the recent increases in the compensation of highly talented persons generally do imply that not all of the rise in CEO compensation is attributable to managerial power. Critics of Bebchuk and Fried also have a point when they argue that, as Vice Chancellor Strine put it, “the current American approach to corporate governance appears, on balance, to produce good results.”⁹¹ They are therefore right to be skeptical about radical changes to the balance of power between boards and shareholders, particularly while there is some question regarding the financial materiality of CEO pay to shareholders, the putative beneficiaries of reform. On the other hand, it is important to note that none of the critics have defended the existing pay-setting *process*, except by claiming that arms length negotiations by a divided and adversarial board could be even worse. One prominent critic implicitly admitted that the process is seriously flawed when he made the following concession:

supra note 86 (proposing the institution of generally accepted compensation practices, analogous to GAAP, which can be audited).

⁹¹ Strine, *supra* note 80, at 1769.

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Judgment calls tend systematically to favour the CEO. Faced with a range of market data on competitive pay levels, committees tend to err on the high side. Faced with a choice between a sensible compensation plan and a slightly inferior one favoured by the CEO, the committee will defer to management. . . . The amounts at stake in any particular case are typically trivial from a shareholder's perspective, but the overall impact of the bias has likely contributed to the ratcheting of pay levels [described in this article].⁹²

What then should be done? In view of the uncertainty regarding the extent of excessive pay, as well as the risks associated with adopting radical changes to corporate governance, reformers should strive to adopt a prudent approach that addresses the process problems without simultaneously creating new problems. Prudent reform would have the following characteristics. First, it would insert into the compensation setting process parties who are immune to CEO pressure and responsive to shareholder concerns. Second, it would address compensation process flaws in a targeted way, with minimal spill-over into other areas of corporate governance. In other words, it would not fundamentally alter the existing balance between directors and shareholders, or jeopardise the collegiality of many well functioning boards. Third, it would provide a substantial enough improvement over the existing system to justify its

⁹² KEVIN J. MURPHY, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS 2485, 2518 (Orley Ashenfelter & David Card eds., 1999).

adoption. It would further the interests of shareholders, while being mindful of the limits and possible disadvantages, discussed above, of direct shareholder involvement. It would avoid imposing on shareholders demands that exceed their expertise or costs that exceed expected benefits, and it would involve shareholders only to the extent likely to promote the long-term interests of the corporation. Fourth, prudent reform would be achievable with minimal changes to existing law, particularly since one could expect that significant legal changes that might be viewed as impinging on power of directors or threatening the pay of COEs would be strongly resisted by powerful members of the business lobbying community.⁹³ Finally, prudent reform would be flexible. Rather than requiring significant changes to all firms, irrespective of individual

⁹³ A case in point is provided by the modest reforms that the SEC proposed in 2003 in order to enhance shareholder nomination rights in limited circumstances. *See* 68 Fed. Reg. 60784 (Oct. 23, 2003). The negative reaction by the Business Roundtable and other lobbying organizations was decisive. According to the SEC staff, "The vast majority of commenters supported modifying the proxy rules and regulations related to the nomination and election of directors. Commenters who did not support such a modification included all of the corporations and corporate executives, most of the legal community, and the majority of associations (mostly business associations)." Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporate Finance (July 15, 2003) http://www.sec.gov/news/studies/proxyrpt.htm#P67_12802. The reforms were ultimately not adopted.

of the corporation. Their rights and duties would instead be limited to the following: (i) to attend all compensation committee meetings (formal or informal), as well as all board of director meetings, to the extent such board meetings concern CEO compensation matters; (ii) to inspect all documents relating to CEO compensation; (iii) to demand compensation-related information from compensation committee members, compensation consultants, and other board members; (iv) to advise and give opinions on CEO compensation matters, including its form, amount, conditions for receipt, and timing; (v) to submit to compensation committees any objections to proposed compensation plans, and, in the event that the full board participates in the determination of CEO compensation, to submit objections to the full board; and (vi) finally, if unsatisfied with the response of compensation committees or boards, as the case may be, to submit objections to the shareholders that appointed them. Following receipt of a compensation representative's objections, an appointing shareholder could take any action thereon which it saw fit. For example, one or more of the appointing shareholders could meet with members of the compensation committee to learn more about the reasons for the proposed compensation package and to discuss ways in which it might be improved. In extreme cases, as discussed below, an objecting shareholder could force the corporation to include in its proxy a proposal to reject any

