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Compensation Representatives: a Prudent Solution to Excessive CEO Pay

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Compensation Representatives

A PRUDENT SOLUTION TO EXCESSIVE CEO PAY

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I. INTRODUCTION

The issue of CEO pay continues to garner significant attention both in the popular press and among regulators. The *New York Times* alone printed 339 stories dealing with executive compensation in 2006.[1] Moreover, the SEC received more than twenty thousand comment letters before it approved new compensation disclosure rules on July 26, 2006.[2] SEC Chairman Christopher Cox noted that "no issue in the 72 years of the Commission's history has generated such interest."[3] The reason for the intense degree of interest is clear: CEO compensation in the United States is extremely high, and is getting higher. In 2003, the average CEO of a large U.S. firm made 500 times the salary of the average worker.[4] This

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1 Culled from a January 13, 2007 Westlaw search of the *New York Times* using "ceo or executive w/5 pay or compensation & da(aft 12/31/2005 & bef 01/01/2007)."

2 Press Release, U.S. Sec. & Exch. Comm'n ("SEC"), SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), http://www.sec.gov/news/press/2006/2006-123.htm [hereinafter SEC Press Release]. For the full text of the executive compensation rules, see Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274). *See also infra* notes 89-91 and accompanying text for a brief discussion thereof.

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

4 *CEOs and Their Indian Rope Trick*, ECONOMIST, Dec. 11, 2004, at 61, *quoted in* Stephen M. Bainbridge, *Executive Compensation: Who Decides*, 83 TEX. L. REV. 1615, 1619 (2005); Janice Revell, *Mo' Money, Fewer Problems; Is it a Good Idea to Get Rid of the $1 Million CEO Pay Ceiling?*, FORTUNE, Mar. 31, 2003, at 34, *quoted in* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1 (2004) [hereinafter PWP].

compares with 140 times worker salary in 1991.[5] In absolute levels, the average pay of CEOs in the S&P 500 has risen (in constant 2002 dollars) from \$3.7 million in 1993 to \$9.1 million in 2003.[6] One study of executive compensation at publicly traded firms with a market capitalization larger than \$50 million found that, during the period from 2001 to 2003, these firms' top five executives received compensation equivalent to 9.8% of the firms' aggregate earnings.[7]

Some commentators have argued that, for the good of society, CEOs should not be allowed to receive such exorbitant compensation.[8] Others take the narrower position that, irrespective of the impact on broader society, excessive CEO pay clearly harms shareholders.[9] Not only must shareholders ultimately pay the bill, but to the extent that such pay levels are pervasive throughout the market, it becomes difficult for them simply to sell the shares of any offending companies.[10] Thus, following the so-called "Wall Street Rule" would force investors to exit the entire equity market, an obviously untenable response.[11]

Still, despite overwhelming evidence that CEO pay is extremely high, it does not follow that CEO pay is "excessive." A figure can only be considered excessive if it is higher than the "correct" price, and numerous unanswerable questions confront anyone attempting to determine the correct price for the services of a CEO.[12] For example: How many people actually have the necessary skills to be a good CEO?[13] How much better is a given CEO than the other candidates?[14] How much of the company's success or failure is attributable to the CEO?[15]

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[5] PWP, *supra* note 4, at 1.

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

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

[8] *See, e.g.*, Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis*,*"* 30 J. CORP. L. 675, (2005); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 206-07 (1996).

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

[10] *Id.*

[11] *Id*.

[12] *See* Gordon, *supra* note 8, at 677; Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 144-46 (2003).

[13] Snyder, *supra* note 12, at 144.

[14] *Id.* at 146

[15] *Id.* at 145.

What is the "fair" allocation of profits as between the CEO and the shareholders?[16] Does "excessive" refer to an absolute pay level, or is pay excessive only if, whatever the amount, it is insufficiently tied to actual performance?[17] In the face of such unanswerable questions, one is left with the market. In short, a fair price for a CEO is the price the market will bear. But one can use the market to legitimize ostensibly excessive CEO compensation only if the market is "fair," in the sense that it has not been manipulated by the participants.

Lucian Bebchuk and Jesse Fried, in their seminal book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, condemn CEO pay for just such manipulation.[18] According to Bebchuk and Fried, boards of directors and CEOs do not engage in real arm's length bargaining over CEO pay.[19] Rather, CEOs exert "managerial power" to extract economic rents above and beyond what they could have obtained in an arm's length negotiation.[20] The result is excessive CEO pay, insufficiently aligned with the CEO's performance.[21] To address the problem, Bebchuk and Fried propose granting shareholders greater power *vis-à-vis* the board of directors.[22] For example, they would allow large shareholders to nominate candidates for the board, and would require the company to pick up the expenses for any proxy fight if the shareholder's nominee received more than a designated minimum level of support.[23]

Bebchuk and Fried's book has received considerable academic attention, with some commentators taking issue with its conclusion that CEOs are in fact overpaid,[24] and others objecting to its proposed remedies.[25] This article accepts the book's fundamental point that the CEO pay-setting process is flawed and that reforms are necessary. Nonetheless, it recognizes that high CEO pay may be attributable to numerous factors other than managerial power, and it questions whether

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16 *Id.* at 146.

17 Without answering this question, I will be using the term "excessive" to refer to both scenarios.

18 *See* PWP, *supra* note 4.

19 *Id*. at 61-64.

20 *Id*.

21 *Id.*

22 *Id.* at 201-16.

23 *Id.* at 210-12.

24 *See infra* Part III.

25 *See infra* Part IV.

certain of Bebchuk and Fried's proposed solutions might, by altering the balance of power between shareholders and directors, have unintended negative consequences for matters beyond CEO pay. Therefore, to remedy the process problems identified by Bebchuk and Fried, this article suggests that shareholders of those corporations with excessive CEO pay can and should amend corporate bylaws to enable qualified large shareholders to appoint non-executive "compensation representatives."[26] Compensation representatives, who would have no right to manage the corporation, would look after the interests of all shareholders on matters relating exclusively to CEO pay. This article contends that the use of compensation representatives could address the most significant problems described in Bebchuk and Fried's book, without fundamentally altering the traditional relationship between the shareholders and the board of directors. As such, it would constitute a prudent solution to the problem of excessive CEO pay.

Part II of this article discusses in detail Bebchuk and Fried's thesis, as well as their suggested reforms. Part III describes and evaluates a number of objections to their managerial power thesis. Part IV discusses the many objections to Bebchuk and Fried's proposal to permit large shareholders to place board nominees on the corporate ballot. Part V introduces the compensation representative approach and outlines its numerous advantages over both the current system and the reforms suggested by Bebchuk and Fried. Part V addresses the feasibility of the compensation representative approach under existing law. Part VI raises and responds to potential objections to the compensation representative approach and concludes by demonstrating that adoption of a compensation representative system is justified by its low costs coupled with its potential benefits to shareholders.

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[26] *See infra* Part V.

II. THE MANAGERIAL POWER THESIS

A. *Bebchuk and Fried's Problems with Current CEO Compensation*

1. Factors Enabling CEOs to Exert Managerial Power over Compensation

Ideally, say Bebchuk and Fried, boards and CEOs should engage in arm's length bargaining over CEO compensation.[27] In such a scenario, boards would vigorously negotiate to receive the best deal for the benefit of the company's shareholders. In fact, argue Bebchuk and Fried, CEOs exert managerial power to ensure that their compensation is superior to what they would receive in an arm's length bargain.[28] Bebchuk and Fried point to five major factors that enable CEOs to exert managerial power. First, although most compensation committees are comprised of independent directors, CEOs have significant control over who will serve on the board from which the committee members will be drawn.[29] Although exchange rules no longer permit CEOs to serve on the nomination committee, a nomination committee is unlikely to propose directors opposed by the CEO.[30] CEOs are not likely to support a critic of high executive pay.[31] As long-time General Electric CEO Jack Welch told an audience of recently appointed CEOs:

> Put someone in charge who is nearing the end of their career, so they're not jealous of you as a younger CEO, is immensely rich, much richer than you, and enjoys seeing other people get rich. . . . Never, ever make a distinguished academic your compensation committee chair because you'll be a poor man by the end of it.[32]

Warren Buffett, a long-time critic of excessive CEO pay, had in mind a similar tendency when he noted, "Though I have served as a director of twenty public companies, only one CEO has put

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[27] PWP, *supra* note 4, at 17-18.
[28] *Id*. at 23-44.
[29] *Id.* at 26.
[30] *Id.*
[31] *Id.*
[32] *See* Symposium, *The Media and Executive Compensation: A Panel Discussion*, 30 J. CORP. L. 795, 796-97 (2005) (statement quoted by Matthew Bishop).

me on his comp[ensation] committee. Hmmmm . . ."[33] Second, CEOs are in a position to steer benefits to board members, though their ability to do so has been reduced by the 2003 changes to listing standards of the major securities exchanges.[34] Third, social and psychological factors discourage board members from bargaining aggressively with CEOs over compensation.[35] Friendship, loyalty, and team spirit encourage directors to be pliant, often at the expense of the interests of parties, such as shareholders, who are present at the table.[36] Also, board members who are highly paid CEOs in their own right are likely to rationalize high CEO pay as being in the best interests of shareholders.[37] A former SEC commissioner described it more nefariously as the "giraffe effect":

> The compensation committee, composed solely of outside directors who were CEOs of their own public corporations, knew that what goes around comes around. Pushing the pay envelope for the CEO who had selected them for his board was only natural, since they would not want anyone they were associated with to rank in the bottom half of surveys, and getting CEOs' scale up could only help them when their scales were reviewed by their outside directors.[38]

Fourth, since board members typically own only a very small fraction of the company's stock, and since the reputations of directors are unlikely to suffer from approving a CEO's pay package unless the terms of the package are truly egregious, directors who comply with CEO pay demands will usually not pay a high financial or reputational cost.[39] Finally, the limits to board members' time and information all but compel them to rely on the advice provided by the company's human resources department and the compensation consultants that have traditionally been hired by that department.[40]

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[33] Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway, Inc., to the Shareholders of Berkshire Hathaway, Inc. (Feb. 28, 2006), *available at* http://www.berkshirehathaway.com/letters/2005ltr.pdf.

