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# The Overcompensation Problem: A Collective Approach to Controlling Executive Pay†

LINDA J. BARRIS\*

## I. THE OVERCOMPENSATION PROBLEM

### A. Introduction

Eighteen million, three hundred one thousand dollars: that was the total 1990 compensation paid to Stephen M. Wolf, the chief executive officer of UAL Corp. (UAL), the parent company of United Airlines.<sup>1</sup> In the same year, United Airlines showed a profit of only \$95 million,<sup>2</sup> a 70% drop from the prior year.<sup>3</sup> Shareholders protested, activists stepped in to negotiate, and eventually, UAL agreed to certain changes in its executive pay disclosure practices.<sup>4</sup> In 1991, Mr. Wolf's salary remained at \$575,000 and he declined his 1991 cash bonus; but he did not turn down a stock option grant valued at \$2.235 million, part of a series of annual grants promised to him when he took over the airline in 1987.<sup>5</sup>

Mr. Wolf's compensation is admittedly above the norm<sup>6</sup> (he was the second highest-paid executive on *Forbes's* 1990 list of highest-paid executives). But an ever-increasing number of his cohorts are surpassing the \$1

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1. *What 800 Companies Paid Their Bosses*, FORBES, May 27, 1992, at 236, 286-87 [hereinafter FORBES].

2. *Id.* at 287.

3. *UAL to Disclose More on Exec Pay Under Accord with Shareholders Group*, 24 SEC. REG. & L. REP. (BNA) 44, 44 (Jan. 10, 1992).

4. Joel Chernoff, *Pressure Builds on Executive Pay*, PENSION & INVESTMENT AGE, Mar. 16, 1992, at 3, 3.

5. Robert J. McCartney, *UAL Links Executive Compensation to Stock Price Rise*, WASH. POST, Mar. 31, 1992, at C1.

6. Salary figures vary depending upon the reporting organization and the methodology employed. The most frequently cited annual surveys are published by the American Management Association, McKinsey & Co., Hay Associates, and *Forbes*. *Forbes's* annual list is the most widely publicized, although the Hay report is more extensive. The latter is relied upon by the Internal Revenue Service as well as litigants in discrimination cases. The American Management report is a confidential report available only to members. Since many of the recipients of the report are the decision makers on compensation issues, it may be the most influential in setting next year's salaries. See Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 247-48 (1983).

million mark.<sup>7</sup> In 1990, *Forbes* put the average total compensation of top executives at \$1.592 million.<sup>8</sup> According to the Hay Group, a Philadelphia consulting firm specializing in compensation issues, the typical 1991 salary of American chief executives had grown to approximately \$1.7 million.<sup>9</sup>

John F. Akers, chief executive of International Business Machines Corporation (IBM), received a 185% raise for 1990. He received a bonus of \$600,000 and stock gains of \$647,000, for a total bonanza exceeding \$3.2 million.<sup>10</sup> In 1991, uneasiness over IBM's cloudy future prompted concerned shareholders to call on Mr. Akers. That year his pay was trimmed to \$1.6 million, a 40% reduction.<sup>11</sup>

Meanwhile, at Sears, Roebuck and Company, chief executive Edward A. Brennan refused his annual bonus "to reflect the spirit of the salary freeze" that affected company employees in 1991.<sup>12</sup> Although Mr. Brennan may have turned down his annual bonus, he did not turn down his three-year performance bonus valued at \$391,206. This bonus was paid to him in addition to his \$979,847 base salary, and the \$680,050 he realized by exercising previously granted stock options. Add to this two grants of stock options totalling 69,696 shares at an average exercise price of \$30.44, plus the grant of 12,098 previously restricted shares with a current market value of approximately \$543,000. In all, his total compensation package for 1991 was valued at approximately \$3.6 million.<sup>13</sup> At the end of March, 1992, Sears announced the elimination of another two thousand jobs. Since August, 1990, the company, in an effort to reduce costs, has eliminated 43,150 jobs.<sup>14</sup>

The seeds of these huge compensation packages were planted in the excesses of the 1980s. Between 1971 and 1981 average executive compensation grew by a significant but respectable 30%.<sup>15</sup> During the frenzied 1980s, CEO compensation jumped by 212% while earnings per share on the Standard and Poor's 500 Index grew by only 78%. In contrast, factory

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7. According to the *Forbes* survey, 258 out of 800 top executives took home \$1 million or more in 1990. *FORBES*, *supra* note 1, at 236.

8. *Id.*

9. Linda Grant, *Shareholders Balk at Shift in Executive Incentive Plans*, *L.A. TIMES*, Apr. 12, 1992, at D1, D7.

10. *FORBES*, *supra* note 1, at 262-63.

11. H. J. Cummins, *Do Top Execs Deserve Huge Salaries?*, *NEWSDAY*, Mar. 29, 1992, (Business), at 76, 68.

12. John Schmeltzer & Charles Storch, *No Letup in Sears Job-Cutting*, *CHI. TRIB.*, Apr. 1, 1992, § 3 (Business), at 1 (quoting SEARS, ROEBUCK AND COMPANY, 1991 PROXY STATEMENT 9 (1992)).

13. *Id.* at 4.

14. *Id.* at 1.

15. Geoffrey S. Rehnert, Note, *The Executive Compensation Contract: Creating Incentive to Reduce Agency Costs*, 37 *STAN. L. REV.* 1147, 1149 n.7 (1985) (citing *Executive Compensation: Looking to the Long Term Again*, *BUS. WK.*, May 9, 1983, at 80, 81).

workers' wages rose only 53%.<sup>16</sup> In recession-plagued 1990, corporate profits fell 7%, but the average CEO's total pay increased 7%,<sup>17</sup> and while the rate of inflation was 6.1%, factory workers received raises of just 2.8%.<sup>18</sup> More than a few disgruntled workers and a contingent of shareholders are once again taking a hard look at enormous executive salaries.

The clamor to control *excessive* compensation has grown so loud it can no longer be ignored. If corporations do not remedy the situation, they face the specter of increased shareholder revolt (manifested by calls for ouster, sale of stock, or derivative suits for corporate waste); loss of employee productivity (and concomitant decline in corporate profits); or governmental action in the form of legislation to force pay ceilings.

### B. Historical Perspective

Executive compensation packages have evolved during the last century in response to changes in the structure of American firms. Gone are the days of owner-managers; in their place is a cadre of professional managers and a system of salaried executives. Most owner-managers preferred to take the rewards of their hard work through stock gains on their investment.<sup>19</sup> Salaried executives, on the other hand, had little incentive to provide services at a level greater than that required to retain their positions. In response, corporations developed incentive compensation plans based on some measure of corporate profits.

The average earnings of corporate presidents during the early part of the century, including incentive compensation, were considerably less than \$100,000.<sup>20</sup> While most compensation plans were modest by present-day standards, there are examples of huge rewards collected by a few executives. One example, which prompted more than one shareholder lawsuit, involved American Tobacco Company President George Washington Hill.<sup>21</sup> Mr. Hill grossed \$1.284 million and netted, after taxes, \$1.050 million—in 1930 dollars.<sup>22</sup>

Executives receiving extra-generous compensation were shielded from scrutiny because compensation levels were kept as closely guarded secrets.<sup>23</sup>

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16. John A. Byrne, *The Flap Over Executive Pay*, Bus. Wk., May 6, 1991, at 90, 90.

17. *Id.* at 91.

18. *Id.* at 93.

19. Vagts, *supra* note 6, at 245.

20. *Id.* at 246. Mr. Vagts cites a 1938 study which found that the median compensation of 100 top industrial CEOs was \$69,728 in 1929. *Id.* at 246 n.63.

21. *Rogers v. Hill*, 289 U.S. 582 (1933); *Heller v. Boylan*, 29 N.Y.S.2d 653 (Sup. Ct. 1941), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

22. For a discussion of the calculations see Vagts, *supra* note 6, at 255 n.111. A bonus of two and one-half percent of profits yielded President Hill \$447,870.30 in 1929 and \$842,507.72 in 1930. *Rogers*, 289 U.S. at 591. These payments were in addition to cash and fixed salary. *Id.* at 585. See Vagts, *supra* note 6, at 245-46.

23. Vagts, *supra* note 6, at 245.

After the stock market crash of 1929, shareholder litigation and bankruptcy proceedings unearthed some of the previously hidden information. Appalled shareholders filed lawsuits charging corporate waste, Congress conducted hearings, and the Federal Trade Commission investigated. But the lawsuits rarely resulted in victories, and no direct governmental action to curb excessive compensation resulted; however, the sudden attention to a previously sacrosanct subject forced corporate directors to exercise more caution when granting compensation packages, and pay levels were kept in check. Due to economic conditions and other factors, including wartime salary stabilization,<sup>24</sup> compensation remained relatively low during the next four decades.

Although the government refused to directly control private sector compensation, it did devise a way in through the back door—redistributing wealth through taxation. Personal income tax levels have historically fluctuated depending on the economic theories of the incumbent administration. The top tax rate rose to a high of 91% in the late 1940s, settling in at the 70% range during the 1960s.<sup>25</sup> While the average executive earned considerably more than the average worker, his proportionally higher tax rate significantly reduced the disparity. Furthermore, the futility of awarding huge salaries only to see them swallowed up by taxes helped to keep salaries lower.<sup>26</sup>

In the early 1980s, the average chief executive's paycheck was \$624,996, a sum which was forty-two times the pay of the average factory worker.<sup>27</sup> But then came the 1980s and the "Reagan Years." By 1990, the average executive's earnings, exclusive of stock options, had risen to \$1,214,090—eighty-five times the salary of the average factory worker.<sup>28</sup> During the same period, President Reagan's tax policies dropped the top rate from 70% to 28%,<sup>29</sup> significantly increasing the disparity between worker/boss income and also removing the "tax obstacle" to granting large salary increases. As the 1990s unfold, corporate profits are declining and the real purchasing power of the worker's paycheck is shrinking, but executive salaries continue to rise. In an echo of the 1930s, the wisdom of enormous pay packages is once again called into question.

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24. *Id.* at 246.

25. Kevin P. Phillips, *Reagan's America: A Capital Offense*, N.Y. TIMES, June 17, 1990, § 6 (Magazine), at 26. In 1920, the top tax rate was 73%. By 1925, the top rate had been reduced to 25%. After the 1929 stock market crash and the advent of the New Deal, the top rate increased to 79% by 1936 and then to 91% post-war. *Id.* at 28. In the 1960s, the top rate again fell, first to 77%, then to 70%, where it remained stable until the 1980s. *Id.*

26. See Vagts, *supra* note 6, at 246.

27. Byrne, *supra* note 16, at 91.

28. *Id.* at 93.

29. *Id.* at 95.

## II. THE EFFECTS OF COMPENSATION PACKAGES

Multi-million dollar compensation for top executives engenders an instinctual negative reaction from the public and many shareholders. Corporations justify these packages by claiming they are "paying for performance." Executives justify these packages by claiming they should be amply rewarded for steering their companies to profits. But do these plans effectively accomplish that goal? Do sizable salaries actually make shareholders worse off? Is the corporation hurt? This Part will begin with a review of the types of compensation paid to corporate executives, turn to the justifications for and criticisms of these packages, and finally look at the actual harm to shareholders and the corporation.

### A. *The Structure of Compensation Packages*

Compensation packages are as varied as the corporations which create them. The particulars of how an executive's contract is structured are determined by a combination of factors, including competitors' compensation plans, current tax laws, phase of a company's growth, and amount of incentives the directors wish to give to top management.<sup>30</sup> But pay packages tend to follow a pattern and usually will include most or all of the following:

- Guaranteed salary
- Benefits, such as life, disability, and medical insurance
- Perquisites
- Cash bonuses for attaining certain goals
- Stock options
- Termination compensation (golden parachutes)

Almost every publicly held corporation includes in its pay package some type of incentive compensation in the form of bonuses and stock options. The original idea behind incentive compensation was to align shareholder and manager interests and to motivate and hold onto top executives. As a stockholder, the executive has a vested interest in maintaining a profitable company, in turn benefitting shareholders.

Cash bonuses are awarded to the executive for meeting short-term goals such as landing a particular contract, meeting annual sales targets, or maintaining a certain share value. These bonuses may be quarterly, annual or biennial, or triggered by a particular event.<sup>31</sup> Stock options are the rights

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30. Rehnert, *supra* note 15, at 1151.

31. General Dynamics, for example, has a controversial bonus plan that pays bonuses equal to one-half the annual salary for every \$10 incremental increase in stock value maintained for a period of 10 days. Robert J. McCartney, *A Most Unusual Executive Bonus Plan*, WASH. POST, Oct. 21, 1991, at A1. See *infra* notes 54 and 170.

to buy company shares at some future date at a pre-determined price<sup>32</sup> and are geared toward promoting corporate growth over an extended period of time. A balanced pay package will usually include incentives for executives to meet both the short- and long-term goals of a company. In a properly constructed plan, the executive will be motivated to activate the plan's contingencies so as to receive the maximum reward.<sup>33</sup> In theory, if an executive works hard, stock value increases and everyone wins.