The compensation representative proposal is preferable to Bebchuk and Fried's proposals, since it is a targeted response to the specific problem of CEO compensation. Its effects would not spill over into other matters, since the role of a compensation representative would be limited to investigating and advising on compensation matters, and would not extend to the management of the corporation's affairs. This limited role ensures that the use of a compensation representative would not substantially alter the traditional balance of power between a corporation's board and its shareholders.⁹⁶ It also would enable a compensation representative, who would not be a board member, to be tough with the CEO without sacrificing board collegiality. The representative could serve as the "bad guy," making it easier for the board to take a harder line with the CEO. Rather than telling the CEO, "Bob, we don't think you're worth that much," a board with a compensation representative could say, "Bob, we'd love to grant you the additional 100,000 options -- and we really think you deserve it -- but if we do, that

⁹⁶ Presumably, Bebchuk for one would not view this limited role as a virtue, since he feels that granting shareholders greater rights would benefit corporate governance more generally. See, e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 883 (2006) (arguing that shareholder value would be increased if shareholders were allowed to initiate changes in the corporate charter, to nominate board members, to change the company's state of incorporation, and to initiate mergers and similar transactions).

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S.O.B. is going to make a big stink about it, and the publicity would be bad for all of us.”

One might argue that a compensation representative provides no improvement on the current system. After all, shareholders are already entitled to vote on significant portions of most compensation packages anyway. But a system that merely allows shareholders the right to reject an inappropriate proposal is clearly inferior to one that could prevent the board from submitting the inappropriate proposal in the first place. A compensation representative could become engaged in the details of the compensation package early in the process. He or she would be in a position to detect manipulation, excess, or potential CEO windfalls from the outset, before the compensation committee or the board presents its recommendation to the shareholders. Take an example in which a huge bonus is conditioned upon the CEO's achievement of certain objective goals. A diligent compensation representative would be better able than shareholders to judge whether the goals could be achieved easily or only through extraordinary CEO performance. He or she could encourage the compensation committee to adopt demanding goals and could otherwise influence the details of the package to ensure the alignment of pay with performance, all prior to the shareholder vote. And certainly a compensation representative would be better able than shareholders to

detect and object to egregious practices such as the backdating of option grants.

What is more, compensation representatives would likely become repeat players, working with more companies than even the most active and sought after board member. Over time, they could develop expertise, market knowledge, and insight into the proper design of compensation packages, as well as into the way such packages can be manipulated. Thus, compensation representatives could not only benefit the shareholders, but they could also educate the compensation committee and board of directors on compensation best practices, thereby alleviating another problem identified by Bebchuk and Fried, the limits on the time and information available to independent directors.⁹⁷

The early involvement of a compensation representative would also benefit shareholders in those (hopefully rare) instances where the inclusion of a shareholder proxy proposal became necessary. Currently, as mentioned above, when shareholders vote on a compensation scheme, they are not generally provided with an alternative to the board's proposal, and may therefore feel compelled to approve inappropriate arrangements.⁹⁸ If, however, a shareholder were to respond to the compensation

⁹⁷ PWP, *supra* note 4, at 36-37.

⁹⁸ *See supra* notes 35 and accompanying text.

shares for at least one year could participate in the appointment of the compensation representative. Likewise, conflicts between insiders and outsiders would be resolved in favour of outsiders, since shareholders with material business dealings with the corporation could not participate in the appointment of the compensation representative.¹⁰¹

What if a shareholder wished to use the compensation representative to sabotage the corporation for private gain? Imagine, for example, that Company S, the largest shareholder of Company A, owns 1% of Company A, as well as 20% of Company B, a competitor of A. What if Company S tried to appoint an unduly aggressive and confrontational compensation representative in order to force the CEO of A to resign, to the detriment of Company S's investment in Company A, but to the much larger benefit of its investment in Company B? Or imagine scenario two, in which Company S tried to use the compensation representative to force Company A to acquire Company B at an excessive price, enabling Company S to capture a large premium on its investment in Company B sufficient to offset the loss on its smaller investment in Company A?

¹⁰⁰ Anabtawi, *supra* note 81, at 593.

¹⁰¹ See David Parthiban, Rahul Kochar & Edward Levitas, *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 *ACAD. MGMT. J.* 200 (1998) (an empirical study indicating that institutional investors that have merely an investment relationship with the firm influence compensation in

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making it difficult to for the representative to pressure the corporation to take specific actions, such as a merger. Finally, at for scenario three, the use of a lap-dog compensation representative would be no worse than the current system, in which the board makes its decision without the input of any shareholder representative. But in any event, the precise scenario described could not occur, since shareholders with significant commercial dealings with the corporation would be excluded from the appointment process.