[34] PWP, *supra* note 4, at 27-28.

[35] *Id.* at 32.

[36] *Id.*

[37] *Id.* at 33.

[38] Bevis Longstreth, *A Real World Critique of* Pay Without Performance, 30 J. CORP. L. 767, 769 (2005).

[39] PWP, *supra* note 4, at 34-36.

[40] *Id.* at 36-37. As discussed *infra* text accompanying note 197, New York Stock Exchange ("NYSE") rules now require that a compensation committee's charter give the committee sole power to retain and fire the compensation consultant. Still, a compensation committee will likely make its decision based in part on the

2. Existing Mechanisms Cannot Effectively Constrain Pay in the Face of Managerial Power

a. *Shareholder Litigation*

Bebchuk and Fried argue that existing mechanisms such as litigation, shareholder voting, the labor market, the market for corporate control, and the product market, cannot effectively constrain pay in the face of managerial power.[41] Litigation's effectiveness is blunted by both the procedural hurdles placed in front of shareholder plaintiffs and the extremely high standard applied to challenges to executive compensation.[42] In order to prevail, plaintiffs in a shareholder litigation must establish that either (i) when nominally independent directors approved CEO compensation, they were in fact engaged in a self-dealing transaction for their own personal benefit, or (ii) the compensation scheme constituted "waste," that is, it was so egregious that no rational person could have approved it.[43]

The difficulty of using shareholder litigation to challenge extraordinary pay was recently confirmed in the Delaware case *In re Walt Disney Co. Derivative Litigation*.[44] In *Disney*, the Delaware Court of Chancery was called upon to rule whether Disney directors had breached their fiduciary duty when, among other things, they approved an employment contract for Michael Ovitz which entitled Ovitz to a ninety million dollar severance package after a mere fourteen months as President of Disney.[45] The court indicated that, prior to

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recommendation of the firm's human resources department, which is ultimately responsible to the CEO.

[41] *Id.* at 45-65.

[42] *Id.* at 45-48.

[43] *Id.* The difficulty of prevailing in a waste claim was colorfully expressed by the Delaware Court of Chancery:

> Absent an allegation of fraud or conflict of interest, courts will not review the substance of corporate contracts; the waste theory represents a theoretical exception to the statement very rarely encountered in the world of real transactions. . . . [R]arest of all—and indeed, like Nessie, possibly non-existent—would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!

Steiner v. Meyerson, No. 13139, 1995 Del. Ch. LEXIS 95, at *13-14 (Del. Ch. July 18, 1995).

[44] No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 09, 2005), *aff'd*, No. 411, 2006 WL 1562466 (Del. June 8, 2006).

[45] *Id.* at *25.

Ovitz's termination, "the Disney board had never met in order to vote on, or even discuss, the termination at a full session . . . . [T]he Disney directors had been taken for a wild ride, and most of it was in the dark."[46] In describing the boardroom culture at Disney, the court wrote of "how ornamental, passive directors contribute to sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit, especially in the executive compensation and severance area."[47] It described CEO Michael Eisner's relationship with other board members as follows:

> By virtue of [Eisner's] Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner to a large extent is responsible for the failings in process that infected and handicapped the board's decisionmaking abilities. Eisner stacked his (and I intentionally write "his" as opposed to "the Company's") board of directors with friends and acquaintances who . . . were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.[48]

Nonetheless, despite board conduct that contained "many lessons on what *not* to do,"[49] the Court of Chancery held, in a decision affirmed by the Delaware Supreme Court,[50] that the Disney directors had not violated their fiduciary duties.[51]

b. Shareholder Voting

If litigation provides no real constraint on excessive compensation, what about shareholder voting? Bebchuk and Fried argue that it too is inadequate in the face of managerial power.[52] It is true that in certain instances, such as the adoption of a stock option plan, the major exchanges' listing rules require that a corporation submit the plan to a shareholder vote.[53] However, the vote does not effectively

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46 *Id.*

47 *Id*. at *28 n.373.

48 *Id*. at *40 (internal citation omitted).

49 *Id*. at *39 (emphasis added).

50 *In re Walt Disney Co. Derivative Litig.*, 2006 WL 1562466, at *33-34.

51 *In re Walt Disney Co. Derivative Litig.*, 2005 WL 2056651.

52 PWP, *supra* note 4, at 48-51.

53 *See, e.g.*, NASDAQ Rule 4350(i) (2006); NYSE Listed Company Manual 303A.08, http://www.nyse.com/lcm (follow the "Click here to open the NYSE Listed Company Manual" hyperlink, the "Section" hyperlink, the "Section 3 Corporate Responsibility" hyperlink, the "Section 303A Corporate Governance Standards" hyperlink, and the "Section 303A.08 Shareholder Approval of Equity Compensation Plans" hyperlink) (last visited Nov. 8, 2006).

constrain CEO compensation since it concerns only general matters, such as the total number of options that may be issued under the plan, rather than the compensation of any particular executive.[54] It is also true that Section 162(m) of the Internal Revenue Code disallows deductions for compensation exceeding $1 million per executive unless it is "performance based."[55] One of the requirements for "performance based" compensation is that the material terms of the excess amount over $1 million be approved by a majority of the shareholders in a separate vote.[56] However, even if shareholders are knowledgeable enough to vote intelligently on compensation issues,[57] they are constrained by the fact that they are not presented with any alternative to the plan approved and proposed by the board.[58] Therefore, if the shareholders were to reject the board's plan before an alternative became available, senior management could resign and throw the company into crisis.[59] To prevent this, a board might simply pay executives the cash equivalent of the rejected plan, since the exchange rules do not require a shareholder vote on cash compensation.[60] That result could make shareholders even worse off, since cash payments would not necessarily be linked to performance of the stock price. If shareholders did not approve the compensation, it would not be deemed "performance based," and amounts over $1 million would not be tax deductible.[61]

c. *"Outrage Costs" and "Camouflage"*

In addition to arguing that litigation and shareholder voting cannot effectively constrain CEO pay, Bebchuk and Fried assert that neither the labor market, the market for corporate control, the capital market, nor the product market

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[54] PWP, *supra* note 4, at 49. *See also Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2213 (2004).

[55] I.R.C. § 162(m) (2006).

[56] *Id.*

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

[58] PWP, *supra* note 4, at 49.

[59] *Id.*

[60] *Id.* at 49-50.

[61] *Id.*

constrains executive pay.[62] Thus, the only remaining restraints on inappropriate compensation are "outrage costs," which Bebchuk and Fried define as outsiders' negative reactions to unjustified, abusive, or egregious pay practices.[63] Even outrage costs can be rendered ineffective, since companies endeavour to camouflage the extent and form of their compensation.

> Because perceptions are so important, the designers of compensation plans can limit outside criticism and outrage by dressing, packaging, or hiding—in short camouflaging—rent extraction. . . . [M]anagers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance based than they actually are, and that package pay in ways that make it easier to justify and defend.[64]

Indeed, the very fact that CEOs feel the need to camouflage their pay (as is not the case with movie stars, athletes, and other highly paid stars) strongly suggests to Bebchuk and Fried that most compensation packages are not arrived at by arm's length negotiation.[65]

Examples of camouflage cited by Bebchuk and Fried include: long-time managerial resistance to the expensing of options;[66] the widespread use of tax-inefficient supplemental executive retirement plans or "SERPs," which do not enable the company to reap tax benefits, but may allow CEOs to reap camouflage benefits;[67] deferred compensation arrangements, which permit the CEO to enjoy an undisclosed, above-market rate of return prior to vesting;[68] and post-retirement perks and consulting compensation, which need not be disclosed because the recipient is no longer CEO at the time he receives the benefits.[69] For example, Bebchuk and Robert Jackson conducted a study of the pension plans among the CEOs of the Fortune 500 who either retired during 2003 or the first five months of 2004, or were at or close to retirement age in 2004.[70] Although the companies were not required to disclose the total

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62 *Id.*

63 *Id.* at 65.

64 PWP, *supra* note 4, at 67.

65 *Id.* at 21.

66 *Id.* at 150.

67 *Id.* at 97-100.

68 *Id.* at 105.

69 *Id.* at 110.

70 Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 826 (2005).

costs of such plans to shareholders,[71] they were required to disclose the existence of the plans and the method for determining the *annual* benefit.[72] Only by examining each company's proxy materials, 8-K filings, and CEO employment contract, as well as by estimating the likely payout by taking into account factors such as each CEO's tenure at the company, age, and expected life span, were the authors able to estimate the costs of such plans to shareholders.[73] They found that, for recently retired CEOs, the average cost exceeded $21 million, and for incumbent CEOs between the ages of sixty-three and sixty-seven, the average cost exceeded $26 million.[74]

According to Bebchuk and Fried, unrestrained managerial power, coupled with camouflage, leads to "pay without performance," in which CEOs enjoy extraordinarily high pay irrespective of whether they increase shareholder value.[75] For example, CEOs of companies in the S&P 500 averaged $2 million in cash salary and bonus in 2002, but the variation in cash pay among the CEOs was not correlated to performance relative to their respective industries.[76] Although option grants were meant to overcome the alignment problems found in cash compensation, Bebchuk and Fried point out that standard, non-indexed, at-the-money option grants[77] often provide CEOs with windfall benefits.[78] After all, the rise in a

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71 *Id.* at 828. New rules approved in July 2006 will require companies to include a pension benefits table disclosing the actuarial present value of each of the accumulated benefits under each pension plan of the CEO and other designated executives. *See supra* note 2.

72 Bebchuk & Jackson, *supra* note 70, at 828.

73 *Id*.

74 *Id.* at 837-38.

75 *Id.* at 831.

76 PWP, *supra* note 4, at 122-23.

77 In a standard, non-indexed, at-the-money grant, the CEO receives the option at any time during a designated period (typically ten years) to purchase shares of the company at the market price (known as the "exercise" or "strike" price) prevailing as of the date of the grant. Thus, for example, if the CEO received 100 options at an exercise price of $20 and five years later, he or she exercised the option when the market price for the stock was $40, the CEO would reap a benefit of ($40-$20) x 100, or $2,000. An "in-the-money" option would set the exercise price below the market price on the date of the grant, while an "out-of-the-money" option would set the exercise price above the market price on the grant date. If the option were indexed, then the exercise price would rise or fall in tandem with a specific index, such as the S&P 500. In the foregoing example, assuming that the option was indexed to the S&P, and the S&P increased 50% over the five-year period, the exercise price would also rise 50% to $30. The CEO's gain on exercise would be reduced to ($40-$30) x 100, or $1,000. *See* THE NEW PALGRAVE DICTIONARY OF MODERN FINANCE 83-89 (1992) (defining and discussing "option pricing theory").