Stock option plans are the fastest-growing component of compensation packages. Long-term incentives accounted for a third of total CEO pay in 1991, or about \$500,000 of the typical \$1.7 million salary.<sup>34</sup> This compares to only 8%, or \$58,000, of a comparable \$725,000 package in 1985.<sup>35</sup> The following table represents the changes in distribution of the typical pay package between 1985 and 1991.<sup>36</sup>

<u>TYPE OF COMPENSATION</u>	<u>PERCENTAGE OF TOTAL</u>	
	<u>1985</u>	<u>1991</u>
Base salary	52%	35%
Long-term awards (options)	8%	31%
Annual bonus	22%	22%
Benefits	16%	11%
Perquisites	2%	2%

Figures regarding stock option compensation can be deceptive. The enormous salary figures quoted in the press often result not from the present award of compensation, but from the actual cashing in of stock options previously granted. In that respect, the figures may represent an accumulation of rights over several years which, exercised in one year, inflate the compensation figures.<sup>37</sup> On the other hand, there are clear exceptions. Stephen M. Wolf, chief of UAL, cashed in \$14.775 million in stock options in 1990. Since he had only been with UAL since 1987,<sup>38</sup> his average take on stock options alone was huge by anyone's standards.

### *B. Justification for Incentive Compensation: Pay for Performance*

Modern chief executives have awesome responsibilities. They must oversee the management of tens of thousands of employees. They must balance the

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32. For example, an executive may be given an option to purchase 10,000 shares of his corporation's stock at \$100 per share, the market price on the day the option is granted. Assume that the executive holds the option for five years. If during that time the market price has risen to \$150, the executive may elect to exercise the option and purchase the stock at the \$100 per share "strike" price, \$50 below the then-market price.

33. Vagts, *supra* note 6, at 240.

34. Grant, *supra* note 9, at D7.

35. *Id.*

36. *Id.* at D1 (citing Hay Group, Executive Compensation Database).

37. Byrne, *supra* note 16, at 93.

38. FORBES, *supra* note 1, at 286-87.

conflicting demands of customers, lenders, workers, governmental agencies, the press, and the public. They are under enormous pressure from Wall Street and shareholders to increase share value. They must keep up with the ever-increasing pace of technological change and the rush of foreign competition.<sup>39</sup> Chief executives are not interchangeable cogs; each has a unique position with a tailor-made job description.<sup>40</sup> This, claim executives, justifies high pay.

Another frequently cited justification for high corporate compensation is the ballplayer analogy.<sup>41</sup> Baseball players and rock stars take home multi-million dollar pay with little comment. Chief executives make no more than other highly compensated individuals, yet seem to be the lightning rod for a more general anger about concentrated wealth and the rich getting richer.<sup>42</sup>

Few people would object to executives being paid well. If a company has the right CEO, with "energy, brains, diligence, daring, and capacity for hard work," any salary would be a bargain.<sup>43</sup> But some critics are pointing to a present lack of a connection between the performance of many executives and the pay they receive. If executives are performing so well, why are corporate profits stagnating or declining? Average corporate profits dropped 7% in 1990 while average CEO pay rose 7%,<sup>44</sup> strong evidence that executives are being rewarded in spite of performance, not because of performance.

If an enormous salary is to be both equitable and palatable to shareholders and the public, pay must be visibly related to the actual responsibility the executive carries and the quality of the executive's performance. If an executive receives a large annual bonus because the corporation showed a profit, that profit should be traceable to a significant degree to the actual efforts of the executive. This is where the ballplayer analogy strikes out. A ballplayer or rock star makes millions because of his or her individual talent. An executive, on the other hand, is just one player on a very big team. Certainly he plays a leading role, but it is difficult to accurately assess his individual contributions to an overall successful year. When a ballplayer hits a home run, his individual contribution is obvious.

Incentive compensation is ideal in the abstract, but in practice it may not function as anticipated. For example, bonuses that reward executives for reaching pre-defined goals are often tied to increases in stock performance. But stock prices may vary due to external influences which pervade the

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39. Byrne, *supra* note 16, at 92.

40. Vagts, *supra* note 6, at 237.

41. Cummins, *supra* note 11, at 76, 68.

42. *Id.*

43. Donald B. Thompson, *Are CEOs Worth What They're Paid?*, *INDUSTRY WK.*, May 4, 1981, at 65, 65 (quoting U.S. Steel Vice President J. Bruce Johnston).

44. Byrne, *supra* note 16, at 91.



economy as a whole or one particular industry.<sup>45</sup> An executive may "earn" a bonus simply because a market fluctuation occurred at the proper time.<sup>46</sup> A steady rise in profits over a period of years, the event stock options are designed to reward, may flow from research breakthroughs or market expansions begun in a predecessor's term. To complicate the matter, contracts spelling out bonus plans are often extremely complex, and the measure of whether a goal has been attained is usually a set of internally produced accounting figures. As with any set of books, these figures are subject to manipulation. In sum, a compensation plan aimed at motivation may in fact reward an executive for lucky circumstance or crafty tactics instead of individual effort.

If corporations justify their compensation practices by claiming to pay for performance, there should be some assurances that executive fortunes rise and fall with the company's. Many compensation packages are constructed so that the executive profits in good times and is protected in bad. If stock prices decline, the executive may lose his bonus, but he may have the ability to renegotiate the option portion of his existing plan to lower the strike price, the price at which the option can be exercised.<sup>47</sup> Thus, the executive is rewarded regardless of his or the corporation's performance and is simultaneously insulated from the ravages suffered by fellow shareholders if stock value declines.<sup>48</sup>

The growing use of incentive compensation suggests that corporations are placing ever-increasing emphasis on executive performance. But sufficient anecdotal evidence exists demonstrating that many plans do not properly motivate and reward. Many of these plans, by design or defect, act to enrich the executive without sufficient return to the corporation. These plans involve substantial costs to the company, so if their existence is to be justified by the claim that the company is paying for performance, it is vital that payment be made only for measurable outstanding performance.<sup>49</sup>

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45. Vagts, *supra* note 6, at 241.

46. *Id.*

47. See *supra* note 32 and accompanying text. A recent case causing controversy involves Paul Lego, chairman of Westinghouse. His corporation suffered immense (\$1.1 billion) losses in 1991. Grant, *supra* note 9, at D7. As a result, Lego lost his 1991 bonus, but in April, 1991, he was given 350,000 shares of stock at a strike price of \$28.56. *Id.* Unfortunately (for the shareholders), the value of Westinghouse stock continued to drop, rendering Mr. Lego's options worthless, so the board dipped into corporate coffers and produced another option package of 350,000 shares, this time with the significantly lower strike price of \$16.00. *Id.*

This replacement of option packages is not a new phenomenon. In 1979, a shareholders' derivative suit was brought against Sears, Roebuck and Co. alleging waste of corporate assets when the company twice called back stock options and replaced them with new options at lower strike prices. *Cohen v. Ayers*, 596 F.2d 733, 736 (7th Cir. 1979). The court refused to find any wrongdoing on the part of the corporation, noting the fact that the action was approved by a significant majority of shareholders. *Id.* at 741.

48. Grant, *supra* note 9, at D7.

49. David Kraus, *Executive Pay: Ripe for Reform?*, HARV. BUS. REV., Sept.-Oct. 1980, at 36, 44.

### C. *The Harmful Effects of Overcompensation*

#### 1. The Effect of Compensation on Shareholder Wealth

In defense of their pay practices, companies often point out that the cost-per-share of an executive's compensation package actually amounts to only pennies, even with the extravagant salaries of some top executives. In 1990, the 800 chief executives listed by *Forbes* earned \$746 million in salaries and bonuses, \$232 million in other forms of compensation, and cashed in stock options for an additional \$296 million. In all, the executives pocketed a total of \$1.3 billion. But in the same year, corporations made profits of \$154 billion. Overall, executive salaries amounted to less than 1% of corporate profits.<sup>50</sup>

If even the largest compensation packages do not strip corporations of assets, devalue the stock, or cheat individual shareholders of significant sums of money, what then is the problem with granting generous salaries and ample incentives? Is the current complaining over excessive compensation merely the "gut" reaction that executives make "too much money"?<sup>51</sup>

Not necessarily. Incentive compensation generates some significant problems which harm corporations and in turn impact shareholder wealth. Two of the most pressing problems are the perverse incentives created when money is used to motivate the executive and the adverse incentives created in demoralized American workers. And left unchecked, stock options could proliferate until they do pose a serious economic threat to corporations.

#### 2. Harming Corporations Through Perverse Incentives

According to generally accepted American corporate theory, the executive's goal should be to maximize firm value for the benefit of the corporation's owners, the shareholders. To facilitate this goal, bonuses are awarded for increasing the firm's value (maximizing shareholder wealth), and stock options are granted to align executive and shareholder interests. The two incentives should act together to provide impetus to maximize both short- and long-term corporate potential.<sup>52</sup> At its most basic level, the granting of incentives is based upon the "greed" principle: An executive will make decisions which he believes will increase the value of his corporation's stock, which in turn will increase his personal wealth. While the executive is busy assuring his personal gain, he assures gain for all.

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50. *FORBES*, *supra* note 1, at 237.

51. Rehnert, *supra* note 15, at 1152.

52. Alfred Rappaport, *Executive Incentives vs. Corporate Growth*, *HARV. BUS. REV.*, July-Aug. 1978, at 81, 84.

In order to maximize his personal wealth, the executive has a perverse incentive to focus on only those programs and factors most closely affecting the amount of his compensation. Since his compensation depends on the company's performance, and the company's performance is measured primarily by earnings-per-share or market price,<sup>53</sup> the executive has incentive to do whatever is necessary to prop up this quarter's earnings or increase the market price of shares. Instead of positioning the company for the future, which is an important objective of shareholders, the executive's attention is diverted to positioning the company to meet his own short-term goals.<sup>54</sup>

These perverse incentives also engender poor decision making.<sup>55</sup> Whether the executive makes a short- or long-term decision will be affected by his perception of the personal economic rewards of a particular action.<sup>56</sup> Economic rationality dictates that an executive weighing two competing courses of action will choose the plan that will have significant impact on this year's profits (and thus on his annual bonus) over one which may pay back handsomely, but only after a number of years. Executive jobs are not necessarily permanent. In 1990, there was a 20% turnover among CEOs at *Forbes* 500 companies through death, retirement, relocation, and ouster.<sup>57</sup> This fact provides added incentive to executives to make short-term, income-enhancing decisions.

Managers holding pay packages heavy with incentives may become unwilling to invest a firm's resources in forward-looking projects. Postponement of discretionary outlays, reductions in advertising, delays in employee development programs, and other cost-cutting measures all contribute to higher short-term earnings (and thus bigger executive bonuses), but adversely

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53. Vagts, *supra* note 6, at 241.

54. One of the most blatant examples of this effect is the "\$1.6 million speech" delivered by General Dynamics's chairman, William Anders, on September 25, 1991. Anders told a group of professional stock market analysts that earnings were up and the company was planning to return its excess cash directly to the shareholders. McCartney, *supra* note 31, at A1. General Dynamics's stock jumped \$4 per share to close at the highest level in two years. *Id.* What Mr. Anders neglected to mention was that the jump triggered a bonus equal to double his \$800,000 annual salary, or \$1.6 million (guaranteed payment of one-half in 1994, the rest at age 65). *Id.* All he had to do to receive the bonus was to keep the average stock price above \$45.56 for 10 consecutive days. *Id.* The speech did the trick.

While Mr. Anders counts his loot, General Dynamics is laying off workers, scaling back production, and trying to reshape its business amid reduced defense spending. *Id.* The company lost \$578 million in 1991. *Id.* Corporate earnings were up due to spending cuts which could, over time, cripple the company. Cummins, *supra* note 11, at 76. This bonus plan, as expected, received harsh criticism because it motivates management to do whatever is necessary to raise stock price in the short term at the potential expense of market share in the longer term. McCartney, *supra* note 31, at A1.

55. Rehnert, *supra* note 15, at 1148.

56. Rappaport, *supra* note 52, at 84.

57. FORBES, *supra* note 1, at 237.

affect the future earning power of a company.<sup>58</sup> Research and development expenditures as a percentage of gross national product began to decline in the 1970s,<sup>59</sup> and the trend has continued into the 1990s.<sup>60</sup> Many critics attribute the decline in long-term research, planning and business development to management's preoccupation with short-term financial results and efforts to boost short-term earnings and stock prices.<sup>61</sup> Research and development expenditures are reduced because these expenses lower current profits and only pay off in the future, if ever.<sup>62</sup> "The easiest expenditures to forgo are investments in the future."<sup>63</sup>

Risk taking is also reduced. If a company embarks on a risky project and loses, the loss is divided among the many shareholders so that each only suffers a small decrease in wealth. A shareholder with an adequately diversified portfolio will hardly notice. However, an executive whose compensation package is chock-full of incentives may find his income significantly reduced. Unlike the shareholder, he is unable to diversify these losses. Consequently, a shareholder may be eager for the corporation to take on risk, but the executive with performance-based bonuses may have powerful incentives to avoid risk taking.<sup>64</sup> Even though incentive compensation is designed to align shareholder and executive interests, when it comes to risk taking, those interests radically diverge.