Assuming that the proposal set forth in this paper would, if implemented, benefit shareholders, is it feasible under existing law? Very much so. In fact, as described below, it could be implemented in Delaware without the active involvement of courts, legislatures, or, perhaps most importantly, company boards.¹⁰³ Under existing Delaware corporate law, a company's by-laws would simply need to be amended to grant the three eligible shareholders the right to appoint a compensation representative having the rights and duties described above.

In Delaware, the by-law amendment could be effected by either the board of directors or the shareholders. Under Section 109(a) of the

¹⁰³ In this sense, the proposal set forth in this paper differs from Bebchuk and Fried's proposal to force companies to pay the costs for board proxy contests that receive sufficient support. Under current law, all such costs must be borne by the contesting shareholders.

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provides: “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”¹⁰⁸ Indeed, the conflict with Section 141(a) was the stated reason that the board of CA, Inc. refused to include the proposal in its proxy. Neither the SEC nor the Delaware courts have expressed an opinion on the merits of the board’s refusal, the former refusing to grant no-action letter pending the resolution of the matter under Delaware law,¹⁰⁹ and the latter refusing to decide the matter on ripeness grounds.¹¹⁰ The Oklahoma Supreme Court, however, when interpreting provisions of its corporate code which are substantially identical to those of Delaware, held in a similar case that the shareholders may propose a by-law to require shareholder approval for the issuance of poison pills.¹¹¹

In any event, an adverse ruling on Bebchuk’s CA proposal would not seem to cast doubt on the legality under Delaware law of a

¹⁰⁸ For a discussion of the conflict under the corporate law of Delaware and other states between corporate law provisions law granting shareholders the right to pass and amend by-laws and those granting the board of directors the power to manage the affairs of the corporation, see generally Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (2005).

¹⁰⁹ SEC No-Action Letter, 2006 WL 1547985, at *1 (June 5, 2006).

¹¹⁰ *Bebchuk v. CA*, 2006 WL 1805545 (Del. Ch. June 22, 2006).

¹¹¹ *See International Brotherhood of Teamsters Gen. Fund v. Fleming Companies*, 975 P.2d 907 (Okla. 1999).

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compensation representative by-law, since the two by-laws could be clearly distinguished. Delaware General Corporation Law provides that by-laws “may contain any provision, not inconsistent with law or the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, or the rights and powers of its stockholders, directors, officers or employees.”¹¹² Unlike Bebchuk’s proposed by-law, a by-law merely calling for the appointment of a compensation representative could not be said to conflict with Section 141(a), since the representative would be explicitly precluded from managing the business or affairs of the corporation. Neither would the by-law conflict with articles of incorporation that explicitly grant the compensation committee or the board of directors the authority to determine officer and director compensation. After all, the compensation representative would not be a member of either the compensation committee or the board, nor would he or she have the authority to vote on the actual compensation being proposed. He or she would merely represent the interests of shareholders and call to their attention compensation plans that shareholders might find objectionable. The legality of a by-law calling for a compensation

¹¹² DEL. CODE ANN. tit 8, §109(b).

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representative is further strengthened by Section 141(h), which permits corporations to use by-laws to restrict the compensation of directors.¹¹³

Once the by-law has been approved by the shareholders, no further legal issues should arise until a compensation representative objects to the board's compensation plan and a shareholder submits a proxy proposal calling on the shareholders to reject it. If the proxy proposal concerns a portion of the plan that is subject to a shareholder approval, there should be no legal hurdles to the proxy proposal, since the proposing shareholder would simply be exercising its right under the securities law. Thus, for example, a shareholder could include a proxy proposal to reject an equity-based compensation plan, since the listing rules of both the New York Stock Exchange and NASDAQ require that the shareholders approve any such plan. Similarly, a shareholder could include a proxy proposal regarding any individual's compensation in excess of \$1,000,000 for which the corporation wished claim a deduction under §162 (m) of the Internal Revenue Code.¹¹⁴

More problematic would be a shareholder proxy proposal that purported either (i) to reject other portions of a compensation plan for

¹¹³ "Unless otherwise restricted by the certificate of incorporation or by-laws, the board of directors shall have the authority to fix the compensation of directors." Del Code Ann. tit 8, §141(h) (emphasis supplied).

¹¹⁴ See *supra* note 34 and accompanying text.

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which neither the tax law nor the exchange rules requires a shareholder vote, or (ii) to compel the corporation to adopt a specific compensation plan that had not already been proposed by the board. Whether or not a corporation could exclude such proxy proposals would depend upon state corporate law since, as discussed above, Rule 14a-8 allows a corporation to exclude any proposal that is invalid under the law of the corporation's jurisdiction of organization.