78 PWP, *supra* note 4.

given company's stock may simply be part of a general rise in the market, resulting from the mere passage of time, or from circumstances beyond the CEO's control, such as a reduction in interest rates.[79] Although boards could solve much of the windfall problem by "indexing" options so that the exercise price would rise or fall in tandem with a given index, such as the S&P 500, indexed options are rare—a fact that Bebchuk and Fried view as further support for the managerial power thesis.[80] And while boards do not index options upward, they do often re-price them downward when the shares drop deeply out of the money, essentially providing CEOs with a gift, despite the poor performance of the company's shares.[81]

An even more egregious practice, which has come to light since the publication of Bebchuk and Fried's book, has been the widespread use of backdated options, particularly, though by no means exclusively, among high technology

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[79] *Id.* at 138-39. Warren Buffett has pointed out another method by which CEOs can ensure that, over time, the value of un-indexed stock options will increase—consistently withholding dividends and buying back company stock. Buffett imagines a Company called Stagnant Corporation, which has granted a ten year, at-the-money option to its CEO, Fred Futile, to purchase 1% of the company. During the ten year period Stagnant Corporation enjoys no growth, each year earning $1 billion on $10 billion net assets, equal to $10 per share on each of its outstanding 100 million shares. If, rather than paying any dividends, Fred uses the $1 billion to repurchase shares, and the shares continue to sell at 10 times earnings, the shares will have appreciated 158% over the ten years. "That's because repurchases would reduce the number of shares to 38.7 million by that time and earnings per share would therefore increase to $25.80. Simply by withholding earnings from owners, Fred gets very rich, making a cool $158 million, despite the business itself improving not at all." Letter from Warren E. Buffett to the Shareholders of Berkshire Hathaway, Inc., *supra* note 33, at 16.

[80] PWP, *supra* note 4, at 141-43. There may be good reasons, however, not to index option grants. For example, suppose Company A's board indexed CEO options to the movement of the S&P 500. If the S&P dropped 10% while Company A shares stayed flat, shareholders might complain that Company A's CEO is being unfairly rewarded for the fall in the price of other shares. Or imagine the CEO of Big Oil, Inc. As a result of rising oil prices, the S&P plummets as Big shares rise spectacularly. Big's CEO would be doubly rewarded for events beyond his control. In order to avoid the problem of sectors whose stocks move counter to a broad index, Big's stock options could be tied to the "energy sector." But defining the sector could be difficult, and it could open the way to manipulation *ex ante*. Query: was Enron in energy or financial services? If, in order to avoid definitional problems, Big indexed options to the stock of a few companies in its peer group, the pay to Big's CEO could vary wildly simply as a result of a large scandal at, or a large windfall to, a competitor. Even a perfectly designed index could present new problems. Saul Levmore has suggested that indexing options might encourage CEOs to take on excessively risky projects, since they will receive the same payout (zero) from their options whether they index returns or take a big risk that fails spectacularly, but will receive a huge payoff if their gamble succeeds. Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1922-23 (2001).

[81] PWP, *supra* note 4, at 165-67.

companies.[82] Options granted on a given date are made effective retroactively, as of a date when the stock price was lower.[83] This decreases the exercise price of the option and enables executives to reap a larger benefit from the option grant. Despite the claim that stock option grants incentivize executives to increase the company's stock price in the future, backdating rewards executives merely for short term volatility in the recent past.[84] SEC investigations into the practice have only just begun, but one academic study using statistical analysis of 7,774 companies' stock option grants between 1996 and 2005 has found that an estimated 29.2%, or 2,270 companies, manipulated stock grants at some point.[85] Even in those companies that do not engage in backdating, Bebchuk and Fried point out that CEOs can often blunt the risks (and alignment of interests) associated with stock options by selling their shares promptly upon exercise of the underlying options or by hedging against the performance of the shares, thereby protecting themselves against a future drop in the company's stock price.[86] In short, Bebchuk and Fried make a persuasive case that, as a result of managerial power, executive pay is both higher and less aligned with shareholder interests than it would be if it were determined by arm's length bargaining, and they demonstrate the current difficulty facing those who would challenge objectionable pay arrangements.

B. *Bebchuk and Fried's Proposed Solutions*

Bebchuk and Fried indicate that their primary goal is to call attention to the problem of executive compensation, rather than to propose solutions.[87] Nonetheless, they do suggest several specific reforms. First, they advocate steps to enhance transparency, such as expensing options, placing a monetary value on all compensation, and disclosing what fraction of executives' option gains resulted from performance that was

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82 Eric Dash, *Study Finds Outside Directors Also Got Backdated Options*, N.Y. TIMES, Dec. 18, 2006, at C2.

83 Floyd Norris, *S.E.C. Clarifies Accounting for Backdated Options*, N.Y. TIMES, Sep. 20, 2006, at C7.

84 *Id*.

85 Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, ___ J. FIN. ECON. (forthcoming 2007) (on file with author).

86 PWP, *supra* note 4, at 176-79.

87 *Id*. at 189.

superior to that of its industry peers.[88] These suggestions are relatively uncontroversial; several have already been implemented. For example, since fiscal year 2006, companies have been required to expense employee stock option grants.[89] Furthermore, the newly-approved disclosure rules, to be effective December 15, 2006, will require companies to disclose in tabular form the actuarial present value of the accumulated benefits under each pension plan of the CEO and other designated executives.[90] Indeed, the new rules include an additional reform not mentioned by Bebchuk and Fried: the requirement that the company insert into the proxy statement a "compensation discussion and analysis" statement, written in plain English and signed by the CEO and Chief Financial Officer.[91]

Disclosure alone will not solve what is arguably the most significant problem in the pay-setting process—the board's lack of accountability to the shareholders. Therefore, Bebchuk and Fried advocate strengthening the influence of shareholders in three ways. First, they would require companies to obtain specific shareholders' approval for certain "suspect" forms of compensation, such as non-indexed options, re-priced options, and large severance payments.[92] Second, they would grant shareholders more say in the appointment and reappointment of directors.[93] Currently, while shareholders have the right to elect directors, nominations for directorships of a publicly-traded company are made, not by the shareholders, but by the nomination committee of the board itself.[94]

Bebchuk and Fried would permit any shareholder who for one year has held, say, five percent of the shares to gain

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[88] *Id.* at 192-94.

[89] Staff Accounting Bulletin No. 107, 70 Fed. Reg. 16693 (Apr. 1, 2005) (codified at 17 C.F.R. pt. 211).

[90] Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542, 6611-12 (Feb. 8, 2006) (to be codified at 17 C.F.R. pts. 229.402(c), 228.402(c), 229.10).

[91] Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6611 (Feb. 8, 2006) (to be codified at 17 C.F.R. pt. 229.402(b)).

[92] PWP, *supra* note 4, at 195-98.

[93] *Id.* at 195-96.

[94] *See* NYSE Listed Company Manual 303A.00, http://www.nyse.com/lcm (follow the "Click here to open the NYSE Listed Company Manual" hyperlink, the "Section" hyperlink, the "Section 3 Corporate Responsibility" hyperlink, the "Section 303A Corporate Governance Standards" hyperlink, and the "Section 303A.04 Nominating/Corporate Governance Committee" hyperlink) (last visited Nov. 8, 2006).

access to the corporate ballot for board elections.[95] Instead of the existing rule, which requires a shareholder to pay its own costs in any proxy fight,[96] Bebchuk and Fried would require the company to cover the costs of proxy campaigns that garner significant support.[97] Third, Bebchuk and Fried would give shareholders the power to initiate changes to the corporate charter.[98]

III. OBJECTIONS TO THE MANAGERIAL POWER THESIS

The managerial power thesis has drawn considerable criticism among commentators. Some have claimed that CEO pay in the United States is not in fact excessive, but that high CEO compensation is justified by the size and complexity of large organizations.[99] For example, one commentator has pointed out that asset managers, who seem to have less complex duties than CEOs, typically receive a higher percentage of "assets under management" than CEOs, even after accounting for the asset managers' costs of doing business.[100] Surely, he argues, CEOs are entitled to pay on par with that of asset managers.[101] As for international comparisons,[102] one commentator has posited four possible explanations for the relatively high pay of U.S. CEOs:[103] (i) U.S. CEOs contribute more to their firms' value than do foreign CEOs; (ii) the tournament to become a U.S. CEO is

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[95] PWP, *supra* note 4 at 197-98.

[96] Currently, Rule 14a-8, pursuant to which a shareholder can shift the costs of a proxy proposal by compelling a corporation to place it on the corporate proxy, is not available for disputes over the election of particular board members. *See* 17 C.F.R. § 240.14a-8 (2005). See *infra* notes 166-74 and accompanying text for further discussion of Rule 14a-8.

[97] PWP, *supra* note 4, at 210-11.

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

[99] Joseph E. Bachelder, *Comments on Pay Without Performance*, 30 J. CORP. L. 777, 781-82 (2005).

[100] *Id.*

[101] *Id.*

[102] The international compensation differential may be shrinking. *See* Geraldine Fabrikant, *U.S.-Style Pay Deals for Chiefs Become All the Rage in Europe*, N.Y. TIMES, June 16, 2006, at A1 (noting that the differential between U.S. and European CEOs is declining as European CEOs demand pay in line with that of their U.S. counterparts).

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

bigger, due to the greater power U.S. CEOs wield compared to their foreign counterparts; (iii) U.S. executives are more mobile and can change companies in order to receive higher pay; (iv) the presence of poison pills and the absence of control shareholders in U.S. companies has shifted bargaining power to management.[104]

Other commentators have argued that even if CEO pay is high, it can nonetheless be justified since, over time, U.S. shares have performed better than those of markets where CEOs are paid less.[105] Certainly, rational shareholders would prefer to pay an extra $1 million to CEOs if that would lead to an additional shareholder return in excess of $1 million.