Play-it-safe decision making, postponed capital expenditures, and bypassed research and development are not always in the best interests of the corporation, the shareholder, or the public. While not accusing all highly-compensated executives of malfeasance, it is unrealistic to assume that executives will always act in the best interests of the corporation when corporate interests conflict with personal interests. A compensation plan that focuses on individual *greed* cannot help but promote *greedy* conduct. This conduct has a trickle-down effect which may not be fully realized by the corporation or its shareholders for many years.

### 3. Demoralizing the Workforce

While the cost-per-share to the corporation for a multi-million dollar compensation package is small, the cost to the firm in terms of human

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58. Rappaport, *supra* note 52, at 82.

59. Rehnert, *supra* note 15, at 1159.

60. Lipton, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 50 U. CHI. L. REV. 187, 210 (1991). Between 1980 and 1985, there was an annual rate of increase in American corporate research and development spending of 8.2%, but the real increases averaged less than one-fifth that rate between 1985 and 1990. *Id.* (citing *R & D Spending Growth Continues to Slow*, RES. TECH. MGMT. 2 (Mar.-Apr. 1990)).

61. *See, e.g.*, Rehnert, *supra* note 15, at 1159; Rappaport, *supra* note 52, at 82; Lipton, *supra* note 60, at 210.

62. Rehnert, *supra* note 15, at 1159.

63. Lipton, *supra* note 60, at 210.

64. Rappaport, *supra* note 52, at 84.

capital is far greater. Those same pay packages which provide executives with incentives create disincentives for employees. Executive compensation strikes at key economic issues: employee morale and productivity.

It is hard for American workers to feel part of the team when the CEO's salary is eighty-five times the average worker's pay.<sup>65</sup> While executive paychecks have been increasing steadily, the "real earnings" for their workers, adjusted for inflation, have been decreasing.<sup>66</sup> At the same time the executives are voting themselves huge raises, they are laying off workers. When workers perceive that top management is on a "gravy train," morale suffers, especially when hard times hit and the suffering is not shared.<sup>67</sup> As workplace resentment rises, labor-management relations deteriorate.

There is more at stake here than just bad feelings. American competitiveness is also suffering, due in part to employee discontent. American manufacturing wages languish behind Switzerland, Germany, Sweden, Canada, Japan, Belgium, and the Netherlands, while executive salaries are nearly double the pay of any foreign peer,<sup>68</sup> a detail not lost on American workers. Production is a social undertaking, not an individual one. It requires teamwork and trust, which is exactly what bloated executive paychecks erode.<sup>69</sup> Employees won't follow executives they cannot trust, and they cannot trust executives who see to it that they are overpaid.<sup>70</sup>

Reining in executive pay will not have a direct impact on the competitiveness of American firms, but it could boost employee morale and, indirectly, make companies stronger. It is symbolic of a shared fate between executives and workers.<sup>71</sup> A few corporations are beginning to acknowledge the correlation: an official of the Colgate-Palmolive company recently admitted that the biggest barrier to teamwork is executive pay.<sup>72</sup> But many corporations continue to grant executive pay increases, generous bonuses,

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65. Byrne, *supra* note 16, at 93.

66. For example, in 1990 the rate of inflation was 6.1% but the average factory employee received a mere 2.8% raise. Even white-collar professionals were outpaced by inflation; they received raises in 1990 of 5.2%. Only the CEOs, who on average increased their total take by 7%, managed to keep ahead of inflation. *See id.* at 91, 93.

67. Jonathan Rowe, *CEO Pay Affects Company Morale*, CHRISTIAN SCI. MONITOR, Mar. 12, 1992, at 13.

68. Laurent Belsie, *Executives Make Hay, but the Sun is Not Shining*, CHRISTIAN SCI. MONITOR, Feb. 13, 1992, at 8.

69. Rowe, *supra* note 67, at 13.

70. Byrne, *supra* note 16, at 90.

71. Belsie, *supra* note 68, at 8.

72. Rowe, *supra* note 67, at 13. Colgate-Palmolive CEO Reuben Mark grossed \$1.907 million in 1991. *Id.* His company showed a profit of \$321 million. *Id.* The company found itself the target of United Shareholders Association which challenged the corporation on governance issues, including compensation arrangements. *Id.* Colgate-Palmolive negotiated a settlement rather than face an adversarial process. 23 SEC. REG. & L. REP. (BNA) 532, 532, Apr. 12, 1991. While the corporation may say it is responsive to workers' concerns, its true concern may have been in avoiding shareholder revolt.

and massive stock options while making regular announcements of cost-cutting measures and layoffs.

#### 4. The Production of "Stealth" Compensation

The increasing popularity of stock option awards (presently comprising up to one-third of executive pay packages), poses a potential for economic harm which may not yet be fully realized. In on-going legislative hearings over compensation issues, incentive compensation has been termed "stealth compensation."<sup>73</sup>

Each year, the typical company with a stock option plan grants new options to its executives. These grants provide rights to purchase stock for periods ranging up to ten years. Simple mathematics proves that, over the years, the number of shares an executive holds outright through exercised options, or which he has the potential to acquire, add up to a very large number. Compensation analyst Graef S. Crystal<sup>74</sup> likens annual granting of stock options to a farmer planting crops—after allowing the newly planted option seeds to germinate for a few years, it is time for the annual harvest.<sup>75</sup> The executive may not be willing to harvest during a year when stock prices are unfavorable, but since he possesses inside information, he knows better than anyone how his company is likely to perform and can plan his harvest accordingly. If all else fails, the executive may be able to trade in his old plan for a new one with a lower strike price.

According to Crystal, CEOs on average were given new options valued at \$1.66 million in 1990.<sup>76</sup> If the stock market returns eight percent per year from now on, and if the CEO exercises his option eight years after its

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73. Graef S. Crystal, *Stealth Compensation*, FIN. WORLD, Feb. 18, 1992, at 74.

74. Graef Crystal is an adjunct professor at the University of California at Berkeley Business School and editor of *The Crystal Report*, a bimonthly newsletter on executive compensation. Mr. Crystal happily admits he is a "turncoat." See John A. Byrne, *Graef Crystal: Is He Paul Revere or Benedict Arnold?*, BUS. WK., Mar. 9, 1992, at 39. Once a compensation analyst working for corporations, he now turns his pen against those he used to serve. Until recently, Mr. Crystal wrote a column for *Financial World* in which he regularly and zealously criticized compensation practices. He was fired on February 24, 1992. *Id.* Mr. Crystal claims his firing came as a result of a mistake he made (and later retracted) in calculating the pay of a certain CEO. *Id.* at 40. There are some who criticize his figures as inaccurate, but those most critical of his accuracy tend to be the corporations who find themselves the targets of his pen, and most of those claims are quibbles over the actual amount a particular executive received. *Id.* Much of the difficulty with accuracy can be blamed on the confusion created by the corporations themselves in their efforts to "bury" compensation information. *Id.* Most of his detractors are more annoyed by his inflammatory style of writing than with any inaccuracies in his work. *Id.* According to Crystal, what they fear most is his vast insider knowledge of compensation issues. *Id.*; see also Allison L. Cowan, *The Gadfly C.E.O.'s Want to Swat*, N.Y. TIMES, Feb. 2, 1992, at C1.

75. Crystal, *supra* note 73, at 74.

76. *Id.*

grant, his *gain* will be \$1.4 million on the 1990 grant.<sup>77</sup> Even if "option growing" conditions are not as ideal in the 1990s as they were in the 1980s, the executives will prosper—if they sow more seeds. And sowing more seeds is just what they are doing as the size of these grants increases each year.<sup>78</sup> Coca-Cola's recent megagrant of one million shares to Chairman Goizueta set a record as the largest individual grant to date.<sup>79</sup> In March, 1992, Paramount Communications awarded almost six million shares to top executives.<sup>80</sup> Westinghouse gave two 350,000 grants to Paul Lego.<sup>81</sup> Other corporations granting options in 1991 in excess of 300,000 shares include United States Surgical, AT&T, Equimark, Merrill Lynch, and Philip Morris.<sup>82</sup>

Corporations have incentive to keep bonuses in check because large cash payments have an immediate impact on the bottom line. Not so with stock option grants. Because of the accounting methods currently employed by corporations, a charge-to-earnings entry may not be made on the corporate books when stock options are distributed.<sup>83</sup> For this reason, the true cost of these options are hidden from both shareholders and boards.<sup>84</sup>

Current accounting rules permit companies to treat stock options differently from salaries or bonuses, which are charged directly to compensation expense and come out of earnings. A shareholder looking at the annual report can probably decipher the amount of direct compensation the executives are receiving, but it is not so easy to determine the amount of compensation earned through stock options or the potential future cost to the corporation when the options are exercised. As long as the prearranged exercise price of a stock option is no less than the market price on the date the options are issued, companies do not need to take a charge on their books,<sup>85</sup> even though the options may some day be used to buy stock at

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77. *Id.* Mr. Crystal uses IBM as an example. *Id.* at 78. In 1990, it issued options on 5.3 million shares carrying a likely average strike price of about \$108 per share. *Id.* If the stock price increases in the future at the rate of eight percent per year, and if IBM's executives exercise their options eight years after the grant date, IBM will incur a pretax cost of about \$500 million, the sum that executives will take as option profits. *Id.*

78. *Id.* at 74.

79. Grant, *supra* note 9, at D7.

80. *Id.* at D1.

81. *Id.* at D7.

82. *Id.* It should be noted that these awards are for one year only and do not include grants received in previous years nor take into consideration any future awards—which are sure to follow.

83. Crystal, *supra* note 73, at 74. If IBM were to charge the \$500 million to the income statement, the company's aggregate eight-year, after-tax earnings would have declined by about 3%. *Id.* at 78. While this in itself is not a large sum, IBM will undoubtedly make more, larger option grants during the next eight years. For example, in 1989 it granted options on 4.6 million shares. In 1990, that total increased to 5.3 million shares. *Id.*

84. *Id.* at 74.

85. Allison L. Cowan, *Executive Stock Rule Considered*, N.Y. TIMES, Jan. 22, 1992, at

below market prices. As a result of this loophole, many companies' net income figures do not reflect the often generous stock options their executives receive.<sup>86</sup> It has been estimated that United States corporations are overstating their income by two to three percent on average by neglecting to charge themselves anything for the stock options they award.<sup>87</sup> The increasing popularity of these options could make this percentage grow sharply.<sup>88</sup>

Mr. Crystal predicts that, left unchecked, the average option gains at the end of the 1990s will have tripled to about \$2.9 million per option grant.<sup>89</sup> In light of Coca-Cola's one million share award and other recently announced stock megagrants, Mr. Crystal's figures could be conservative. The future costs to shareholders of the grants which are now being handed out like candy is potentially staggering. The potential social costs cannot be estimated or ignored as executives start cashing in these megagrants and report earnings of 100 or 200 times the average worker's pay, instead of the eighty-five times that is causing consternation today.

The ability of large option grants to change company performance for the better is questionable. Crystal and other critics have attempted to measure the relationship between the size of option grants and the company stock price after the option was made.<sup>90</sup> The result of most of these studies indicate no significant correlation between a company's future performance and the size of an option grant.<sup>91</sup> Comparing the likely future costs to shareholders of these huge grants with the benefits to the corporation, the continued award of this form of compensation in these amounts is a highly questionable practice.

### III. SOLVING THE EXECUTIVE COMPENSATION PROBLEM

The current outcry over excessive executive compensation will undoubtedly cause some changes in the methods used by some corporations to recompense

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D1. Cowan notes that stock options may not be a "free lunch" since company earnings per share usually fall when the options are exercised because of the greater number of shares outstanding. *Id.* at D12. But the dilution in circulation does less damage to a company's bottom line than a straight charge to earnings. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. Graef Crystal, *You Ain't Seen Nothin' Yet*, FIN. WORLD, Oct. 1, 1991, at 74. Crystal uses as his base executives who have for the last three years received option grants averaging \$1 million, and assumes the executive holds an option for 10 years with stock prices rising at 8% per year. *Id.* He calculated the total compensation by multiplying the number of option shares executives have been granted during 1990 by the strike price per share. *Id.*

90. *Id.*

91. *Id.* Mr. Crystal measured the relationship over a four-year period between the size of CEO option grants and company stock price performance after the option grants. *Id.* He reports that there was no statistical significance or correlation between the company's future performance and the size of the executive's option grant. *Id.*



top personnel. A few have responded to criticism by reducing pay. IBM, Westinghouse, and Eastman Kodak Co. are three examples of corporations that have announced cuts in executive paychecks.<sup>92</sup> But what is taken away one year can be put back the next; reactionary measures are not necessarily permanent solutions. Furthermore, the current cuts may not be all that they seem; they may merely reflect a shift from one type of compensation to another with a less-than-meets-the-eye reduction in executives' real earnings.<sup>93</sup> Instead of applying band-aids to remedy a hemorrhage, corporations must effect lasting changes from within, lest they find changes forced from without.