Therefore, the legality of a proposal to reject, for example, cash compensation under \$1,000,000 would depend in Delaware on whether the corporate charter or by-laws permitted the shareholders to approve officer and director compensation in such a case. Certainly, a corporation could amend its charter to require such a vote. Under Delaware law, however, any charter amendment must be first initiated by the board, following which the shareholders must approve it,¹¹⁵ and it seems unlikely that many boards would unilaterally initiate charter amendments that subject their compensation decisions to a shareholder vote. As for by-law amendments, their terms are generally subordinate to contrary provisions in the charter.¹¹⁶ Thus, a shareholder could probably only initiate a by-law

¹¹⁵ Del Code Ann. tit 8, § 242(b).

¹¹⁶ *See, e.g., Gaskill v. Gladys Belle Oil Co.*, 146 A.337, 340 (Del. Ch. 1929).

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amendment to require a shareholder vote on executive compensation if the charter contained no contrary provision.¹¹⁷

The same problem would confront a proxy proposal purporting to compel the board to adopt a compensation plan containing specific terms. Such a proposal would not be valid unless a provision of the charter or by-laws actually granted shareholders the right to dictate executive compensation, as opposed to simply granting them the right to approve a plan proposed by the board. Presumably such a provision would be rare, certainly among listed companies, all of which are required under exchange rules to appoint compensation committees satisfying criteria specified by the relevant exchange.¹¹⁸

Although a corporation could exclude a proxy proposal to reject certain portions of a pay package or to compel the board to adopt a particular compensation plan, a shareholder could still require the company to include a precatory proxy proposal.¹¹⁹ Some may be skeptical of the

¹¹⁷ But, in view of the potential conflict of interest, it is not inconceivable that a court in equity could give preference to the by-laws. *See* *Gow v. Consolidated Coppermines Corp.*, 165 A. 136, 138-142 (Del. Ch. 1933) (holding that a by-law determining the number of directors prevails over a contrary clause in the charter).

¹¹⁸ *See, e.g.*, NYSE Listed Company Manual Rule 303A.05(a).

¹¹⁹ Since precatory proposals are not binding on the board, they are not deemed by the SEC to conflict with the requirement that the board have the authority to manage the affairs of the corporation. "In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company

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studied actually passed.¹²² One can expect that a precatory proposal submitted following the report of a compensation representative to be at least as effective. Indeed, such a precatory proposal, even if it do not pass, should be more effective than those studied by Thomas and Martin, since the board would realize that the proposal had the support of at least one major shareholder. If such a precatory proposal were to pass, one could expect the impact to be even greater, especially if the precatory proposal were to be accompanied by the shareholders' actual rejection of those portions of the compensation plan submitted for their approval. In the face of such a rejection, a board would ignore the precatory proposal at its peril.

As discussed above, one advantage of implementing the compensation representative system by by-law is that it would obviate the need for new legislation. A related advantage to case-by-case implementation is flexibility, especially since the extent of the CEO compensation problem may vary greatly by firm.¹²³ For example, at some

¹²² *Id.* at 1065, *quoted in* PWP, *supra* note 4, at 68-69.

¹²³ For evidence that flexibility in matters of corporate can improve company performance, see Arcot, Sridhar R. and Bruno, Valentina Giulia, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* (May 16, 2006). Available at SSRN: <http://ssrn.com/abstract=887947> (an empirical study finding that rigid adherence to "best practices" does not necessarily lead to superior performance, due to the heterogeneity of circumstances facing different companies). *See also* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 Sec. Reg. L.J. 370, ____ (2002)(arguing that

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firms, such as those controlled by a large independent shareholder, executive compensation may not be a serious issue, and the controlling shareholder may have the means and motivation to monitor executive compensation better than could a compensation representative. Indeed, empirical studies have indicated that firms with a shareholder controlling more than 5% of the shares may already be engaged in significant monitoring,¹²⁴ and that the doubling of the percentage holdings of large outside shareholdings is associated with a 12-14% drop in CEO pay.¹²⁵ Shareholders of such a firm might see no benefit to adding an additional layer of bureaucracy on top of an already well-working system.

On the other hand, shareholders of an underperforming firm that is dominated, not by an outside shareholder, but by an unresponsive CEO and his or her complicit board of directors, may find that the executive compensation system lies at the heart of the company's problems. They

independent directors are not an unalloyed good, in part because different companies may require different accountability mechanisms).

¹²⁴ See, e.g., Parthiban et al., *supra* note 101 (finding that the presence of institutional owners without significant business ties to a company is associated with lower levels of CEO pay); Donald C. Hambrick & Sydney Finkelstein, *The Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises*, 16 STRATEGIC MGMT. J. 175 (1995) (finding that the pay of CEOs at firms containing a large outside shareholders was tied significantly more strongly to profitability than was the case at firms without such a shareholder).