Still other commentators have attempted to refute the managerial power thesis by pointing out that increased CEO pay is part of the larger labor market phenomenon known as the "superstar effect." The superstar effect takes hold in markets where, as a result of the large scale of an organization, even small differences in the quality of those responsible for the organization's success can have extremely large impact on the organization's results. This leads to dramatic increases in the compensation at the top of such organizations.[106] Various types of stars, other than CEOs, have been enjoying large pay increases as the scales of their organizations have increased over time. For example, professional baseball players have been receiving significantly higher pay as the amount of money in professional baseball has been increasing, even though baseball players cannot manipulate the negotiation process.[107] Similarly, as corporations get larger, such that even slightly better management can cause a dramatic increase in total shareholder value, one could expect that CEO pay would rise as well, whether or not CEOs exert managerial power.[108] And indeed a recent empirical study of CEO compensation at S&P 500 companies between the years 1980 and 2003 has argued that the six-fold increase in CEO pay during that period can be explained by the six-fold increase in the asset value of the

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104 *Id.*

105 John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1165-66 (2005); Ira T. Kay, *CEO Pay for Performance: The Solution to "Managerial Power*,*"* 30 J. CORP. L. 785 (2005).

106 *See generally* Sherwin Rosen, The Economics of Superstars, 71 AM. ECON. REV. 845 (1981).

107 Snyder, *supra* note 12, at 155-59.

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

companies in the S&P 500 over the same period.[109] While the mere fact that recent increases in CEO pay have tracked increases in company size does not prove that current pay levels are appropriate,[110] it does suggest that not all of the increases in CEO pay can be attributed to managerial power.

Bebchuk and Fried have also been faulted for failing to distinguish between the legitimate bargaining power of talented people and the illegitimate manipulation of the negotiation process.[111] One study of CEO compensation during the years 1992 to 2000 indicated that externally hired CEOs, who do not tend to have power over the existing board, made on average ninety-six percent more compensation than CEOs hired from within the corporation.[112] This finding implies that the high salaries of outsiders result from their strong, but legitimate, bargaining power.[113]

Other commentators concede that boards and CEOs do not engage in idealized arm's length bargaining over CEO salaries, but deny that the arm's length negotiation model is the correct standard by which to judge the negotiations.[114] They claim that the relationship between the CEO and the board (or company) would be best described as a long term

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109 Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?* (MIT Dep't of Econ. Working Paper No. 06-13, 2006), *available at* http://www.ssrn.com/abstract=901826.

110 For one thing, it is not clear that the pay levels in 1980 were themselves appropriate. For another, it seems implausible that running a 2003 sized corporation requires six times the effort that it did to run a 1980 sized corporation. And even assuming that a CEO is entitled to more pay for running a larger company, one might expect that as companies grow larger, CEOs would be called upon to offer "volume discounts" as other commercial actors do, in which case pay, as a percentage of assets at least, would have decreased since 1980.

111 Snyder, *supra* note 12, at 152-55.

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

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

114 *See, e.g.*, Longstreth, *supra* note 38, at 767-68; Snyder, *supra* note 12, at 149-52.

relational contract.[115] In such contracts, parties tend not to fight for every advantage, but recognize that a given negotiation is only part of a broader relationship.

> The directors' perception that they should support the CEO, their reluctance to override substantive decisions except under unusual circumstances, and their desire to be part of the "team" are not necessarily abdications of authority but may instead reflect the board's view that the long-term interest of the corporation is furthered by cooperation and team-building.[116]

As a senior consultant and former board member of Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) succinctly put it, "[b]oards have to be tough. They have to be collegial at the same time, though."[117] Or, to use the words of a former SEC Commissioner, "[m]oney may be 'left on the table.' And, yet, the best interests of shareholders may have been served."[118] If, instead, a board adopted an overly adversarial attitude towards the CEO, the costs to shareholder returns could outweigh any benefits arising from robust CEO pay negotiations. For example, the CEO could simply withhold information from board members he or she considered hostile, thereby rendering the board less effective.[119]

Turning to the specific pay practices criticized by Bebchuk and Fried, such as non-indexed at-the-money options, Kevin Murphy claims that there is a better explanation than managerial power for their widespread adoption.[120] Boards may simply have considered such options a "cheap" form of compensation, since they require no immediate cash outlay and, until recently, they did not need to be treated as an expense for accounting purposes.[121] On the other hand, risk averse and undiversified managers discount the value of high

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115 Snyder, *supra* note 12, at 149.

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

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

118 Longstreth, *supra* note 38, at 768.

119 *See* Bengt Holmstrom, Pay Without Performance *and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 711-12 (2005).

120 Murphy, *supra* note 112, at 859-60

121 *Id*.

risk options, and demand large option grants in lieu of cash.[122] In short, boards' and managers' respective assessments of the cost and value of such options may explain their increased use better than does managerial power alone.[123] As evidence of this, one study found "that nearly 80% of [the] options granted in S&P 500 Industrials, S&P 500 Financials, and New Economy firms in 2000 were granted to executives and employees below the top five," presumably employees without significant power over the board.[124] Thus, critics of Bebchuk and Fried have countered the managerial power thesis with a variety of plausible arguments.

IV. REACTIONS TO BEBCHUK AND FRIED'S PROPOSED REFORMS

Given the controversy surrounding Bebchuk and Fried's diagnosis of the problem of CEO pay, one could expect similar reactions to their proposed solutions. In fact, as described in this part, while commentators have not objected to their proposals to increase transparency, they have raised numerous objections to their proposals to allow shareholders to appoint nominees to the board and to initiate changes to the corporate charter. Critics have pointed out that institutional shareholders are often unwilling to become engaged in the internal matters of corporations in which they invest, since their costs in time and liquidity would likely exceed the expected benefits.[125] Rational institutional investors would rather sell the shares of companies that destroy shareholder value (either through inappropriate payment practices or otherwise) than hold on to under-performing shares long enough to effect the necessary improvements.[126]

Moreover, commentators note, one cannot assume that those shareholders who are willing to become engaged in corporate governance issues will necessarily promote the financial interests of all the corporation's shareholders.

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[122] *Id.* at 859.

[123] *Id.* at 857.

[124] *Id.*

[125] Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1751-52 (2006).

[126] *Id.* *See also* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 629-33 (2006); Olin Kramer, Pay Without Performance: *The Institutional Shareholder Perspective*, 30 J. CORP. L. 773, 774-75 (2005); Thomas & Martin, *supra* note 57, at 1034.

Delaware Vice Chancellor Strine makes the point as follows: "Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest."[127] For example, a large union pension fund might threaten to mount a proxy fight for the election of board members who would accede to the union's wage demands. Indeed, some have argued that such a scenario was at the heart of the decision by California Public Employees' Retirement System ("CalPERS") (a former president of which was the regional director of the United Food and Commercial Workers) to withhold support for the election of the Safeway CEO, following a strike at Safeway.[128]

Commentators have also pointed out that, even assuming shareholders do not pursue non-economic agendas, differing types of shareholders could have widely divergent interests.[129] For example, a hedge fund with a short term investment horizon might clamour for policies that sacrifice long term interests for short term gain.[130] Similarly, diversified shareholders (who have eliminated firm-specific risk) might advocate the implementation of projects that undiversified shareholders would consider to be too risky.[131] Companies generally attempt to reconcile these divergent interests by placing the authority to make decisions on behalf of the corporation into the hands of the board of directors.[132] Courts facilitate this centralization of authority when they apply the business judgment rule[133] to insulate most board decisions from

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[127] Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006); *see also* Bainbridge, *supra* note 125, at 1754-55.

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

[129] *Id*.

[130] *Id*. at 591.

[131] *Id.* at 577-92.

[132] Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 468 (1992).

[133] The business judgment rule has been characterized by the Delaware Supreme Court as "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). Absent a showing of fraud, overreaching, lack of good faith, or being uninformed, a court will defer to the business judgment of the directors, and will not substitute its

shareholder challenge.[134] Granting shareholders greater power might enhance the board's accountability, but only at a cost to board authority.[135] To exacerbate matters, Bebchuk and Fried's proposal could make directors more accountable, not to shareholders generally, but simply to those shareholders that attempted to assert their newfound power. As demonstrated above, there is no guarantee that the assertive shareholders' interests are always aligned with those of other shareholders.[136] In short, commentators have pointed out that Bebchuk and Fried's proposed reforms could entail great costs. Thus, they should only be undertaken if they would bring shareholders even greater benefits.

Turning to the putative benefits of Bebchuk and Fried's proposed reforms, critics have argued that they would be rather small in comparison to the costs described above. After all, they argue, there is evidence that despite the absolute size of CEO pay, the amounts involved may not be material to

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judgment for that of the board. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985).

[134] *See* Dooley, *supra* note 132.

> The business judgment rule can only be understood as intended to protect the authority of the board and thus to promote the value of Authority. . . . [T]he power to hold a party accountable is the power to interfere and, ultimately, the power to decide. Thus, affording shareholders the right to demand frequent judicial review of board decisions has the effect of transferring decision-making authority from the board to the shareholders.

Id. at 470.

[135] Stephen Bainbridge describes the dichotomy between authority and accountability as follows:

> A complete theory of corporate governance . . . requires balancing the virtues of discretionary fiat against the need to ensure that such power is used to further the interests of shareholders. Because the power to hold to account differs only in degree and not in kind from the power to decide, fiat and accountability also are antithetical.

Bainbridge, *supra* note 125, at 1747 (internal citations omitted). Or, as he states elsewhere in the same article: "[T]here are limits on one's ability to reduce agency costs without undermining the centralization of fiat that makes the modern corporation work." *Id.* at 1741.

