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Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"

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Jeffrey N. Gordon*

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ABSTRACT

High levels of executive compensation have triggered an intense debate over whether compensation results primarily from competitive pressures in the market for managerial services or from managerial overreaching. Professors Lucian Bebchuk and Jesse Fried have advanced the debate with their recent book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, which forcefully argues that current compensation levels are best explained by managerial rent-seeking, not by arm's-length bargaining designed to create the optimum pay and performance nexus. This paper expresses three sorts of reservations with their analysis and advances its own proposals. First, enhancing shareholder welfare is not, as a positive or normative matter, a sufficient

* Alfred W. Bressler Professor of Law, Columbia Law School. Contact at jgordon@law.columbia.edu. This paper benefited from presentations at the Columbia University Symposium on Executive Compensation, a Columbia Law School Faculty Workshop, a conference at Washington University (St. Louis) Law School, and from comments by Lucian Bebchuk, Brian Cheffins, Jack Jacobs, Scott Hemphill, Bevis Longstreth, Mark Roe, and Leo Strine. I appreciate the research assistance of Nicolas Diefenbacher, Waqaas Fahmawi, and Michael Horwitz.

framework for understanding the controversy or devising a remedy. Second, many of the compensation practices identified by Bebchuk and Fried as veritable "smoking guns" of managerial power may have benign explanations. Third, in improving the corporate governance apparatus in the executive compensation area, the better remedy is not a wholesale expansion of shareholder power, but a tailored series of measures designed to bolster the independence of the compensation committee. Most important, the SEC should require proxy disclosure of a "Compensation Discussion and Analysis" statement (CD&A) signed by the members of the compensation committee (or by the responsible independent directors for firms without a compensation committee). Such a CD&A ought to collect, itemize, and summarize all compensation elements for each senior executive, providing bottom line analysis and then a justification by the compensation committee of the compensation paid. This process of "ownership," reputation-staking, and publicity will strengthen the committee's hand against managerial pressure and will elicit both shareholder and public responses that necessarily contribute to the compensation bargain. In addition, serious thought should be given to a shareholder approval vote on the CD&A, following the new United Kingdom practice.

I. INTRODUCTION

There is a clear thesis in *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* by Lucian Bebchuk and Jesse Fried. It is that the high levels of executive compensation are explained by managerial rent-seeking, not by arm's-length bargaining designed to create the optimum pay and performance nexus. The authors support this conclusion with three sorts of evidentiary claims.

First, various compensation terms, in particular non-indexed stock options, seem poorly designed for the purpose of connecting pay and performance.

Second, "camouflage"—hiding the ball from shareholders through opaque or incomplete disclosure—characterizes certain important forms of compensation that are large in amount but not linked to performance, most particularly, pension benefits and deferred compensation.

Third, various governance arrangements make it unlikely that the board will act as a good faith bargaining agent for the shareholders in an arm's-length process. There are four salient elements in the faulty governance story: (1) the CEO's influence in the selection and retention of directors, which undercuts director independence in the bargaining process; (2) in contrast, the lack of shareholder influence in the director selection process, which could otherwise buttress director independence; (3) interlocking membership among boards of directors that lead to back-scratching among business elite who share a mutual self-interest in escalating levels of executive compensation; and (4) the use of compensation consultants with disabling conflicts of interest, in particular, provision to the firm of a wide range of compensation consulting services.

In reflecting upon the Bebchuk and Fried analysis, sometimes critically, I want to be clear about the importance of the book's contribution in comprehensively setting forth the different elements of compensation packages and in raising many serious questions about compensation practices and the corporate governance institutions that have countenanced them. After reading the book, one of my colleagues commented that something certainly

seems "fishy." The question, of course, is how fishy and what to do about it.

My concerns about the book fall into three categories: first, the normative foundations of the project; second, the evidentiary case; and third, the remedy. In particular, Bebchuk and Fried have only partially captured the reason why the public is concerned about executive compensation. It is not only the alleged disconnect between pay and performance, but the absolute level, especially in relation to other social frames of value. The authors may also have overstated the evidentiary case for the pay-for-performance breakdown, since many of the practices they question may be explained, at least in part, by factors other than managerial rent-seeking.