¹²⁵ Richard M. Cyert, Sok-Hyon Kang & Praveen Kumar, *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453 (2002), *quoted in* Bebchuk & Fried, *supra* note 7, at 660.

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may discover that the introduction of a compensation representative both captures the attention and increases the accountability of the CEO and the board, to the substantial benefit of shareholders.

In short, rather than mandating a procrustean system that could lead to unforeseen negative effects, the proposal set forth in this paper would give shareholders, the intended beneficiary of the new system, the ability to determine for themselves whether its adoption addresses their concerns. If it does, the system will likely be adopted by numerous corporations, and may evolve into corporate best practice. Indeed, if it became widely adopted, its benefits could be reflected in law subsequently. For example, courts could adopt a different standard of review of executive compensation depending upon whether a compensation representative was involved. Compensation plans involving a compensation representative could continue to enjoy the deferential waste standard or could be entirely immunized from judicial review, while plans adopted without such involvement could be subjected to a stricter scrutiny. Or state corporate law could be amended to provide for compensation representatives in all cases, unless a company's articles of incorporation explicitly opted-out of the system.¹²⁶ In the unlikely event, however, that the use of compensation

¹²⁶ In a similar development, shareholder proposals seem to be affecting statutory law relating to the election of directors. Currently, under the Delaware General

Ostensibly, compensation consultants were hired by the CEO to perform an objective analysis of the company's executive pay package and to make whatever recommendations the consultant felt were appropriate. In reality, if those recommendations did not cause the CEO to earn more money than he was earning before the compensation consultant appeared on the scene, the latter was rapidly shown the door. I learned this fact of life early on.¹²⁷

One might argue that Crystal's description no longer applies, since the listing rules of the New York Stock Exchange now require companies listed thereon to (i) have a compensation committee comprised entirely of independent directors, and (ii) to have a written charter that gives the compensation committee sole authority to retain and terminate any compensation consultant employed by the company.¹²⁸ The mere fact, however, that a member of the compensation committee is independent for purposes of the exchange listing rules does not address another major problem with compensation consultants: the possibility of other, much larger contracts between the consultant and the company. These contracts would be managed by the company's human resources department, under the control of the CEO rather than the compensation committee. Consultants would likely be very chary of jeopardizing these contracts by

¹²⁷ GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 218 (1991).

¹²⁸ Commentary to NYSE Listed Company Manual Rule 303A.05(b)(ii).

representative only if the majority of the shares voted to grant them that right. There is no obvious reason to paternalistically deny shareholders the right to vote in line with their perceived best interests, especially since, as stated above, Delaware law allows the by-laws to contain any provision relating to the affairs of the corporation as long as the provision is not contrary to law or the company's certificate of incorporation.¹³⁰

In any event, there is a practical reason to place the right to appoint the representative in the hands of large shareholders; namely, there is no good alternative. Even if the representative were appointed by a vote of all of the shareholders, someone would first have to nominate the candidate. Giving the nomination right to the board would defeat the purpose of employing a compensation representative, since the representative would then be neither more nor less accountable to the shareholders than are other board members, who are also nominated by the board and elected by the shareholders. If every shareholder, regardless of the size of its holdings, were permitted to nominate a candidate, shareholders with only a small economic stake in the corporation might abuse the compensation representative to further their own political or other non-financial agenda. If only those shareholders who held, say, 5% of the outstanding shares were allowed to nominate, compensation representatives could never be

¹³⁰ See *supra* note 112 and accompanying text.

would be paid by the corporation. Likewise, the costs of searching for an appropriate representative should be quite low, particularly for institutional shareholders that repeatedly appoint the same representatives for the various corporations in their portfolio. Costs in time and effort should also be low, since the actual tasks relating to reviewing, discussing, and if necessary amending the compensation plans would be delegated to the compensation representative. The only significant task required of participating shareholders would be to respond in those limited instances in which a compensation representative has objected to the board's final compensation determination.

Given the low costs to participating shareholders, even modest benefits would be sufficient to justify the use of compensation representatives. In fact, the potential benefits to shareholders could be significant. First, compensation representatives would provide a means of objectively evaluating whether a CEO's pay is excessive. When they find that a pay package is inappropriate, compensation representatives could suggest improvements to the package before it is even submitted to the board. Thus, they would be more efficacious than the newly mandated disclosure rules, which merely require corporations to better inform shareholders about a *fait accompli*. Second, if the use of a compensation representative led to lower CEO pay at a given company, one could expect the pay of