[136] Commentators have pointed out a number of other unintended consequences that might arise if shareholders had the power to nominate board members. For example, perfectly independent board members who significantly improve compensation practices might nonetheless be unqualified to fulfil other more important tasks, such as selecting good projects and making good investment decisions. The net result could be negative for shareholders. *See* Core et al., *supra* note 105, at 1162-63.

shareholders.[137] If shareholders really felt that CEO pay was a material concern, one would expect that they would often reject option plans submitted for shareholder approval. In fact, a study of shareholder voting on stock option plans during the 1998 proxy season found that less than one percent failed to receive the approval of shareholders.[138] One former SEC Commissioner put the materiality point forcefully as follows:

> The Chartered Financial Analysis Institute, representing more than 70,000 money managers, investment advisers, and Chartered Financial Analysts (CFAs), teaches CFAs how to study a corporation and how to determine what matters and what does not matter in assessing the buy, sell, or hold decision. It even teaches CFAs about the voting decisions and how, with professional confidence, to reach conclusions on which many will rely. The CFA represents the best of the breed. When and if they start to attribute telling importance to executive compensation arrangements in deciding what to recommend, this matter will become important to investors . . . . Until this time comes, the issue, by definition, lacks materiality . . . .[139]

In sum, critics have opposed Bebchuk and Fried's proposed solutions due to their concern that, once empowered, shareholders would either fail to use their new power, or would use it to the detriment of the corporation. In any event, they argue, the costs associated with the reforms would likely outweigh the benefits.

V. COMPENSATION REPRESENTATIVES: A PRUDENT APPROACH

The controversy can now be summarized as follows: Bebchuk and Fried have pointed out numerous defects in the process for determining CEO pay, and have demonstrated how the process falls short of the ideal of the arm's length negotiation.[140] They have argued that the defects have led to excessive CEO pay, largely attenuated from CEO performance.

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

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

[139] Longstreth, *supra* note 38, at 770-71. But another explanation for CFAs' apparent apathy is that, to the extent that the excessive compensation is endemic to publicly traded U.S. corporations, CEO pay is not material for determining *relative* returns. If, however, CEO pay were to decline or to become better aligned with actual performance, material benefits would accrue, especially to the diversified investor.

[140] *See supra* Part II.A.

To address the problem, they have suggested, among other things, making boards more responsive to shareholders by empowering shareholders (i) to specifically approve certain "suspect" forms of compensation, (ii) to nominate directors, and (iii) to initiate changes to the corporate charter.[141] Critics have responded by arguing that CEO pay may not, in fact, be excessive, and that CEOs may simply be using their legitimate bargaining power to command high pay.[142] They have justified mega option grants by noting that options are viewed by the corporation as inexpensive and by CEOs as risky.[143] As for Bebchuk and Fried's proposal to increase shareholder power, critics have argued, in effect, that the proposed cure is worse than the disease, especially since the amounts involved may not be material to investors.[144]

A. *Reconciling the Debate*

The arguments on both sides of this debate appear to have merit, but can they be reconciled? To a certain degree, the answer is yes. On the one hand, the recent increases in the compensation of highly talented persons generally, along with the demonstrated correlation between company size and CEO pay, do imply that not all of the rise in CEO compensation is attributable to managerial power. Critics of Bebchuk and Fried also have a point when they argue that, as Vice Chancellor Strine put it, "the current American approach to corporate governance appears, on balance, to produce good results."[145] They are therefore right to be skeptical of significant changes to the balance of power between boards and shareholders, particularly while there is some question regarding the financial materiality of CEO pay to shareholders, the putative beneficiaries of reform.[146] On the other hand, it is

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[141] *See supra* Part II.B. For other proposed reforms, see, e.g., Charles M. Elson, *Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (proposing that all directors be paid only in stock of the relevant corporation); Holmstrom, *supra* note 119 (proposing the institution of generally accepted compensation practices, analogous to GAAP, which can be audited); Loewenstein, *supra* note 9 (proposing that shareholders be allowed an advisory up or down vote on CEO pay).

[142] *See supra* Part III.

[143] *See supra* notes 121-24 and accompanying text.

[144] *See supra* Part IV.

[145] Strine, *supra* note 127, at 1769.

[146] This article does not take a position on whether allowing shareholders to nominate directors would be advisable to help address broader corporate governance

important to note that none of the critics have defended the existing pay-setting *process*, except by claiming that arm's length negotiations by a divided and adversarial board could be even worse.[147] Even a prominent critic of the managerial power thesis implicitly admitted that the process is seriously flawed when he made the following concession:

> Judgment calls tend systematically to favour the CEO. Faced with a range of market data on competitive pay levels, committees tend to err on the high side. Faced with a choice between a sensible compensation plan and a slightly inferior one favoured by the CEO, the committee will defer to management. . . . The amounts at stake in any particular case are typically trivial from a shareholder's perspective, but the overall impact of the bias has likely contributed to the ratcheting of pay levels [described in this article].[148]

B. Adopting a System of Prudent Reform

1. Characteristics of Prudent Reform

What then should be done? In view of the uncertainty regarding the extent of excessive pay, as well as the risks associated with adopting radical changes to corporate governance, reformers should strive to adopt a prudent approach that addresses the process problems without simultaneously creating new problems. Prudent reform would have five distinct characteristics. First, it would insert into the compensation-setting process parties who are immune to CEO pressure and responsive to shareholder concerns. Second, it would address compensation process flaws in a targeted way, with minimal spill-over into other areas of corporate governance. In other words, it would not fundamentally alter the existing balance between directors and shareholders, or jeopardize the collegiality of many well-functioning boards. Third, it would provide a substantial enough improvement over the existing system to justify its adoption. It would further the interests of shareholders, while being mindful of the limits and possible disadvantages, discussed above, of direct shareholder involvement. It would avoid imposing on shareholders demands that exceed their expertise or costs that exceed

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concerns. It simply argues that shareholder nominations may constitute too strong a remedy if the primary concern is executive compensation.

[147] *See supra* note 119 and accompanying text.

[148] Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2518 (Orley Ashenfelter & David Card eds., 1999).

expected benefits, and it would involve shareholders only to the extent likely to promote the long-term interests of the corporation. Fourth, prudent reform would be achievable with minimal changes to existing law, a particularly important characteristic since one could expect that powerful members of the business lobbying community would strongly resist significant legal changes that might be viewed as impinging on power of directors or threatening the pay of CEOs.[149] Finally, prudent reform would be flexible. Rather than requiring significant changes to all firms, irrespective of individual circumstances, it would allow arrangements to be tried in the marketplace and vindicated or discredited by the market itself.[150]

2. The "Compensation Representative"

Bearing in mind the foregoing principles for prudent reform, this article proposes that shareholders of those corporations with excessive CEO pay should amend corporate bylaws to create a special non-executive position, tentatively entitled "compensation representative," to represent the interests of shareholders with respect to CEO compensation. The amended bylaw could provide that the three largest eligible shareholders of the corporation, acting by consensus, would appoint the compensation representative. If they are unable to agree on a candidate, they may submit the decision to a neutral arbitrator of their choosing. In order to be eligible to participate in the appointment of the compensation representative, a large shareholder must: (i) have held its shares for at least one year; and (ii) not have material business

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[149] A case in point is provided by the modest reforms that the SEC proposed in 2003 in order to enhance shareholder nomination rights in limited circumstances. *See* Security Holder Director Nominations, 68 Fed. Reg. 60784 (Oct. 23, 2003) (codified at 17 C.F.R. pts. 240, 249, 274). The negative reaction by the Business Roundtable and other lobbying organizations was decisive. According to the SEC staff, "The vast majority of commentators supported modifying the proxy rules and regulations related to the nomination and election of directors. Commentators who did not support such a modification included all of the corporations and corporate executives, most of the legal community, and the majority of associations (mostly business associations)." SEC Div. of Corp. Fin., Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors (July 15, 2003), *available at* http://www.sec.gov/news/studies/proxyrpt.htm. The reforms were ultimately not adopted.

[150] Prudent reform would not set a ceiling on CEO pay, whether in absolute terms or as a multiple of worker salaries. If, as some commentators claim, high CEO pay results from the limited supply of exceptional CEOs and their legitimate use of the resulting bargaining power, a corporation should not be restricted from awarding appropriately high compensation.

dealings with the company, other than in its capacity as a shareholder. Finally, to help guard against opportunistic behavior, both the appointing shareholders and the compensation representative would be required to sign an agreement with the company requiring them to fulfil their duties under the system in the interests of the shareholders as a whole.[151]

a. *Rights and Duties of the Compensation Representative*

Compensation representatives would not have the right to vote either as members of the compensation committee or the board of directors. They would not be authorized to manage the business or affairs of the corporation. Their rights and duties would instead be limited to the following: (i) to attend all compensation committee meetings (formal or informal), as well as all board of director meetings, to the extent such board meetings concern CEO compensation matters; (ii) to inspect all documents relating to CEO compensation; (iii) to demand compensation-related information from compensation committee members, compensation consultants, and other board members; (iv) to advise and give opinions on CEO compensation matters, including its form, amount, conditions for receipt, and timing; (v) to submit to compensation committees any objections to proposed compensation plans, and, in the event that the full board participates in the determination of CEO compensation, to submit objections to the full board; and (vi) finally, if unsatisfied with the response of compensation committees or boards, as the case may be, to submit objections to the shareholders that appointed them. Following receipt of a compensation representative's objections, an appointing shareholder could take any action thereon which it saw fit. For example, one or more of the appointing shareholders could meet with members of the compensation committee to learn more about the reasons for the proposed compensation package and to discuss ways in which it might be improved. In extreme cases, as discussed below, an objecting shareholder could force the corporation to include in its proxy a proposal to reject any

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[151] For a discussion of other protections against possible conflicts of interest between appointing shareholders and other shareholders of the corporation, see *infra* notes 158-60 and accompanying text.

portions of the compensation package submitted for shareholder approval. It could also force the corporation to include in the proxy pay-related precatory proposals, in which the shareholders formally recommend that the board take certain actions without purporting to require that the board do so.[152]

b. Advantages of a Compensation Representative System

There are numerous advantages to the compensation representative system over either the current system or the reforms proposed by Bebchuk and Fried. First and foremost, the use of a compensation representative would address the most serious process problem raised by Bebchuk and Fried—the current failure of boards to adequately represent the interests of shareholders. It would insert into the compensation process a party who is beholden not to the CEO, but to the shareholders. Since the compensation representative would not be nominated or appointed by the board or CEO, he or she would be less susceptible to managerial power than are directors under the current system. Moreover, the large shareholders that appointed the compensation representative would have a sufficient stake in the corporation to ensure that the representative would be accountable to the shareholders; and representatives who wish to be repeat players would have a strong incentive to develop a reputation for protecting shareholder interests.