### A. *Internal Corporate Solutions*

The board of directors has the power to make decisions on all matters affecting the "business and affairs of the corporation."<sup>94</sup> By long-established rule, the setting of executive salaries falls under the umbrella of "business and affairs of the corporation" and thus the directors acting as a body have the right to fix the compensation of the executive officers.<sup>95</sup> Ideally, corporations would police themselves and take the necessary steps to control excessive or inappropriate compensation. While some companies do have strict policies which keep compensation within a predetermined range,<sup>96</sup> it is naive to believe that the corporate directors who presently abuse the system will approve reductionist proposals beyond window dressing.

Recognizing that the approval of their own pay packages leaves executives open to charges of self-dealing, every major corporation has emplaced

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92. Michelle L. Johnson, *Forget the Rhetoric—Executive Pay Fell For Many in '91*, INVESTOR'S BUS. DAILY, Mar. 13, 1992, at 8.

93. Westinghouse cut its chairman's compensation by more than \$1 million after the corporation lost \$1.1 billion in 1991, *id.*, but he did receive two grants of stock options at 350,000 shares each. The first grant is presently of little, if any, value, but the second grant, if exercised at March, 1992 stock prices, would give Mr. Lego a profit of \$1.225 million. His \$1 million "cut" in pay looks more like a \$225,000 increase. Robert J. McCartney, *Stock Options Soften Bite of Executive Pay Cuts*, WASH. POST, Mar. 11, 1992, at F1. Stock values must remain above the \$16 strike price for Mr. Lego to realize a gain on his options; on the other hand, if the stock value drops, the corporation could award Mr. Lego additional stock options at a still lower strike price. See *supra* note 47.

94. See DEL. GEN. CORP. L. § 141(a) ("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.").

95. *Heller v. Boylan*, 29 N.Y.S.2d 653, 671 (Sup. Ct. 1941), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

96. One frequently cited example of corporate restraint is Ben & Jerry's Homemade, Inc., the Vermont-based ice cream company. Ben & Jerry's restricts top executives to no more than seven times what the lowest paid full-time employee earns. Under this formula, co-founder Ben Cohen earned only \$85,100 in 1991. While Mr. Cohen's salary may be capped, he is by no means pauperized by this corporate rule. Mr. Cohen owns \$18.65 million in company stock. Cummins, *supra* note 11, at 68.

internal mechanisms to superintend the compensation process. Unfortunately, these arrangements add a mere patina of respectability without adequately addressing the admittedly complex issues surrounding executive compensation.

### 1. Compensation Committees and Outside Directors.

In essence, compensation decisions are the ultimate in self-interested transactions. Self-interested transactions are exchanges between a corporation and one or more of the corporation's directors or senior executives.<sup>97</sup> These transactions require (1) that the director or executive make full disclosure to the corporate decision makers who authorize the transaction; and (2) that the transaction be fair to the corporation.<sup>98</sup> But compensation matters differ from other self-interested transactions in two respects.<sup>99</sup> First, the appropriate level of compensation is an individual matter which must take into account personal talents and characteristics of the executive and the unique nature of the corporation.<sup>100</sup> Finding the market value of these services is, admittedly, more difficult than finding the market value in a typical self-interested transaction setting (such as establishing the fair market value of personally-owned real estate which a director proposes to sell to the corporation). Second, unlike other types of self-interested transactions, compensation is an absolutely necessary transaction.<sup>101</sup> While other types of self-interested transactions may be avoided so as not to raise the specter of self-dealing (for example, the corporation need not buy that particular piece of real property), compensation transactions cannot be avoided. For these reasons, compensation matters are generally treated differently than other self-interested transactions. So long as full disclosure is made and the compensation is approved by disinterested directors, it will be reviewed under the business judgment standard<sup>102</sup> with only a cursory review, if any, for fairness to the corporation.<sup>103</sup>

As one means to satisfy the requirement of disinterested director approval, most publicly held corporations have formed compensation committees, usually composed of three to five outside directors who review, analyze, and approve or revise compensation proposals. These proposals are generated internally or on behalf of the corporation by outside pay consultants;

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97. Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 997 (1988).

98. *Id.* at 998.

99. *Id.* at 1006.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* See discussion *infra* Part III.B.

committees themselves rarely initiate the plans.<sup>104</sup> After review, the committee forwards its recommendations to the board of directors which then enacts the plan as written or modifies it as it feels appropriate. So long as the board does not greatly deviate from the committee's recommendation, the business judgment rule should protect the decision.

The composition of these committees negates any pretense of their impartiality or ability, while the corporate environment in which these teams operate provides a playground for groupthink.<sup>105</sup> It is not unusual for chief executives to sit on one another's compensation committees in the capacity of outside directors.<sup>106</sup> These CEOs may approve increases for friends because they expect the favor will be returned,<sup>107</sup> or simply because the corporate environment in which they operate approves of lavish spending on top executives. So much for impartiality. As for ability, these committees suffer several handicaps, including: (1) Because the committees are composed of other executives, not compensation specialists, they often lack technical expertise in compensation issues; (2) Time constraints preclude a thorough analysis of extremely complicated contracts; (3) As outsiders, they seldom know enough about a company's inner workings to effectively review corporate plans and objectives or evaluate executive performance; and (4) They rely heavily on outside consultants who in turn are hired and fired by the CEOs whose pay packages are under consideration, making their recommendations suspect.<sup>108</sup>

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104. Kraus, *supra* note 49, at 37.

105. "Groupthink" is a rationalization process resulting in "lockstep" behavior by individuals who will not speak their mind or disagree with the group for fear of upsetting the boss or the status quo. The comforts of unanimity and perceived requirements of loyalty to the group ensure that no one raises embarrassing questions or attacks weak arguments. See Daniel Goleman, *Insights Into Self-Deception*, N.Y. TIMES, May 12, 1985, § 6, at 40. The more amiable the *esprit de corps* among members of the policy-making group, the greater the danger that independent critical thinking will be replaced by groupthink. *Id.* at 40. It most often occurs when certain conditions exist: The group members know and like each other; the group is insulated from outsiders; stress levels are high because of the need for a swift decision; and the leader has made clear at the outset what the preferred choice is. J. Edward Russo, *Decision Traps and How to Avoid Them*, CHEMICAL ENGINEERING, May 1991, at 181, 181. See generally IRVING L. JANIS, GROUPTHINK (1983).

106. United Airlines, frequently criticized for its compensation practices, reveals in its March 28, 1991 proxy statement that its compensation committee members are: Chairman John McGillicuddy, CEO of Manufacturers Hanover Corp. and Manufacturers Hanover Trust Co. (also a director of Continental Corp. and USX Corp.); Juanita Kreps, economist and former Secretary of Commerce (also a director of AT&T, Armco, Chrysler, Deere and Co., Eastman Kodak, J.C. Penney, and Zurn Industries); Fujio Matsuda, Executive Director of Research Corp., University of Hawaii (also a director of First Hawaiian, Inc.); James O'Connor, CEO of Commonwealth Edison (also a director of American National Can Co., Corning Inc., First Chicago Corp., Midwest Stock Exchange, Scotsman Industries Inc., The First National Bank of Chicago, and The Tribune Co.). UAL CORP., Mar. 28, 1991 PROXY STATEMENT at 14 (1992), available in LEXIS, Compny Library, Proxy File [hereinafter PROXY STATEMENT].

107. Sen. Carl Levin, Address to the Luncheon at the United Shareholders Meeting (Nov. 15, 1991), available in LEXIS, Nexis Library, Fednew file.

108. See Kraus, *supra* note 49, at 37; Rehnert, *supra* note 15, at 1153; Levin, *supra* note 107.

In searching for solutions to compensation committee problems, tinkering with the composition of the committee seems to offer few answers. Even a compensation committee made up entirely of outsiders who do not sit on the boards of other corporations and only marginally operate within the corporate environment (thus in theory avoiding the impartiality and socialization problems) may provide scant protection against the granting of inappropriate compensation packages. A committee thus composed would suffer the same handicaps as a committee of insiders: lack of adequate and unbiased information, lack of time, and lack of incentive. Since independent nondirector committee members would serve part-time and have little or no financial stake in the firm, it can be argued that CEOs would be even more dominant and less accountable in setting salaries if a majority of the committee lacks the knowledge or incentive to challenge senior management.<sup>109</sup>

A committee composed of compensation specialists would be no better. While specialists may have access to better information and expertise and could propose their own packages instead of relying on management proposals, corporate socialization factors and the self-preservation instinct creep back in. Since compensation analysis is a narrow specialty, it operates in its own social sub-group where large salaries are the accepted norm. Additionally, any compensation specialist would quickly see that his or her continued presence on the board is dependent upon his or her continuing approval of pro-management packages. Salary and bonus increases would likely become institutionalized, and compensation packages in such a system would have no greater guarantees of accuracy in reflecting executive ability or performance.

In short, no matter what their composition may be, these committees have neither the information nor the necessary incentives to implement effective contracts. They offer either blind approval of the proposal submitted to them, or rely on formulas which purport to pay for performance but seldom reward effectively. As presently constituted, the committees are too much a part of the corporate institution to effectively control compensation. It is unlikely many compensation abusers will take wholly voluntary actions to slash excessive compensation or realign incentive compensation to accurately reflect "pay for performance." At the very least, these committees should have their own legal counsel and independent consultants with no ties to management.<sup>110</sup>

As one prong of their current reform movement, institutional investors are addressing the issue of compensation committees.<sup>111</sup> The investors want

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109. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282-83 (1982).

110. Byrne, *supra* note 16, at 96.

111. See discussion *infra*, Part III.C.1.

the committees to be composed entirely of independent directors<sup>112</sup> instead of the mix of insiders and outsiders found at many corporations. This is only a partial solution which, by itself, offers little protection against spiraling compensation awards. Regardless of who sits on the committee, whether insiders, outsiders, or independent consultants, it is the CEO who signs their paychecks. Any decision the committee makes will necessarily be tainted by this fact. Independence is a step in the right direction, but certainly no cure-all. The creation of independent committees must be backed up with further incentives, provided either by the threat of shareholder activism or judicial action, before any significant permanent changes will be realized.

Once the compensation committee makes a recommendation, it is up to the board of directors to approve the plan, with or without modifications. To avoid charges of self-dealing and unfairness and to insulate the board with the business judgment rule, only outside directors actually vote on compensation packages. But again, institutional biases plague the process. Outside directors who vote on the packages are often inside directors at other corporations. Crossover directorships are not only common, they are the norm.<sup>113</sup> The "I'll scratch your back if you'll scratch mine" attitude, if not blatantly present, has to be lurking in the background.

Added to the problems of inherent bias is the fact that board members are paid handsomely for their efforts.<sup>114</sup> Most corporations pay annual retainers plus a fee (typically \$1,000) for each meeting attended. On average, outside directors are paid between \$20,000-40,000 for what amounts to

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112. Chernoff, *supra* note 4.

113. For example, the March 28, 1991 proxy statement of UAL discloses that every one of its 15 board members sits on the board of at least one other corporation. PROXY STATEMENT, *supra* note 106, at 4-11. In total, these 15 UAL directors occupy board positions at approximately 50 separate corporations (not including UAL), ranging from AT&T to J.C. Penney, USX, Chrysler, and numerous banking organizations. *Id.*

114. The Conference Board, a business-funded research group, surveyed 851 companies regarding average pay for directors in 1991. The group reported a 10% increase for director pay over the previous year. According to its survey, the average pay for directors of manufacturing firms was \$27,200; for financial firms, \$23,400; and service companies weighed in at \$23,640. Another survey by the consulting firm Hewitt Associates found higher figures: \$39,774 for industrial firms; \$35,278 for service companies; \$32,033 for banks; and \$30,498 for utilities. Bill Barnhart, *Recession Doesn't Dampen Raises for Corporate Directors*, CH. TRIB., Mar. 10, 1992, at C1.

In a not atypical plan, UAL discloses in its March 28, 1991 proxy statement that it pays its directors an annual retainer of \$20,000 plus a \$1,000 fee for each meeting attended. Members of certain special committees receive an additional retainer of \$3,000 and a fee of \$1,000 for each committee meeting attended. Officers who are also directors do not receive retainers or fees. Non-employee directors are eligible to participate in retirement income plans and may have surviving spouse benefits available. Each director, his or her spouse, and his or her dependent children are entitled to free transportation on the airline with reimbursement by the corporation for any income taxes resulting from the taxation of the airline benefits. The average cost of these latter benefits for each director in 1990 was \$9,472. PROXY STATEMENT, *supra* note 106, at 15-16.

about two weeks of work.<sup>115</sup> If an executive is sitting as an outside director on two or three boards, he or she may take home an extra \$100,000 per year; thus there is little incentive to rock the boat. It goes against reason to expect a board member to take a contrary stance on compensation issues if he or she wishes to be renominated the following year. It is even more unlikely that any permanent change in compensation practices will be instigated by this body without threat of action from other quarters. While some boards are reducing pay, these reductions should be scrutinized to determine if they are merely cosmetic or temporary.