The compensation representative proposal is preferable to Bebchuk and Fried's proposals, since it is a targeted response to the specific problem of CEO compensation. Its effects would not spill over into other matters, since the role of a compensation representative would be limited to investigating and advising on compensation matters, and would not extend to the management of the corporation's affairs. This limited role ensures that the use of a compensation representative would not substantially alter the traditional balance of power between a corporation's board and its shareholders.[153] It also would enable a compensation

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[152] *See infra* notes 166-88 and accompanying text.

[153] Presumably, Bebchuk for one would not view this limited role as a virtue, since he feels that granting shareholders greater rights would benefit corporate governance more generally. *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing*

representative, who would not be a board member, to be tough with the CEO without sacrificing board collegiality. The representative could serve as the "bad guy," making it easier for the board to take a harder line with the CEO. Rather than telling the CEO, "Bob, we don't think you're worth that much," a board with a compensation representative could say, "Bob, we'd love to grant you the additional one hundred thousand options—and we really think you deserve it—but if we do, that S.O.B. is going to make a big stink about it, and the publicity would be bad for all of us."

One might argue that a compensation representative provides no improvement on the current system. After all, shareholders are already entitled to vote on significant portions of most compensation packages.[154] However, a system that merely allows shareholders the right to reject an inappropriate proposal is clearly inferior to one that could prevent the board from submitting the inappropriate proposal in the first place. A compensation representative could become engaged in the details of the compensation package early in the process. He or she would be in a position to detect manipulation, excess, or potential CEO windfalls from the outset, before the compensation committee or the board presents its recommendation to the shareholders. Take an example in which a huge bonus is conditioned upon the CEO's achievement of certain objective goals. A diligent compensation representative would be better able than shareholders to judge whether the goals could be achieved easily or only through extraordinary CEO performance. He or she could encourage the compensation committee to adopt demanding goals and could otherwise influence the details of the package to ensure the alignment of pay with performance, all prior to the shareholder vote. Furthermore, a compensation representative certainly would be better able than shareholders to detect and object to egregious practices such as the backdating of option grants.

Another advantage to a compensation representative system is that compensation representatives would likely become repeat players, working with more companies than

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Shareholder Power, 118 HARV. L. REV. 833, 865-70 (2005) (arguing that shareholder value would be increased if shareholders were allowed to initiate changes in the corporate charter, to nominate board members, to change the company's state of incorporation, and to initiate mergers and similar transactions).

[154] *See supra* notes 53-56 and accompanying text.

even the most active and sought after board member. Over time, they could develop expertise, market knowledge, and insight into the proper design of compensation packages, as well as into the way such packages can be manipulated. Thus, compensation representatives could not only benefit the shareholders, but they could also educate the compensation committee and board of directors on compensation best practices, thereby alleviating another problem identified by Bebchuk and Fried, the limits on the time and information available to independent directors.[155]

The early involvement of a compensation representative would also benefit shareholders in those (hopefully rare) instances where the inclusion of a shareholder proxy proposal became necessary. Currently, as mentioned above, when shareholders vote on a compensation scheme, they are not generally provided with an alternative to the board's proposal, and may therefore feel compelled to approve inappropriate arrangements.[156] If, however, a shareholder were to respond to the compensation representative's objections by including a proxy proposal under Rule 14a-8 of the Securities Exchange Act of 1934, the shareholder would have 500 words in which to state not only its objection to the board's proposal, but the material terms of the recommended alternative pay arrangement, thereby providing a real alternative to the board's proposal.[157] Regardless of whether the general shareholders ultimately accepted the shareholder proposal, its very inclusion in the proxy could encourage directors to be more transparent regarding executive pay, since they would need to clearly justify their proposed arrangements in response to the specific objections set forth in the shareholder proposal.

What about the potential dissention and conflict among participating shareholders? Since neither the compensation representative nor the appointing shareholders would be engaged in the management of the corporation, the likelihood of significant conflict among shareholders would be small. All shareholders would benefit proportionally if a compensation representative either lowered CEO pay, enhanced CEO performance, or both.[158] However, if a conflict were to arise

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[155] PWP, *supra* note 4, at 36-37.

[156] *See supra* note 57 and accompanying text.

[157] 17 C.F.R. § 240.14a-8(c), (d) (2005). For details regarding the use of Rule 14a-8, see *infra* notes 166-74 and accompanying text.

[158] Anabtawi, *supra* note 128, at 593.

between long and short term shareholders, the proposal set forth in this article specifically favors long term shareholders, since only shareholders who have held their shares for at least one year could participate in the appointment of the compensation representative. Likewise, conflicts between insiders and outsiders would be resolved in favor of outsiders, since shareholders with material business dealings with the corporation could not participate in the appointment of the compensation representative.[159]

What if a shareholder wished to use the compensation representative to sabotage the corporation for private gain? Imagine, for example, that Company S, the largest shareholder of Company A, owns one percent of Company A, as well as twenty percent of Company B, a competitor of A. What if Company S tried to appoint an unduly aggressive and confrontational compensation representative in order to force the CEO of A to resign, to the detriment of Company S's investment in Company A, but to the much larger benefit of its investment in Company B? Or imagine scenario two, in which Company S tried to use the compensation representative to force Company A to acquire Company B at an excessive price, enabling Company S to capture a large premium on its investment in Company B sufficient to offset the loss on its smaller investment in Company A? Finally, imagine scenario three, in which Company S, a large financial institution, manages Company A's very profitable pension program. What if Company S hesitated to appoint a hard-nosed compensation representative, for fear of jeopardizing its relationship with the CEO of Company A?

The proposal set forth in this article presents significant hurdles to all three scenarios. As to scenario one, even if a shareholder wanted to use the compensation representative to force the resignation of a valuable CEO, it could not likely convince the other two appointing shareholders to appoint such a representative. If a bad faith compensation representative threatened to contest the board's compensation proposal unless his or her demands were met, the threats would ring hollow,

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[159] *See* Parthiban David et al., *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200, 205 (1998) (an empirical study indicating that institutional investors that have merely an investment relationship with the firm influence compensation in accordance with shareholder preferences, but that institutional shareholders that depend on the firm for their own business have no such influence).

since unreasonable proxy proposals would likely be rejected by the full shareholder vote.[160] A shareholder's attempt to effect scenario two would be subject to the same difficulties as scenario one. In addition, the shareholder in scenario two would be stymied by the fact that a compensation representative cannot engage in the management of the corporation, making it difficult for the representative to pressure the corporation to take specific actions, such as a merger. Finally, as for scenario three, the use of a lap-dog compensation representative would be no worse than the current system, in which the board makes its decision without the input of any shareholder representative. In any event, the precise scenario described could not occur, since shareholders with significant commercial dealings with the corporation would be excluded from the appointment process.

c. A Compensation Representative System is Feasible Under Existing Law

Assuming that the proposal set forth in this article would, if implemented, benefit shareholders, is it feasible under existing law? Very much so. In fact, as described below, it could be implemented in Delaware without the active involvement of courts, legislatures, or, perhaps most importantly, company boards.[161] Under existing Delaware corporate law, a company's bylaws would simply need to be amended to grant the three eligible shareholders the right to appoint a compensation representative having the rights and duties described above. In Delaware, this bylaw amendment could be effected by either the board of directors or the shareholders. Under Section 109(a) of the Delaware General Corporation Law, the power to adopt, amend, or repeal the bylaws is held by the shareholders, provided that the certificate of incorporation may confer such power on the board.[162] But "[t]he fact that such power has been so conferred upon the

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[160] Rule 14a-8 would allow Company S to include the same compensation-related proxy proposals whether or not the company has a compensation representative. The participation of a bad faith compensation representative would add little to the threat posed to the CEO from such a proposal.

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

[162] DEL. CODE ANN. tit. 8, § 109(a) (2001).

directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws."[163] The Revised Model Business Corporation Act provides both boards and shareholders with similar rights to amend bylaws.[164] Under the reasonable assumption that most boards would not unilaterally propose such a bylaw amendment, shareholders who meet certain rather easy eligibility requirements[165] may, under SEC Rule 14a-8 of the Securities Exchange Act of 1934, compel the corporation to include it in its proxy.[166]

Rule 14a-8(i) provides, however, that a company may exclude a proposal from its proxy "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."[167] Recently, Professor Bebchuk has attempted to use Rule 14a-8 to propose that CA, Inc. (formerly Computer Associates International, Inc.) amend its bylaws to limit the board's ability to issue poison pills.[168] Such proposals, however, are subject to the objection that they conflict with Section 141(a) of the Delaware General Corporation Law, which provides: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[169] Indeed, the conflict with Section 141(a) was the stated reason that the board of CA, Inc. refused to include the proposal in its proxy. Neither the SEC nor the

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[163] *Id.*

[164] Article 10.20(a) of the RMBCA provides that "[a] corporation's shareholders may amend or repeal the corporation's bylaws." Article 10.20(b) permits the board of directors to amend or repeal the bylaws as well, but gives shareholders the final word, since the board may not amend or repeal bylaws if "the shareholders in amending, repealing, or adopting a bylaw provide that the board of directors may not amend, repeal, or reinstate that bylaw. *See* REVISED MODEL BUS. CORP. ACT § 10.20(b)(2) (2003).

[165] Under Rule 14a-8(b), in order to be eligible to submit a proposal, a shareholder must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date the shareholder submits the proposal, and must continue to hold those securities through the date of the meeting.

[166] SEC v. Transamerica, 163 F.2d 511 (3d Cir. 1947).

[167] 17 C.F.R. § 240.14a-8(i) (2006).

[168] *See* Bebchuk v. CA, Inc., 902 A.2d 737, 738 (Del. Ch. 2006).

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

Delaware courts have expressed an opinion on the merits of the board's refusal; the former refusing to grant a no-action letter pending the resolution of the matter under Delaware law,[170] and the latter refusing to decide the matter on ripeness grounds.[171] The Oklahoma Supreme Court, however, when interpreting provisions of its corporate code which are substantially identical to those of Delaware, held in a similar case that the shareholders may propose a bylaw to require shareholder approval for the issuance of poison pills.[172]

In any event, an adverse ruling on Bebchuk's CA, Inc. proposal would not seem to cast doubt on the legality under Delaware law of a compensation representative bylaw, since the two bylaws could be clearly distinguished. Delaware General Corporation Law provides that bylaws "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."[173] Unlike Bebchuk's proposed bylaw, a bylaw merely calling for the appointment of a compensation representative could not be said to conflict with Section 141(a), since the representative would be explicitly precluded from managing the business or affairs of the corporation. Neither would the bylaw conflict with articles of incorporation that explicitly grant the compensation committee or the board of directors the authority to determine officer and director compensation. After all, the compensation representative would not be a member of either the compensation committee or the board, nor would he or she have the authority to vote on the actual compensation being proposed. He or she would merely represent the interests of shareholders and call to their attention compensation plans that shareholders might find objectionable. The legality of a bylaw calling for a compensation representative is further strengthened by Section 141(h), which permits corporations to use bylaws to restrict the compensation of directors.[174]

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170 Sullivan & Cromwell LLP, SEC No-Action Letter, 2006 WL 1547985, at *1 (June 5, 2006).

171 *Bebchuk*, 902 A.2d at 737.

172 *See* Int'l Bd. of Teamsters Gen. Fund v. Fleming Co., 975 P.2d 907, 908 (Okla. 1999).

173 DEL. CODE ANN. tit. 8, § 109(b) (2001).

174 "*Unless otherwise restricted by the certificate of incorporation or bylaws*, the board of directors shall have the authority to fix the compensation of directors." *Id.* § 141(h) (emphasis added).

Another possible hurdle to the use of bylaws to adopt compensation representatives might be found in Rule14a-8(i)(8), which allows companies to exclude from the proxy a proposal which relates to an election to "the board of directors or analogous governing body." Apart from the obvious fact that a compensation representative is not a board member and does not otherwise have the right to govern the affairs of the company, the ability of companies to use Rule 18a-8(i)(8) to exclude shareholder proposals has been weakened by the recent Second Circuit holding in *American Federation of State, County & Municipal Employees v. American International Group, Inc*.[175] The court held that a shareholder proposal to require that AIG include certain shareholder board nominees on the corporate ballot under Rule 14a-8 could not be excluded from the corporate proxy materials.[176] The court rejected the SEC's interpretation of its own rule, holding that, although Rule 14a-8(j)(8) would allow a corporation to exclude specific nominees from an election, it would not allow it to exclude a bylaw proposal to permit shareholder nominees to be included on the corporate ballot in the future.[177] *A fortiori*, a company should not be able under Rule 14a-8(i)(8) to exclude a resolution relating to a mere compensation representative.

Once the bylaw has been approved by the shareholders, no further legal issues should arise unless and until a compensation representative objects to the board's compensation plan and a shareholder submits a proxy proposal calling on the shareholders to reject it. If the proxy proposal concerns a portion of the plan that is subject to a shareholder approval, there should be no legal hurdles to the proxy proposal, since the proposing shareholder would simply be exercising its right under the securities law. Thus, for example, a shareholder could include a proxy proposal to reject an equity-based compensation plan, since the listing rules of both the New York Stock Exchange and NASDAQ require that the shareholders approve any such plan.[178] Similarly, a shareholder could include a proxy proposal regarding any individual's compensation in excess of $1 million for which the

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[175] Am. Fed'n of State, County, & Mun. Employees v. Am. Int'l. Group, Inc., 462 F.3d 121 (2d Cir. 2006).

[176] *Id*. at 123.

[177] *Id*. at 127.

[178] *See supra* notes 53-54 and accompanying text.

corporation wished to claim a deduction under § 162 (m) of the Internal Revenue Code.[179]

More problematic would be a shareholder proxy proposal that purported either (i) to reject other portions of a compensation plan for which neither the tax law nor the exchange rules requires a shareholder vote, or (ii) to compel the corporation to adopt a specific compensation plan that had not already been proposed by the board. Whether or not a corporation could exclude such proxy proposals would depend upon state corporate law since, as discussed above, Rule 14a-8 allows a corporation to exclude any proposal that is invalid under the law of the corporation's jurisdiction of organization.[180]

Therefore, the legality of a proposal to reject, for example, cash compensation under $1 million would depend in Delaware on whether the corporate charter or bylaws permitted the shareholders to approve officer and director compensation in such a case. Certainly, a corporation could amend its charter to require such a vote. Under Delaware law, however, any charter amendment must be first initiated by the board, following which the shareholders must approve it.[181] It seems unlikely that many boards would unilaterally initiate charter amendments that subject their compensation decisions to a shareholder vote. As for bylaw amendments, their terms are generally subordinate to contrary provisions in the charter.[182] Thus, a shareholder could probably only initiate a bylaw amendment to require a shareholder vote on executive compensation if the charter contained no contrary provision.[183]

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

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[179] *See supra* notes 54-56 and accompanying text.

[180] *See supra* note 167 and accompanying text.

[181] DEL. CODE ANN. tit. 8, § 242(b) (2001).

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

[183] But, in view of the potential conflict of interest, it is not inconceivable that a court in equity could give preference to the bylaws. *See* Gow v. Consol. Coppermines Corp., 165 A. 136, 138-42 (Del. Ch. 1933) (holding that a bylaw determining the number of directors prevails over a contrary clause in the charter).

committees satisfying criteria specified by the relevant exchange.[184]

Although a corporation could exclude a proxy proposal to reject certain portions of a pay package or to compel the board to adopt a particular compensation plan, a shareholder could still require the company to include a non-binding, or "precatory" proxy proposal.[185] Some may be skeptical of the effectiveness of precatory proposals, since they have tended not to garner significant shareholder support. A study of such proposals in the 1994 proxy season conducted by Randall Thomas and Kenneth Martin found that precatory proposals relating to compensation garnered, on average, support of only 12.8%.[186] However, precatory proposals submitted on the recommendation of the compensation representative should have greater credibility among shareholders than have past precatory proposals, which were often made by shareholders, such as unions or governmental actors, who held non-financial objectives. Another empirical study by the same authors relating to the 1993-1997 proxy seasons found that "shareholders are statistically more likely to support executive compensation proposals that raise corporate governance issues than those that raise social responsibility issues."[187] Still, one might wonder whether, if a precatory proposal were to pass, the board would act on it, since it has no legal obligation to do so. Yet Thomas and Martin's study found that in the two-year period following the inclusion of compensation-related precatory proposals, total compensation declined by a statistically significant average of $2.7 million, although not a single proposal they studied actually passed.[188] One can expect

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184 *See*, *e.g*., NYSE Listed Company Manual Rule 303A.05(a), http://www.nyse.com/lcm (follow the "Click here to open the NYSE Listed Company Manual" hyperlink, the "Section" hyperlink, the "Section 3 Corporate Responsibility" hyperlink, the "Section 303A Corporate Governance Standards" hyperlink, and the "Section 303A.05 Compensation Committee" hyperlink) (last visited Nov. 8, 2006).

185 Since precatory proposals are not binding on the board, they are not deemed by the SEC to conflict with the requirement that the board have the authority to manage the affairs of the corporation. "In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 41 Fed. Reg. 52,994, at *7 (Dec. 3, 1976).

186 Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41, 68 (1998).

187 Thomas & Martin, *supra* note 57, at 1022.

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

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

d. Flexibility of Compensation Representative System

As discussed above, one advantage of implementing the compensation representative system by bylaw is that it would obviate the need for new legislation.[189] A related advantage to case-by-case implementation is flexibility, especially since the extent of the CEO compensation problem may vary greatly by firm.[190] For example, at some firms, such as those controlled by a large independent shareholder, executive compensation may not be a serious issue, and the controlling shareholder may have the means and motivation to monitor executive compensation better than could a compensation representative. Indeed, empirical studies have indicated that firms with a shareholder controlling more than five percent of the shares may already be engaged in significant monitoring,[191] and that

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[189] *See supra* note 161 and accompanying text.

[190] For evidence that flexibility in matters of corporate governance improves company performance, see Sridhar R. Arcot & Valentina G. Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* (May 16, 2006) (unpublished working paper), *available at* http://www.ssrn.com/abstract=887947 (an empirical study finding that rigid adherence to "best practices" does not necessarily lead to superior performance, due to the heterogeneity of circumstances facing different companies). *See also* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002) (arguing that independent directors are not an unalloyed good, in part because different companies may require different accountability mechanisms).

[191] *See*, *e.g.*, David et al., *supra* note 159 (finding that the presence of institutional owners without significant business ties to a company is associated with lower levels of CEO pay); Donald C. Hambrick & Sydney Finkelstein, *The Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises*, 16 STRATEGIC MGMT. J. 175 (1995) (finding that the pay of CEOs at firms containing a large outside shareholder was tied significantly more strongly to profitability than was the case at firms without such a shareholder).

the doubling of the percentage holdings of large outside shareholdings is associated with a twelve to fourteen percent drop in CEO pay.[192] Shareholders of such a firm might see no benefit to adding an additional layer of bureaucracy on top of an already well-working system.[193]

On the other hand, shareholders of an underperforming firm that is dominated not by an outside shareholder, but by an unresponsive CEO and his or her complicit board of directors, may find that the executive compensation system lies at the heart of the company's problems. They may discover that the introduction of a compensation representative both captures the attention and increases the accountability of the CEO and the board, to the substantial benefit of shareholders.

In short, rather than mandating a procrustean system that could lead to unforeseen negative effects, the proposal set forth in this article would give shareholders, the intended beneficiaries of the new system, the ability to determine for themselves whether its adoption addresses their concerns. If it does, the system will likely be adopted by numerous corporations, and may evolve into corporate best practice. Indeed, if it became widely adopted, its benefits could subsequently be reflected in law. For example, courts could adopt a different standard of review of executive compensation depending upon whether a compensation representative was involved. Compensation plans involving a compensation representative could continue to enjoy the deferential waste standard or could be entirely immunized from judicial review, while plans adopted without such involvement could be subjected to a stricter scrutiny. Alternatively, state corporate law could be amended to provide for compensation representatives in all cases, unless a company's articles of incorporation explicitly opted-out of the system.[194] If, on the

[192] Richard M. Cyert et al., *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453 (2002), *quoted in* Bebchuk & Fried, *supra* note 7, at 660.