This is not to say that every board and committee of every corporation acts every time out of avarice, routinely approving unjustified remuneration. Many corporations can and do approve reasonable compensation packages. But in the last two decades, compensation has steadily increased, and in some instances skyrocketed, despite the advent of compensation committees and increased emphasis on disinterested board approval. It is clear these systems offer at best only a leaky bulwark to stem the tide of rising compensation, if indeed they offer any protection at all.

## 2. Legislative Solutions to the Internal Control Problem

If corporations do not rectify the overcompensation problem by implementing internal changes, some legislators are willing to force the issue. Legislation is pending which would disallow tax deductions for compensation in excess of certain pre-established levels.<sup>116</sup> While these bills do not require corporations to reduce compensation, they could make it expensive if corporations do not.

Legislation sponsored by U.S. Senator Tom Harkin would amend the Internal Revenue Code to redefine the term "reasonable allowance for salaries or other compensation" to include only the first \$500,000.<sup>117</sup> A second, similar bill introduced by Thomas Daschle includes cost-of-living adjustments to the \$500,000 figure.<sup>118</sup> A third bill, the Income Disparities Act of 1991, would deny deductions for "excessive" salaries and bonuses, with "excessive" defined as an amount equal to twenty-five times the lowest compensation paid to any employee.<sup>119</sup>

The theory behind these bills is simple: Public policy does not support extreme distortions in income distribution, and taxpayers should not have to subsidize high-level executives through business tax deductions.<sup>120</sup> The

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115. Barnhart, *supra* note 114.

116. As of April 15, 1992, six compensation-related bills were pending before Congress.

117. S. 2329, 102d Cong., 2d Sess. (1992).

118. S. 2261, 102d Cong., 2d Sess. (1992).

119. H.R. 3056, 102d Cong., 1st Sess. (1991) (introduced by Rep. Sabo).

120. 137 CONG. REC. E2727 (daily ed. July 25, 1991) (statement of Rep. Sabo).

Internal Revenue Service (IRS) regularly examines closely held corporations' pay schedules and disallows excessive pay on a case-by-case basis. These bills would extend this scrutiny to public corporations.<sup>121</sup>

These bills are not without their critics. Commenting on Representative Sabo's bill, Ralph Whitworth, executive director of United Shareholders Association, stated this approach is "wrongheaded because it doesn't address the central issue, which is pay for performance. It's not how much [executives] get paid, it's how they get paid."<sup>122</sup> Further, it is unrealistic to think that these top executives will take a pay cut ranging up to several million dollars in order to save the company a tax deduction. The shareholder will be hit twice: once by excessive compensation and once by losing the tax deduction.<sup>123</sup>

The bills suffer from further defects. The Income Disparities Act is flawed because it applies only to salary, wages, and bonuses. If a corporation wishes to preserve both its high compensation and its income tax deduction, it may concentrate on awarding stock options, perquisites, or some other form of compensation that escapes the label "salary, wages, and bonuses." Ingenuity knows no bounds when the challenge is to beat the IRS. Senator Daschle's proposal would apply to "salary or any other compensation" but does not further define "other compensation."<sup>124</sup> Senator Harkin's bill extends its reach to "the combined amount of any compensation, whether in the form of cash or otherwise, paid to such employee including the value of any property which is transferred to such employee."<sup>125</sup> If the language of these latter bills is construed to include stock options, there is a further problem: the bills provide no mechanism for the valuation of options, and no uniform method presently exists to accomplish this. Without a standard system for valuation, a corporation could shift the emphasis to stock options, then devise a valuation plan assigning the least possible value to the options to preserve the largest possible share of tax deductibility.

If legislation of this type is enacted, a company wishing to pay its executives in excess of the prescribed limits need only explain to its shareholders that adequate business justifications exist to sacrifice the deduction. If a sufficient number of corporations exceed the limit, a board need only point to those companies and argue that its pay must be competitive to attract and retain the best executives. In such an environment, it is unlikely the legislation will work any miracles on excessive compensation.

This type of legislation is tempting in that it seems to confront most of the evils of overcompensation. It takes aim at the disparity in pay between

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121. 138 CONG. REC. S3120 (daily ed. Mar. 10, 1992) (statement of Sen. Harkin).

122. Johnson, *supra* note 92, at 8.

123. *Id.*

124. S. 2261, *supra* note 118.

125. S. 2329, *supra* note 117.

worker and boss which contributes to the demoralization of the American worker. It controls the perverse incentives created by excessive bonuses and stock options. But the effectiveness of these proposals will be seriously undermined if corporations opt to forego tax deductions or if a cadre of experts is unleashed to find a way around the restrictions in the statute. In effect, these are merely voluntary compliance programs. But the alternative to a voluntary approach seems to be direct legislative control of compensation—in effect, a “maximum wage” to offset the workers’ minimum wage. Such a solution contemplates an overhaul of corporate governance and political and social policies that is, at present, not on the horizon.

### B. Judicial Action

If executives neglect or refuse to take action to control runaway compensation, shareholders have the ability to take their grievances to court. But potential litigants face one tremendous hurdle—the courts do not want to get involved. Inevitably, citation is made to the business judgment rule to avoid the sticky question of “how much is too much.” Only a few cases show the courts actually grappling with this question, and many of those cases are short on analysis.<sup>126</sup>

#### 1. Defining “Too Much” and the Business Judgment Rule

By a long established principle, the amount and type of compensation paid to an executive in return for his services is considered within the “business and affairs” of the corporation, which is managed by or under the board of directors.<sup>127</sup> Directors are charged with an unyielding fiduciary duty to the corporation and its shareholders,<sup>128</sup> but the court recognizes that in most cases the directors are more qualified to make business decisions than are judges.<sup>129</sup> Absent any wrongdoing, the board’s business decisions will not be “fodder for in-depth ex post legal scrutiny.”<sup>130</sup> In compensation matters, courts allow corporate boards wide discretion in setting the amount and type of compensation to be paid to top executives and generally will not substitute their judgment for that of the directors.<sup>131</sup> A survey of the cases indicates that courts rarely find sufficient wrongdoing on the part of a board to merit such ex post review. So long as the directors take reasonable procedural precautions in awarding pay, the board will gain for itself the

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126. Vagts, *supra* note 6, at 252-53.

127. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

128. *Id.*

129. *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 (11th Cir. 1989).

130. *Id.* at 1458 n.20 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

131. *Johns*, 874 F.2d at 1458.



protection of the business judgment rule: the 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.<sup>132</sup>

While there are relatively few cases involving direct challenges to the amount of compensation paid to directors in large publicly held corporations, the courts that have taken on the issue have reached similar results. In virtually every case since the turn of the century, courts have either applied the business judgment rule and endorsed the compensation practice, or simply thrown in the towel and refused to deal with the problem. One court stated the rationale for avoiding the question thus:

Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? . . .

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. . . . 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. . . . The elements to be weighed are incalculable; the imponderables, manifold. . . .

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. Courts are concerned that corporations be honestly and fairly operated by its [sic] directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders. This does not mean that fiduciaries are to commit waste, or misuse or abuse trust property, with impunity. A just cause will find the Courts at guard and implemented to grant redress.<sup>133</sup>

In sum, the courts are willing to “grapple” with compensation issues only when the compensation practice is so egregious that it is patently a waste of corporate assets.

In approaching a compensation case, the courts routinely look first to whether the corporation made a proper “business judgment.” If the corporation followed a reasonable course of action in adopting a compensation plan, the courts will then look to whether the payments constitute corporate waste. If the answer to the second question is no (and it usually is), the compensation practice is upheld.

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132. *Van Gorkum*, 488 A.2d at 872.

133. *Heller v. Boylan*, 29 N.Y.S.2d 653, 680 (Sup. Ct. 1941), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

## 2. Defining a Business Judgment

The requirement that a corporation make a "proper" business judgment is essentially a procedural drill which requires salaries to be approved by disinterested parties. So long as the recipient does not vote on the plan, the business judgment rule will cloak the decision with the presumption that the amount and type of pay awarded is in the best interests of the corporation.

If a board of directors fixes its own salary without a vote of disinterested directors, the action can be challenged as a voidable self-interested transaction, shifting the burden to the directors to affirmatively establish that the compensation is fair and reasonable to the corporation.<sup>134</sup> However, ratification by the shareholders or the disinterested directors after the disclosure of all material facts shifts the burden of proving unfairness back to the challenging party.<sup>135</sup>

A plan approved by a compensation committee comprised of independent directors is *prima facie* subject to the protections of the business judgment rule.<sup>136</sup> Unless it can be shown that the independent directors breached their duty of loyalty or care, or that the resulting plan amounts to corporate waste, a court will not substitute its judgment for that of the board as to how much the executive should be paid.<sup>137</sup>

## 3. The Corporate Waste Standard

Because of their great deference to the business judgment rule, courts do not invalidate properly adopted compensation systems unless they constitute corporate waste.<sup>138</sup> Waste is found only if inadequate consideration is returned to the corporation.<sup>139</sup> But determination of the adequacy of consideration is committed to the "sound business judgment of the corporation's directors."<sup>140</sup> In short, whatever the corporation deems adequate, the court will deem adequate.

Some courts purport to apply a reasonableness test to compensation cases to determine if corporate waste has occurred, but this test is easily met. So long as the compensation the executive receives bears a reasonable relationship to the services rendered, the court will not invalidate the compensation

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134. *Cohen v. Ayers*, 596 F.2d 733, 739-40 (7th Cir. 1979).

135. *Id.* at 740.

136. *Nomad Acquisition Corp. v. Damon Corp.*, FED. SEC. L. REP. (CCH) ¶ 90,868, at 90,872 (Del. Ch. 1988).

137. *Id.* at 6; *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 (11th Cir. 1989).

138. *Johns*, 874 F.2d at 1461.

139. *Cohen*, 596 F.2d at 739.

140. *Id.*

plan.<sup>141</sup> If the corporation received *no* benefit, corporate waste is easily found. But where the corporation received some benefit, a plaintiff attacking a corporate payment has the heavy burden of demonstrating that no reasonable businessperson could find that adequate consideration had been supplied by the executive in return for the payment,<sup>142</sup> an extremely difficult burden to carry.

The reasonableness analysis is complicated by the fact that compensation is awarded for two purposes: to reward and to retain. If a compensation committee is in place, the court will bow to the committee's conclusion that the plan "reasonably" represents the amount of reward deserved and the amount required to retain key employees. Absent a plaintiff's persuasive proof which seriously questions the judgment of the compensation committee, or a clear showing of fraud or bad faith, the court will not further inquire into the reasonableness of the decision.<sup>143</sup> In the end, even when applying a reasonableness test, the court will find reasonable what the compensation committee has said is reasonable.

Courts have modified certain compensation plans on technicalities<sup>144</sup> and invalidated others after finding no benefit accrued to the corporation.<sup>145</sup> But, as yet, no court has found in any case involving a large publicly held corporation that pay was so unreasonably high that its excess, by itself, constituted waste. Nor has any court struck down bonus or option plans, even if under their terms the executive received a disproportionate benefit.

#### 4. Specific Applications

One of the earliest, and still most significant executive compensation cases, *Rogers v. Hill*,<sup>146</sup> involved a shareholder challenge of bonuses paid to executives of American Tobacco Company. The suit asked the Court to declare that the amounts paid were unreasonably large and requested a determination of what would be "fair and reasonable compensation" for the individual defendants.<sup>147</sup> The Court was troubled by the size of the bonuses and, encouragingly, noted that the plan would not withstand scrutiny if the payments were so large as in substance and effect to amount

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141. *Johns*, 874 F.2d at 1461; *see also* *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933) (citing rule determining when payments to executives are gifts); *Cohen*, 596 F.2d at 739.

142. *Cohen*, 596 F.2d at 739; *see also Johns*, 874 F.2d at 1461 (listing four factors, one of which a plaintiff must prove before a court will substitute its judgment for that of a board of directors).

143. *Freedman v. Barrow*, 427 F. Supp. 1129, 1156 (S.D.N.Y. 1976).

144. *See generally* Vagts, *supra* note 6, at 253-54.

145. *Kerbs v. California E. Airways*, 90 A.2d 652 (Del. 1952).

146. 289 U.S. 582 (1933).

147. *Id.* at 585. The Court noted that the profit-based bonuses system had paid President Hill \$447,870 in 1929 and \$842,507.72 in 1930, in addition to his salary. *Id.* at 591. Those sums are enormous if computed to the present dollar value.

to spoliation or waste of corporate property.<sup>148</sup> But the Court did not establish any boundary between reasonable and wasteful, nor did it establish any methodology to distinguish between the two. Instead, it sent the case back to the district court to consider whether and to what extent payments to the individual defendants constituted misuse and waste. Unfortunately for the sake of precedent, the case was subsequently settled, divesting the court of the opportunity to establish a rule.<sup>149</sup>

A few years later American Tobacco was back in court, once again defending its bonus payments on charges of corporate waste. In *Heller v. Boylan*,<sup>150</sup> the court stated that the bonus payments received by the chief executive were "immense, staggeringly so,"<sup>151</sup> but balked at substituting its judgment for that of the stockholders who had ratified the plan. The court emphasized that the ruling in *Rogers*, which sent the case back to the district court for determination of whether the payments were so large as to constitute waste, was not to be interpreted as setting aside the regular common law rule that the directors have discretion in determining compensation issues. According to the *Heller* court, the court in *Rogers* was not attempting to substitute its judgment for the discretion of the board; rather, it was merely directing an inquiry to determine if the discretion had been honestly and fairly exercised.<sup>152</sup> The court went on to say that Mr. Hill was an "able, astute, aggressive executive" and that "[m]any improvements in the business are due to his sagacity and ingenuity."<sup>153</sup> In refusing to strike down the bonus plan, the court voiced the eternal problem: "Just how much of the [company's] growth is due to Hill's leadership and how much to causes beyond Hill's influence, it is not possible to fathom. . . . Whether he was worth the \$4,500,000 paid him between 1926 and 1938 only the stockholders can judge; it was *their* \$4,500,000."<sup>154</sup>

Stock option plans have received similar treatment in the few cases coming before the courts. Exxon's stock option program was attacked<sup>155</sup> after the corporation granted extensions of time in which to exercise options and made other changes to the plans which benefitted the option holders. Stockholders argued that the amendments amounted to gifts of assets because the corporation received no benefit or consideration in exchange for the amendments.<sup>156</sup> But the court found that the amended plans were

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148. *Id.* at 590-91.

149. *Heller v. Boylan*, 29 N.Y.S.2d 653 (Sup. Ct. 1941) (containing a history of this action, and related actions filed by Mr. Rogers), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

150. *Id.*

151. *Id.* at 671.

152. *Id.*

153. *Id.* at 675.

154. *Id.* at 675-76 (emphasis in original).

155. *Freedman v. Barrow*, 427 F. Supp. 1129 (S.D.N.Y. 1976).

156. *Id.* at 1155.

“not defeated by the fact that there was no measurable and definite consideration passing to the corporation.”<sup>157</sup> In its opinion, what controlled was the business judgment of the granting committees and the majority of shareholders, who approved plans that the stock options would operate to retain the employees and would, in the long run, spur all employees to greater efforts, which could “only benefit the corporation.”<sup>158</sup> The court further stated that the only limitation on this doctrine is that there must be some adequate assurance in the plans that makes it reasonable to expect that the corporation will receive the contemplated benefits, that is, the services of those key employees.<sup>159</sup>

Not all option plans have been blessed by the courts. A Delaware court struck down an option plan which gave the option recipients the right to immediately exercise their options upon issuance and for a period up to six months after termination of employment.<sup>160</sup> The plan was deemed deficient because these conditions did not reasonably insure that the corporation would receive the contemplated benefits.<sup>161</sup> This case, however, merely addresses a defect in a particular plan; it in no way reflects a general hostility toward stock options. Most option plans have been upheld. For example, the Seventh Circuit approved a Sears, Roebuck and Co. plan which allowed a reduction of option prices to meet declining stock values.<sup>162</sup>

While these are just a few examples of the courts' treatment of compensation cases, they do illustrate the general “hands off” approach the courts have employed and give an indication of the likelihood of success a shareholder may expect in bringing a derivative action to challenge excessive or inappropriate compensation. So long as the corporation follows the established pattern—proposal by a compensation committee followed by a vote of disinterested directors (and approval of shareholders, if required)—and the plan ensures that some consideration passes back to the corporation, the court will undoubtedly validate the compensation plan without pausing to determine the sufficiency of consideration or propriety of the amounts.

## 5. Excessive Compensation in Close Corporation and Tax Cases

The courts are not merely unwilling to determine the boundary between acceptable and excessive compensation for large publicly held corporations,

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157. *Id.*

158. *Id.*

159. *Id.*

160. *Kerbs v. California E. Airways*, 90 A.2d 652, 657 (Del. 1952).

161. *Id.*

162. *Cohen v. Ayers*, 596 F.2d 733, 743 (7th Cir. 1979). The court stated:

[T]he reduction of an option price to meet declining stock value is not waste per se and in fact may well be necessary to maintain the value of the originally conferred benefits. Contesting shareholders, in order to overturn the ratified discretion of directors, must therefore present sufficient additional evidence that price reductions did more than maintain the intended value of the options.

*Id.* at 743.

they also claim an *inability* to make such determinations. But courts have resolved the issue of excessive compensation in hundreds of cases involving close corporations and partnerships, and the Tax Court regularly decides compensation matters. In those cases, courts manage to find a fair market value for the services rendered.<sup>163</sup> There are obvious differences in scale between public and close corporations, and certain differences in purpose between tax cases and derivative actions, but when stripped to the essentials, the court is merely asked to evaluate whether or not the pay is reasonably related to the tasks performed and the abilities of the performer. Since courts have been able to grapple with this problem in other contexts, there seems to be no real justification to balk at applying the same analysis to public companies. In either large or small operations, clear abuses should be recognizable.

In one example of a tax case, the compensation paid to executives at Pfeiffer Brewing Co. was questioned for "reasonableness."<sup>164</sup> The Tax Court looked at comparative surveys of compensation paid within the brewing industry and matched it with sales, administrative expenses, and operating profit figures. It then factored in the value of the prior work experience of the executives and other intangibles. In the end, the court found that Pfeiffer paid top dollar, but thereby secured top performance.<sup>165</sup> The court concluded the compensation was reasonable.<sup>166</sup> This court seemed to be able to find a "rational or just gauge" for analyzing compensation, a task which the New York courts had previously found so troublesome.<sup>167</sup>

The close corporation and tax cases demonstrate that the courts do possess the ability to review compensation packages for fairness. If the court purports to hold that compensation must "bare [sic] a reasonable relationship to the services rendered,"<sup>168</sup> it should examine that relationship itself—instead of entrusting the matter to the questionable judgment of compensation committees and "disinterested" directors. Not only is the court capable of determining "how much is too much," but there is no rational reason why a court cannot examine a compensation package to ensure that "contingent schemes are not skewed so as to warp the judgment of management."<sup>169</sup> The court should go beyond a mere inquiry into whether the corporation has followed the proper procedure and get to the ultimate question of the appropriateness of huge compensation packages. Plenty of tools are available to assist in the undertaking, including independent

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163. See Vagts, *supra* note 6, at 255-57.

164. Pfeiffer Brewing Co. v. Commissioner, 11 T.C.M. (CCH) 586 (1952).

165. *Id.* at 596.

166. *Id.* at 597; see also Vagts, *supra* note 6, at 258-59.

167. See *supra* text accompanying note 133.

168. International Ins. Co. v. Johns, 874 F.2d at 1447, 1461; accord Rogers v. Hill, 289 U.S. at 582, 591-92; Cohen v. Ayers, 596 F.2d 733, 739 (7th Cir. 1979).

169. Vagts, *supra* note 6, at 275.

analysts and masses of comparative compensation data. If the court finds compensation that is substantially out of line, it should not hesitate to prune off the unjustified amounts or strike down incentive plans that do not properly motivate. With compensation reaching astronomical proportions, arguments that these payments reflect reasonable compensation for services rendered are growing weaker and courts have the perfect opportunity to act. If the courts begin to reject these plans, corporations will have no choice but to take notice and take action.

### C. Shareholder Action

Shareholders, as owners of the corporation, should be in the best position to challenge executive excess. But cost, collective action problems due to widely dispersed share ownership, and formidable SEC regulations are just some of the roadblocks facing the investor who seeks change. And even if shareholders are given the opportunity to participate, apathy or the proclivity to "vote with management" may effectively halt reforms.<sup>170</sup>

"[D]ispersed shareholders suffer from the same problems of collective action as other politically disenfranchised people: (1) The cost of individual action is high and unlikely to result in a commensurate reward, and (2) the incentives toward collective action are inadequate."<sup>171</sup> "Because no compulsory cost-sharing mechanism exists in these circumstances [where shareholders wish to oppose a management policy], and because no single shareholder can capture the whole gain to shareholders generally from the proposal's defeat, there will be insufficient incentive to organize opposition."<sup>172</sup>

To discuss all the ramifications of the "shareholder passivity problem" is beyond the scope of this Article; however, it seems clear that the only

170. An example can be seen in the recent activity at General Dynamics. General Dynamics is, of course, facing an uncertain future. In a special meeting of the shareholders held January 15, 1992, shareholders were asked to approve a 1992 compensation plan similar to the previous year's, awarding more than \$35 million in pay, bonuses, and options to 23 top executives. It includes a pay package for CEO William Anders in excess of \$9 million. Like last year's model, the new plan rewards executives for increases in the company's stock price, but a new clause in the 1992 plan provides for a reduction in compensation if stock value declines. However, stock options awarded to the top executives can be re-priced to the advantage of the executives if stock values fall; thus, the actual compensation to the directors will remain stable.

Even in the face of the current controversy over executive pay in general, and mounting criticism of General Dynamics' pay packages in particular, shareholders approved the plan by an 85% majority. The only real opposition came from the California and New York pension funds. Steven Pearlstein, *Shareholders Approve General Dynamics Pay; Only Small Changes Made at Special Meeting*, WASH. POST, Jan. 16, 1992, at D10, D14.

171. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1149 (1991).

172. Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3, 44 (1988).

practical way individual shareholders can acquire a voice in compensation issues is through uniting. Several groups representing shareholder interests have announced plans to target executive compensation issues, including the United Shareholders Association and several pension funds. On their agenda: linking corporate performance to compensation.<sup>173</sup> But the real impetus for change may come from the growing power of the institutional investors.

### 1. The Emerging Voice of the Institutional Investor

As collective entities, institutional investors have amassed billions of dollars in assets, giving them the power to exert substantial influence over the companies in which they invest.<sup>174</sup> The top twenty pension plans and largest money managers now hold more than 16% of the shares in the ten largest U.S. corporations.<sup>175</sup> Public, corporate, and union pension funds, retail mutual funds, and banks now represent more than 40% of the equity market.<sup>176</sup>

Not all of these funds share the same reform agenda. Because mutual fund managers have the ability (and desire) to move in and out of funds quickly, and because of the competitive and highly liquid nature of the assets, the likely focus of these investors is on quarterly or annual results.<sup>177</sup> Compensation issues are of relatively minor concern since these do not generally affect the short-term market price. Managers of corporate pension funds are unlikely to take a stand for obvious reasons. Bank fund managers face fiduciary duty and conflict of interest problems which make them wary of involvement.<sup>178</sup> But public pension fund managers are interested in long-term growth<sup>179</sup> rather than just short-term gains or liquidity, so they have a keen interest in rectifying the short-term myopia engendered by incentive compensation. One of the most active and vocal proponents of corporate reform is the California Public Employees' Retirement System (CalPERS). This \$64 billion fund holds about one percent of the shares in many *Fortune* 500 companies.<sup>180</sup>

In the past, pension fund managers chose to remain "rationally ignorant" of the details of a particular firm's operation, preferring to rely on the

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173. *Institutions May Use Negotiations More in 1992 to Change Corporate Governance*, 24 Sec. Reg. & L. Rep. (BNA) No. 1 at 13, 14 (Jan. 3, 1992).

174. Barnard, *supra* note 171, at 1135.

175. *Id.* at 1140 (citing William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70, 71).

176. *Id.* at 1140-41.

177. *Id.* at 1142.

178. *Id.* at 1142-43.

179. *Id.* at 1142.

180. *California Funds Likely to Oppose Champion*, UPI, Mar. 6, 1992, available in LEXIS, Nexis Library, UPI File.



Wall Street Rule and to sell when prices dropped. However, these funds have grown to a point where the sheer volume of share ownership virtually precludes their adhering to this Rule.<sup>181</sup> Now that pension funds have adopted indexing, the "exit" option is being replaced by the "voice" option—using their power and resources to encourage improvements in company performance.<sup>182</sup> Having found the will to take on the corporations, these institutional investors must now turn their attention to finding the way.