[193] Ironically, since Bebchuk and Fried's proposal gives nomination rights only to shareholders holding five percent or more of the company's shares, the only companies impacted by their proposal would be the very companies which, statistically at least, are least likely to have compensation problems.

[194] In a similar development, shareholder proposals seem to be affecting statutory law relating to the election of directors. Currently, under the Delaware General Corporation Law and the Model Business Corporation Act, a nominee need only receive a plurality of shareholder votes to be elected to the board. Recently, however, numerous corporations have received shareholder proposals to require the resignation of directors who receive less than a majority vote. In response, the

other hand, the use of compensation representatives provided no material shareholder benefit, additional corporations could refrain from adopting it, and those which had adopted it could repeal it by a simple shareholder vote, without the need for legislative or judicial action.

VI. RESPONSES TO POTENTIAL OBJECTIONS

This article concludes by addressing a few possible objections to the compensation representative proposal. One objection might be that another layer of corporate bureaucracy is unnecessary, since most companies already have a compensation committee, along with a compensation consultant, to advise them. But as pointed out by Graef Crystal, a compensation consultant and long-time critic of executive pay, the presence of a compensation consultant is no panacea.[195] Quite the contrary:

> Ostensibly, compensation consultants were hired by the CEO to perform an objective analysis of the company's executive pay package and to make whatever recommendations the consultant felt were appropriate. In reality, if those recommendations did not cause the CEO to earn more money than he was earning before the compensation consultant appeared on the scene, the latter was rapidly shown the door. I learned this fact of life early on . . . .[196]

One might argue that Crystal's description no longer applies, since the listing rules of the New York Stock Exchange now require companies listed thereon to: (i) have a compensation committee "composed entirely of independent directors;" and (ii) have a written charter that gives the compensation committee "sole authority to retain and terminate" any compensation consultant employed by the company.[197] The mere fact, however, that a member of the compensation committee is independent for purposes of the exchange listing rules does not address another major problem with compensation consultants: the possibility of other, much

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Committee on Corporate Laws of the American Bar Association Section of Business Law has recently approved changes to the Model Business Corporation Act which would permit, among other things, the irrevocable resignation of a director who receives less than a specified shareholder vote. *See Changes in the Model Business Corporation Act – Proposed Amendments to Chapters 8 and 10 Relating to Voting by Shareholders for the Election of Directors*, 61 BUS. LAW. 399, 421-23 (2006).

[195] GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 218 (1991).

[196] *Id.*

[197] Commentary to NYSE Listed Company Manual Rule 303A.05(b)(ii).

larger contracts between the consultant and the company. These contracts would be managed by the company's human resources department, under the control of the CEO rather than the compensation committee. Consultants would likely be very chary of jeopardizing these contracts by taking a tough line on CEO pay. Hewitt Associates, a compensation consultant for Verizon Communications, provides a real-life example of the problem. In its role as compensation consultant, it reports to the compensation committee of the board. However, in its other consulting roles, it reports through the corporate hierarchy, and ultimately to the Verizon CEO. In 2005 it assisted the compensation committee in devising a CEO pay package worth $19.4 million, a forty-eight percent increase over that of 2004.[198] Without passing judgment on whether such an increase was justified, in view of the twenty-six percent decline in Verizon stock over the same period, the fact that, since 1997, Hewitt Associates has received more than half a billion dollars in consulting revenue from Verizon and its predecessor companies does call into question its independence.[199] One suspects that a compensation representative appointed by the major shareholders might have viewed such a pay package differently than either the compensation committee or its compensation consultant did.

Other skeptics of compensation representatives might contend that it is unfair to give the three largest eligible shareholders a right not available to the other shareholders, that is, the right to appoint the representative. The large shareholders, however, would be entitled to appoint the representative only if the majority of the shares voted to grant them that right. There is no obvious reason to paternalistically deny shareholders the right to vote in line with their perceived best interests, especially since, as stated above, Delaware law allows the bylaws to contain any provision relating to the affairs of the corporation as long as the provision is not contrary to law or the company's certificate of incorporation.[200]

In any event, there is a practical reason to place the right to appoint the representative in the hands of large shareholders; namely, there is no good alternative. Even if the representative were appointed by a vote of all the shareholders,

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[198] Gretchen Morgenson, *Gilded Paychecks: Troubling Conflicts; Advice on Boss's Pay May Not Be So Independent*, N.Y. TIMES, Apr. 10, 2006, at A1.

[199] *Id*.

[200] *See supra* note 173 and accompanying text.

someone would first have to nominate the candidate. Giving the nomination right to the board would defeat the purpose of employing a compensation representative, since the representative would then be neither more nor less accountable to the shareholders than are other board members, who are also nominated by the board and elected by the shareholders. If every shareholder, regardless of the size of its holdings, were permitted to nominate a candidate, shareholders with only a small economic stake in the corporation might abuse the compensation representative to further their own political or other non-financial agenda. If only those shareholders who held, say, five percent of the outstanding shares were allowed to nominate, compensation representatives could never be nominated for companies which did not have any large shareholders—precisely the sort of companies in which, as discussed above, a compensation representative could be most useful. Also, if there were multiple five percent shareholders who each nominated competing candidates, smaller shareholders would have difficulty making an informed decision among them.

One possible solution to this problem would be to permit the three largest eligible shareholders jointly to nominate a single candidate, subject to the approval of the shareholders. But since the purpose of adopting the compensation representative system would be to ensure the appointment of a party independent of the board of directors, the board could not be allowed to nominate an alternative. As a result, the shareholder vote would devolve into the empty formality of electing a candidate without opposition. Having said that, if shareholders wanted to include a voting procedure into the bylaw adopting compensation representatives, there is no obvious policy reason (other than a desire for simplicity) to prohibit it.

Other skeptics might argue that, although a bylaw implementing a compensation representative system can be adopted by a mere shareholder vote, in fact, shareholders will not approve proxy resolutions opposed by management. After all, it may be contended, large shareholders vote overwhelmingly with management.[201] Pension funds may support management, in part at least, in order to secure

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[201] This concern was part of the motivation behind the SEC's decision in 2003 to require mutual funds and investment advisors to disclose their actual proxy votes. *See* 17 C.F.R. §§ 239, 249, 270, and 274 (2003).

business with the company.[202] Other large investors may be motivated by a desire to gain privileged access to information.[203] Neither type of investor, it might be argued, would likely sacrifice these benefits for the sake of a compensation representative system. However, substantial shareholder benefit can be achieved even if only a small percentage of companies actually adopt the bylaw, particularly if, as one might expect, the adopting companies are the very ones with the most egregious pay arrangements.[204] Not only would the bylaw help to rectify pay practices at the most objectionable companies, but it might have an *in terrorem* effect, encouraging CEOs at other companies to moderate their own pay demands.

Finally, some might suspect that, even if the bylaw were to pass, large shareholders would not be willing to participate in the compensation representative system, since the costs to such shareholders would exceed the benefits. The total costs to participating shareholders, however, would be trivial. Out-of-pocket costs would be close to zero, since fees for the compensation representative would be paid by the corporation. Likewise, the costs of searching for an appropriate representative should be quite low, particularly for institutional shareholders that repeatedly appoint the same representatives for the various corporations in their portfolio. Costs in time and effort should also be low, since the actual tasks relating to reviewing, discussing, and, if necessary, amending the compensation plans would be delegated to the compensation representative. The only significant task required of participating shareholders would be to respond in those limited instances in which a compensation representative has objected to the board's final compensation determination.

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[202] *See* Gerald F. Davis & E. Han Kim, *Would Mutual Funds Bite the Hand that Feeds Them? Business Ties and Proxy Voting* 2 (Feb. 15, 2005), *available at* http://www.ssrn.com/abstract=667625 (revised Jan. 18, 2006) (studying proxy votes of mutual funds, and finding a "positive relation between the volume of pension business a fund company does and its propensity to vote with management" on corporate governance issues).

[203] *See* Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233, 236 n.8 (2000).

[204] A recent empirical study of shareholder proposals between the years 2000 and 2004 has indicated that proposals relating to executive compensation have received less support than those relating to poison pills or board declassification. Still, proposals relating to executive compensation received majority support at 6.4% of the applicable corporations in 2003, although, as mere precatory proposals, they were non-binding on the board. *See* Jason M. Loring & C. Keith Taylor, *Shareholder Activism: Directorial Responses to Investors' Attempts to Change the Corporate Governance Landscape*, 41 WAKE FOREST L. REV. 321 (2006).

VII. CONCLUSION

Given the low costs to participating shareholders, even modest benefits would be sufficient to justify the use of compensation representatives. In fact, the potential benefits to shareholders could be significant. First, compensation representatives would provide a means of objectively evaluating whether a CEO's pay is excessive. When they find that a pay package is inappropriate, compensation representatives could suggest improvements to the package before it is even submitted to the board. Thus, they would be more efficacious than the newly mandated disclosure rules, which merely require corporations to better inform shareholders about a *fait accompli*. Second, if the use of a compensation representative led to lower CEO pay at a given company, one could expect the pay of other high-ranking executives at the company to decrease proportionally—hardly a trivial consideration when the top five executives are receiving 9.8% of all corporate earnings.[205] Third, oversight by compensation representatives could improve the alignment between executive pay and performance, thereby potentially enhancing shareholder returns by reducing agency costs. Fourth, even if compensation representatives brought only minor benefits for any individual company, they could, if widely employed, provide substantial benefits to diversified institutional investors, which could enjoy lower executive pay and better alignment between pay and performance for each company in their portfolios. Finally, compensation representatives could have a substantial prophylactic benefit for investors. At a bare minimum, they could help put an end to the "ratcheting effect" by which CEO pay might otherwise continue indefinitely to increase without obstruction. This possibility alone should be enough to encourage investors to consider introducing compensation representatives, a prudent solution to excessive CEO pay.

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[205] *See* Bebchuk & Fried, *supra* note 7.