## 2. Battling the Proxy Process

With the exception of certain stock option plans that require shareholder approval, decisions on how much and what type of compensation executives are to receive remains strictly a board prerogative. Disenchanted shareholders face two options: either vote the board out of office or submit shareholder proposals directing the board to take specified actions. Option one is fraught with the enormous difficulty of gaining sufficient votes to oust the board, compounded by the lack of meaningful alternative candidates. If shareholders "vote the rascals out," they will likely find themselves with a new set of rascals with the same agenda. Option two, placing shareholder proposals onto the ballots, is a more viable option because it requires only a vote on one issue instead of promoting a shareholder coup. Shareholders have increasingly sought this remedy. In 1986, the Securities and Exchange Commission (SEC) received thirty-five proposals on compensation matters for inclusion in corporate proxy materials.<sup>183</sup> By 1990, that number had grown to 110,<sup>184</sup> many of which were sponsored by institutional investors or shareholder action groups. The Council of Institutional Investors has adopted a model shareholder proposal seeking an independent compensation committee with the power to hire an outside consultant.<sup>185</sup> Until recently, however, the SEC considered these shareholder proposals to be "ordinary business," which is not, according to SEC rules, of any concern to shareholders.<sup>186</sup> Requests to place compensation proposals on the ballot were routinely rejected by the SEC.

On February 13, 1992, the SEC announced a major change in its policy regarding executive compensation issues. Effective with the announcement, advisory proposals intended to express shareholder views on compensation

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181. Barnard, *supra* note 171, at 1151.

182. *Id.* at 1152.

183. Press Conference with Richard Breeden, SEC Chairman, Fed. News Serv., Feb. 13, 1992, available in LEXIS, Nexis Library, Fednew File [hereinafter Press Conference].

184. *Id.*

185. Chernoff, *supra* note 4.

186. Bachelder, *Executive Compensation: Corporate Pay Responsibility Act*, 206 N.Y. L.J. 3 (1991).

matters would be treated as "major policy issues," which, unlike *ordinary business*, are includable in proxy materials.<sup>187</sup> Concurrently with its announcement, the SEC issued ten no-action letters regarding already-submitted shareholder proposals, requiring that the pending proposals be included in the 1992 proxy materials.<sup>188</sup>

The SEC's action was a preemptive strike aimed at preventing the passage of legislation to force the SEC to make this change. In announcing the new policy, SEC Chairman Richard Breeden said, "Hopefully, this decision will bring a market solution to a market problem by allowing the affected private sector groups—management, directors and shareholders—to resolve the compensation questions in each company on a case-by-case basis without government regulation."<sup>189</sup>

### 3. Legislating a Voice on Compensation Issues

The government regulation the SEC was trying to head off when it adopted its new policy is Senate Bill 1198, the Corporate Pay Responsibility Act.<sup>190</sup> Introduced June 3, 1991, by Senator Carl Levin, the bill would, among other provisions, amend section 14 of the Securities Exchange Act of 1934 to make shareholder advisory proposals on compensation issues proper subjects for action by shareholders. In addition to Senator Levin's proposed legislation, other bills with similar provisions have been introduced.<sup>191</sup> One bill, introduced by Senator Tom Harkin as a companion to his bill limiting corporate tax deductions,<sup>192</sup> would allow shareholders to submit binding proposals on compensation matters.<sup>193</sup>

In remarks prefacing the introduction of his bill, Senator Levin stated that the people who own the corporation should have some voice as to how it is governed.<sup>194</sup> His bill, as well as a similar bill introduced by Senator

187. Press Conference, *supra* note 183.

188. The ten companies affected are Aetna Life and Casualty Co., Baltimore Gas and Electric, Battle Mountain Gold Co., Bell Atlantic Corp., Black Hills Corp., Chrysler Corp., Eastman Kodak Co., Equimark Corp., Grumman Corp., and IBM. *Compensation, Breeden Announces SEC Initiative on Executive Compensation Issues*, Daily Rep. for Executives (BNA), Feb. 14, 1992 at A4, A5.

189. *Id.*

190. S. 1198, 102d Cong., 1st Sess. (1991). A companion bill was introduced simultaneously in the House. H.R. 2522, 102d Cong., 1st Sess. (1991).

191. S. 2030, 102d Cong., 1st Sess. (1991).

192. S. 2329, *supra* note 117.

193. S. 2330, 102d Cong., 2d Sess. (1992). Senator Harkin's bill reads, in pertinent part: [R]ecommendations, binding proposals, binding and nonbinding criteria, and policies or methods to be used in determining or providing for the compensation to be paid to directors, the chief executive officer, or other senior officers of an issuer of a security registered under section 12 of this title shall be proper subjects for action by its security holders.

*Id.*

194. Levin, *supra* note 107.

Cohen,<sup>195</sup> would not give shareholders direct authority over pay levels, but only an advisory vote. The hope is, of course, that responsible boards will heed the words of advice from their shareholders. If, however, an irresponsible board disregards recommendations,<sup>196</sup> the legislation offers no remedy. Stockholders would be left with the arduous task of either "voting the rascals out" or pursuing a derivative action. In either case, it is questionable whether the effort and expense required to challenge the incumbents would be worth any monetary savings to the company.

Senator Harkin's bill presents a more controversial issue. His bill would allow binding proposals to be submitted to the board on compensation matters. This raises troubling questions regarding the respective roles of shareholders and the board and the responsibility for corporate decision making. Undoubtedly, it would be the institutional investor who would take the lead in challenging pay practices. Institutional investors possess or can acquire sufficient resources and abilities to make informed suggestions on compensation matters and certainly should be given some voice in the decision-making process. But to cure the defects in the present compensation process by allowing institutional investors the opportunity to directly set pay scales through binding proposals may be a step too far (assuming, *arguendo*, any proposal, binding or non-binding, could garner sufficient votes for passage). The role of institutional investors should be advisory, not dictatorial. The bill proposed by Senator Harkin, by allowing binding proposals but not limiting them in scope, could open the door to investor influence well beyond what was intended.

The shareholder voting provisions of these bills have been largely mooted by the SEC's policy shift, and it is questionable whether Congress will enact such legislation in light of the SEC developments. Regardless, shareholders now have the ability to voice their concerns to management; the outfall of this new right remains to be seen. If shareholders remain apathetic or continue to vote with management, no real change will be experienced. Even the institutional investors, powerful as they are, do not own sufficient shares to overcome an apathetic majority. But if corporations are flooded with shareholder proposals, it will send a clear signal to boards that their actions are under scrutiny. Whether this will lead to reductions in pay or improved methods for distributing incentives—or simply prompt boards to produce a better paper trail justifying pay increases—is unclear.

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195. S. 2030, *supra* note 191.

196. Disregarding shareholders is not a wholly unlikely event. So long as the board accompanies its actions with sufficient investigation, discussion, and rationale, fully documenting and purporting to justify its decision to disregard the shareholder's advisory vote, the board should receive the protection of the business judgment rule as the courts presently apply it. *See supra* notes 126-69 and accompanying text.

#### 4. The "Informed" Shareholder and Information Obstacles

With the SEC's new ruling on shareholder proposals, the path is cleared for shareholders to vote on compensation issues. But if shareholders are to make intelligent decisions, they must possess sufficient comprehensible information on compensation practices. A portion of the shareholder apathy problem can be attributed to a lack of meaningful data supplied by corporations and the confusing manner in which it is presented.

Current SEC rules require disclosure of all pertinent information regarding compensation,<sup>197</sup> but they do not necessarily require the information to be easily digestible. Compensation tables indicating the amount of salaries and bonuses paid to the top five executives must be included in the proxy materials,<sup>198</sup> but the table need not include the value of stock options. While option compensation must be disclosed, the corporation may do so in text form.<sup>199</sup> Often, the text information is nearly incomprehensible. According to SEC Chairman Richard Breeden, one major U.S. automaker's incentive compensation plan was described in sixteen pages and required "a Ph.D. in Finance to begin to understand what was paid."<sup>200</sup> Even the information that is disclosed may not adequately reflect the true state of affairs. "[M]anagers may easily manipulate accounting figures to reflect higher earnings for a given period,"<sup>201</sup> thus justifying salary or bonus increases.

Senator Levin's Corporate Pay Responsibility Act contains a legislative solution to the information dilemma. His bill contains a clause requiring proxy materials to include clear and comprehensive information regarding compensation, including single dollar figures for total compensation, estimated present value of deferred compensation, and graphic representation of compensation figures for the prior two years and succeeding five years.<sup>202</sup> Additionally, the SEC is proposing revisions to its proxy rules that would clarify and enhance the disclosure of current executive compensation pack-

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197. Bachelder, *supra* note 186, at 4. Pending adoption of revisions to disclosure requirements, the SEC requires disclosure of the following: cash compensation in table form for each of the five highest paid executive officers and all executive officers as a group; compensation relating to long-term incentive compensation, including option plans; certain perquisites; and certain types of termination arrangements (golden parachutes). *Id.*

198. *Id.*

199. Press Conference, *supra* note 183.

200. *Id.*

201. Rehnert, *supra* note 15, at 1158. One example cited by the author was the 1973 decision of Chrysler's management to change inventory accounting methods to increase reported earnings. While earnings did show an immediate increase, the gain was short-lived. Chrysler had to pay more than \$50 million in additional taxes as a consequence of its action and the firm's market value dropped approximately \$50 million after the facts were announced. *Id.* at n.57. While this action was not necessarily taken to increase or justify salaries, it does illustrate the ease with which corporations can juggle figures to achieve their ends.

202. S. 1198, *supra* note 190.

ages, and it announced on June 23, 1992, that it will seek comment on several revisions to its executive compensation disclosure rules.<sup>203</sup>

The requirement of additional disclosure is without question a step in the right direction. However, it is too soon to tell how effective any new rules will be in better informing shareholders. Accounting figures are still subject to manipulation, although too much tinkering could leave the corporation open to charges that it has issued false or misleading proxy materials.<sup>204</sup> The proposed SEC rules requiring justification for compensation programs leave the crafting of those justifications up to the compensation committee and its hired wordsmiths who can shape the explanation as best fits the need. The individual shareholder—the one holding the voting power—may be only marginally better informed. And it may be some time before any changes take place. The pending legislation requiring greater disclosure may die in Congress, in part due to the pendency of SEC rule changes which require a lengthy hearing and public comment process,<sup>205</sup> thereby postponing implementation of any changes to some indeterminable future date. Furthermore, there are no guarantees that any or all of the SEC's proposals will be adopted.

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203. The SEC proposes that the disclosure of executive compensation be reformatted into a series of tables and that the requirement that general descriptions of compensation plans be dropped. *SEC Proposes Proxy Reforms Including Exec Pay Disclosure*, 61 U.S.L.W. 2014 (July 7, 1992). The summary table would provide an overview of each compensatory item paid to the CEO and the four most highly paid executive officers over each of the three preceding years. A separate table would disclose a range of potential realizable values for stock options or free-standing stock appreciation rights, and the gain that would be realized if options or appreciation rights were exercised when the stock price had appreciated by certain specified percentage levels (50%, 100%, and 200%) from the market price on the date of the grant. *Id.*

The SEC's proposal would also require compensation committees to issue written reports discussing the specific factors affecting each executive's compensation during the last fiscal year and explaining how the individual compensation package relates to corporate performance. A graph would accompany the proposed report comparing the cumulative returns to the company's shareholders over at least the last five years to the return on the Standard and Poor's 500 Stock Index, and the return on either a nationally recognized industry index or a peer group index. *Id.*

Finally, if a corporation's compensation committee is composed of other than non-employee directors or if the corporation has an interlocking compensation committee, expanded disclosure on executive compensation would be required. *Id.*

204. SEC Rule 14a: Solicitation of Proxies states:

No solicitation subject to this regulation shall be made by means of any proxy statement . . . containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statement therein not false or misleading . . . .

17 C.F.R. § 240.14a-9 (1992).

205. Press Conference, *supra* note 183. The change in the SEC's treatment of shareholder proposals was a change in policy only and could be implemented immediately since policy changes, unlike rule changes, do not require public hearings or comment.

The shareholder evaluating a compensation package is further hindered by current accounting rules which work against a shareholder trying to decipher the fine print and footnotes in the proxy statements. Generally Accepted Accounting Principles can be used to legally obscure the true size and cost of option compensation. Information on stock options must be disclosed, but not necessarily in a meaningful way because a company need not take a charge to earnings when it issues stock options, as it must do with cash compensation.<sup>206</sup> Consequently, net income figures for the corporation may be overstated<sup>207</sup> and the total amount of compensation an executive is receiving may be artfully hidden in the text of the proxy statements.<sup>208</sup> The Financial Accounting Standards Board (FASB), which oversees corporate accounting and reporting and fashions the nation's accounting rules,<sup>209</sup> is responding to pressure from institutional investors to examine the issue and make revisions. But the FASB has tried this before. In 1984, the Board's attempt to overhaul reporting requirements resulted in such an outcry from corporations that the project was tabled pending agreement regarding underlying concepts.<sup>210</sup> Such an agreement has not yet been reached.

It appears the FASB will have to do something. Pending legislation requires disclosure of information and a reduction of corporate earnings by the estimated present value of deferred compensation,<sup>211</sup> but there are no Generally Accepted Accounting Principles to accomplish this calculation. While the SEC has the statutory authority to establish accounting principles,<sup>212</sup> the process would be greatly enhanced with the cooperation of the FASB. The FASB claims it will need a minimum of two years to devise rules that could require companies to recognize compensation expenses from stock option plans,<sup>213</sup> but admits that at present there is no consensus at the Board on how or when to value an option.<sup>214</sup> On a cynical note, the FASB derives more than a third of its revenues via donations from corporations and accounting firms.<sup>215</sup> Obvious conflicts of interest are present and may, once again, delay or curtail efforts to change the system.

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206. See *supra* notes 83-86 and accompanying text; see also Crystal, *supra* note 73.

207. Cowan, *supra* note 85; Crystal, *supra* note 73.

208. See *supra* notes 83-88 and accompanying text.

209. Accounting for employee stock compensation plans is governed by Accounting Principles Board Opinion No. 25. ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, Opinions of the Accounting Principles Board No. 25 (Am. Inst. of Certified Pub. Accountants, 1972).

210. Cowan, *supra* note 85, at D12.

211. S. 1198, *supra* note 190.

212. Press Conference, *supra* note 183.

213. FASB Says New Employee Option Rules Will Take at Least Two Years to Complete, 24 Sec. Reg. & L. Rep. (BNA) No. 1, at 13 (Jan. 3, 1992).

214. Cowan, *supra* note 85, at D12.

215. *Id.* at D1.

The SEC has announced that it will "study" the adequacy of current accounting rules for grants of stock options and that it will "suggest" revisions to proxy rules to clarify and enhance the disclosure of current executive compensation.<sup>216</sup> But, once again, because any revisions to reporting rules must pass through committee and public comment before enactment, reforms may be mired in the process for a considerable time.

### 5. Negotiating Out of the Proxy Battle

Some institutional shareholders have found their power to influence corporate governance has reached a level where companies are willing to negotiate changes to avoid a messy proxy battle.<sup>217</sup> Increased institutional muscle-flexing comes at the same time shareholder activists are expanding their campaigns on compensation reform. Institutional investors are focusing on three issues: (1) placement of independent directors on compensation committees; (2) better presentation of pay-related information; and (3) disclosure of the methodology used in setting pay.<sup>218</sup>

Shareholder activists and institutional investors have been exerting pressure through a combination of proxy resolutions and negotiations.<sup>219</sup> CalPERS, however, has temporarily abandoned proxy battles after private talks proved more effective than shareholder proposals. CalPERS announced in October, 1991, that it would, on an experimental basis, concentrate on direct negotiations with twelve corporations with respect to various corporate governance issues. Four of the companies have been specifically challenged on pay practices: American Express Co., Dial Corp., IBM Corp., and ITT Corp.,<sup>220</sup> all corporations whose stocks performed poorly over the previous five years.<sup>221</sup> After this announcement, CalPERS quickly reached agreements with ITT and American Express. ITT changed the structure of its compensation package to more closely tie pay to corporate performance following

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216. Press Conference, *supra* note 183. The SEC is approaching this problem with extreme caution due to concerns that changes in accounting rules for valuation of stock options could create new problems. Because this issue is of great significance, Mr. Breeden does not believe that "any decision should be reached on a hasty or ill-informed basis." *Id.*

217. *Institutions May Use Negotiations More in 1992 to Change Corporate Governance*, 24 Sec. Reg. & L. Rep. (BNA) No. 1, at 13 (Jan. 3, 1992).

218. Chernoff, *supra* note 4, at 34.

219. *Id.*

220. Other targeted companies include: Hercules, Inc., Salomon, Inc., and Time Warner, Inc. (seeking independence for the board of directors); and Chrysler Corp., Control Data Corp., Polaroid Corp., Ryder Systems, Inc., and USAir Group (seeking the formation of shareholder advisory committees). *CalPERS Identifies Corporate Governance Targets*, Bus. Wire, Mar. 20, 1992, available in LEXIS, Nexis Library, Bwire File.

221. Stuart Silverstein, *Corporations Under Pressure; CalPERS Raps Big Business for Neglecting Shareholders*, L.A. TIMES, Mar. 21, 1992, at D1.

criticism of the \$11.7 million package given to its chairman in 1990.<sup>222</sup> American Express announced a pay cut one week after meeting with two top officials from CalPERS, who questioned whether Chairman James E. Robinson III was overpaid in light of the company's long-term stock performance.<sup>223</sup> IBM recently announced major pay cuts for its chief executive which may resolve some of CalPERS objections.<sup>224</sup> Dial met with CalPERS representatives in June, 1992, and satisfied the pension fund's management that its compensation program is sufficiently tied to corporate performance.<sup>225</sup>

In another example of a negotiation success, the combined efforts of CalPERS and United Shareholders Association (with the cooperation of mutual fund giant Fidelity Investments) won concessions last year from UAL Corp.<sup>226</sup> The CEO of UAL was the second highest paid executive on the *Forbes* 1991 list of big money earners.<sup>227</sup> In response to the concerted efforts of the investor representatives, UAL agreed to give shareholders more information on its compensation policies and procedures beginning with the 1992 proxy season, and the level of Chairman Stephen Wolf's compensation was reduced.<sup>228</sup> In return, the organizations agreed not to initiate a shareholder activism campaign against the airline.<sup>229</sup>

Several institutional investors followed the lead of CalPERS in attempting compromise rather than proxy fights. These negotiation activities nearly

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222. Chernoff, *supra* note 4. CalPERS criticized ITT for doubling Chairman Araskog's pay between 1989 and 1990, when company profits rose just 4%. In 1991, ITT's earnings dropped nearly 15%. CalPERS voted its 1 million ITT shares against ITT's slate of directors. The Board recognized the threat and reconsidered the Chairman's earnings. His 1991 package dropped salary and bonuses to \$4 million from about \$7 million. Araskog also received 170,000 stock options worth potentially \$3.5 million, compared with options on restricted stock worth \$4.2 million the year before. *Disgruntled Investors Show Chairman Who's Boss*, CHI. TRIB., Mar. 30, 1992, § 4, at 3.

223. Robert J. McCartney, *American Express Cut CEO Robinson's Pay in 1991*, WASH. POST, Mar. 19, 1992, at D10, D16. American Express has tried to minimize the effect of the meetings with CalPERS, but publicity over Robinson's pay appears to have played a role in reducing his annual bonus, which dropped to \$650,000 from \$850,000 in a year when profits nearly quadrupled. An American Express spokesman attributed the drop in Robinson's pay to his failure to receive a long-term performance grant for the years 1989 through 1991. *Id.*

224. Chernoff, *supra* note 4, at 34.

225. *CalPERS and the Dial Corporation Agree on Compensation and Related Matters*, Bus. WIRE, June 19, 1992, available in LEXIS, Nexis Library, Bwire File.

226. Kathy M. Kristof, *Regulators Consider Rules That May Scale Back Executives' Pay*, L.A. TIMES, Jan. 27, 1992, at D1, D6.

227. UAL's CEO earned over \$18 million in 1990. FORBES, *supra* note 1.

228. *UAL to Disclose More on Exec Pay Under Accord with Shareholders Group*, *supra* note 3.

229. See Chernoff, *supra* note 4. The negotiation process has also produced settlements with such concerns as Avon Products, Inc., Boise Cascade Corp., Consolidated Freightways, Inc., Colgate-Palmolive Co., General Motors Co., Honeywell, K-Mart, Inc., Lockheed Corp., Marriott Corp., Sears, Roebuck and Co., Unisys Corp., and Weyerhaeuser Co., to name just a few. *Companies Are Using Negotiations With Investors to Resolve Disputes*, 23 Sec. Reg. & L. Rep. (BNA) No. 15, at 532 (Apr. 12, 1991).



halved the number of shareholder resolutions filed during the 1992 proxy season.<sup>230</sup> Many investors combined negotiations with the withholding of votes for board nominees as a means of registering dissatisfaction to management.<sup>231</sup> Although it is still too early to tell if the negotiation/vote withholding technique will be successful over the long-term,<sup>232</sup> it appears at this stage that negotiations won more concessions in the 1992 season than proxy fights ever have.

Fighting the proxy battle is difficult, expensive, and often ineffective. Despite the withholding of votes by institutional investors and the massive publicity presently surrounding corporate governance issues, of the more than one thousand resolutions advanced by corporate management (on all issues) which were included on the ballots during the 1992 proxy season, only seven failed to pass.<sup>233</sup> The shareholders' proclivity to vote with management is a difficult obstacle to overcome. Although institutional investors have considerable clout, their total shares in any one corporation are not enough to win a vote hands down, and merely getting a measure before the shareholders is certainly no guarantee of its passage. It is apparent that shareholder resolutions by themselves are an inadequate means to address corporate governance problems. Negotiated agreements between corporations and institutional investors may be the most promising avenue for shareholders seeking changes in compensation and other issues and may offer the greatest cost-per-share benefit to all shareholders, institutions, and individuals alike.

The new approach to compensation issues is creating a radically different corporate governance dynamic with a focus on shareholders and boards working together to improve both long-term performance and short-term competitiveness.<sup>234</sup> Institutional investors and shareholder representatives are seeking neither to wrest corporate control away from the board, nor to effect major restructuring. The changes they propose will not significantly tilt the balance of power toward or away from shareholders.<sup>235</sup> Instead, they

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230. Marlene G. Star, *Proxy Resolutions Plummet in '92*, PENSIONS & INVESTMENT AGE, June 22, 1992, at 3.

231. *Id.* The United Shareholders Association and the Teachers Insurance and Annuity Association-College Retirement Equities Fund used a vote withholding tactic, and announced plans to do the same next year. *Id.* Votes were withheld at the meetings of Champion International Corp., Sears, Roebuck and Co., Travelers Corp., and others. *Id.* CalPERS voted against all standing Sears directors, citing poor performance and reluctance to change practices; and voted against the slate of directors at Champion, in which it owns 0.8% of outstanding shares. *California PERS Votes Against Slate of Champion International's Directors*, BNA Pensions & Benefits Daily, June 1, 1992, available in LEXIS, BNA Library, BNAptd File.

232. CalPERS may return to a shareholder resolution strategy in the 1993 proxy season. Star, *supra* note 230, at 3.

233. *Id.* at 39.

234. John Pound, *The Glorious Oversight Revolution*, N.Y. TIMES, Mar. 15, 1992, § 3, at 11.

235. *Id.*

allow a constructive approach to resolving compensation issues. This move has begun to strike a responsive chord with corporations,<sup>236</sup> albeit with a certain measure of grimacing involved. Regardless of whether corporations willingly embrace institutional investors' suggestions, or must be dragged to the table to talk, the process seems to be working at a time when little else is having a significant impact on this serious problem.

### CONCLUSION

Robert Reich of Harvard University claims that what we are now experiencing is a legacy of 1980s greed.<sup>237</sup> Salary and bonus increases became institutionalized by pay consultants and compensation committees composed of friends and associates hired by CEOs, forming an "old boys" network. The compensation packages they approve bear no relationship to past performance, future performance, or anything else—except greed.<sup>238</sup>

Greed is a fundamental part of the American economic system, and it need not be eliminated to control the overcompensation problem. Instead, compensation practices should be revised and managed in a way that uses greed in its most positive form: as a motivational tool to spur executives to work for the long-term well-being of the corporation. High salaries and incentive compensation are not in themselves evil. But the present system is so out of control that compensation does not represent pay-for-performance, but greed run amok.

There is no single answer to controlling overcompensation. Self-control is an ideal—but idealistic—solution. Some corporations may be trimming pay this year in response to mounting criticism, but these reductions may prove only temporary. Resort to the courts is possible, but presently impractical and ineffectual. The legislation currently proposed will do little to actually control compensation, and while the legislation is likely to disappear, the problem will not. If this legislation fails, more drastic legislation to dictate pay ceilings or methodology may be proposed. While individual shareholder agitation is helpful, the few concerned individuals are overwhelmed by an apathetic majority.

The most hope for real change seems to lie at the doorstep of the institutional investors. These groups are growing in strength to the point where corporations can no longer ignore their views. They have the resources and expertise to make meaningful suggestions on how to better compensate top executives and the incentive to work toward compensation programs directed at long-term as well as short-term goals. Because each corporation

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236. *Id.*

237. *Nightline: Huge CEO Salaries in Hard Times* (ABC television broadcast, May 20, 1991), transcript available in LEXIS, Nexis Library, ABCnew File.

238. *Id.*

is unique, a standardized compensation formula is an inadequate answer. Institutional investors have the ability to work with individual corporations to seek individualized solutions to the pay-for-performance dilemma. At present, they are the best available watchdog.

But the institutional investors need backup in the form of active shareholder participation and support from the courts. The former has been, and always will be, problematic, but the latter is possible. With the massive compensation now being awarded, courts have the perfect opportunity to find specific plans are unreasonable and unfair to shareholders, instead of shielding excess compensation practices with the business judgment rule. A concerted effort by institutional investors, shareholders, and courts could uncover solutions to this intractable overcompensation problem.