The nub of the problem is that the "right" level and mechanism of executive compensation is not obvious. The market for executives, especially CEOs, is "thin" (not many buyers and sellers at a given moment), "lumpy" (CEO services are not divisible and they are attached to a long career built by substantial human capital investments), and relational (consisting of an extended course of performance whose objectives and measures will vary over time). Thus there will be no spot market prices that are discernable by looking up the daily stock tables. It is a "positional" market as well, in that senior managers evaluate compensation in relative terms as well as absolute levels. Thus in trying to police potential abuses in this unusual market, the remedy is key. I argue that for the large diffusely-owned public firm, we are likely to get a more satisfactory outcome through a process overseen by a compensation committee of independent directors that is required to justify compensation practices and levels as part of the firm's annual disclosure. In addition to enhanced state law fiduciary duty monitoring of appropriate process in compensation setting, I argue that the SEC should require proxy disclosure of a "Compensation Discussion and Analysis" statement (CD&A) signed by the members of the compensation committee (or by the responsible independent directors for firms without a compensation committee). Such a CD&A ought to collect, itemize, and summarize all compensation elements for each senior executive, providing bottom line analysis that is currently lacking. The CD&A should also explain why the compensation committee believes that the compensation is warranted, in light of the demands of the job, the industry, the executive's performance, and other factors deemed relevant. This process of "ownership," reputation-staking, and publicity will strengthen the compensation committee's hand against managerial pressure and will elicit both shareholder and public responses that become part of the social construction of value that is necessarily part of the compensation bargain.

In addition to the CD&A, serious thought should be given to a shareholder approval vote on the CD&A, following the new United Kingdom practice. Such a vote—an expression of shareholder views that would not formally affect any of the corporation's legal obligations—could be required by an exchange listing standard, perhaps by an SEC rule, by a change in state corporate law, by a court as a condition for obtaining business judgment review of compensation arrangements, or by a shareholder-initiated bylaw amendment for particular firms. My tentative view is that a formal advisory vote is not required because the U.S. practice of "just vote no" campaigns in director reelections could function as a substitute in cases where shareholders felt that compensation committees had not satisfactorily explained high compensation levels in a CD&A.

II. NORMATIVE FOUNDATIONS

What is the proper basis for the setting of executive compensation? Bebchuk and Fried are true believers in the desirability of the pay-for-performance nexus. As they say, "We would accept compensation at current or even higher levels as long as such compensation, through its incentives effects, actually serves shareholders."[1] They seem to suggest that the "outrage constraint" that limits managerial rent extraction would operate only where compensation practices clearly reduce shareholder value.[2] But in so doing, Bebchuk and Fried may be underplaying a significant source of the general unease over compensation—namely, the widespread feeling that levels of executive compensation are simply too high.

An illustrative example is the controversy over Harvard University's compensation of the managers of its $20 billion-plus endowment and the university's palpable embarrassment in responding to the outrage of some alumni.[3] Two particular managers each received approximately $35 million for 2003, which we know because they are the most highly paid employees of Harvard, as revealed in its tax filings. In all, the top five investment managers received approximately $100 million. For 2004, the top two managers each received approximately $25 million; the top six, approximately $80 million.[4] These are handsome salaries indeed; by comparison, the president of Harvard receives approximately $500,000. Yet there seems to be no reason to dispute the pay-for-performance nexus for these managers, much less to think that their high compensation results from their untoward influence over the worthies who sit on the Harvard Corporation. Among other things, Harvard's endowment performance has been superlative, at the very top of university endowment performance over a ten-year period, both in good markets and difficult markets.[5] The two highest paid managers delivered

1. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 8 (2004).

2. *Id.* at 64-66.

3. *See Extraordinary Bonuses*, HARV. MAG., Mar.-Apr. 2004, *available at* www.harvardmagazine.com/on-line/030422.html (summarizing the matter); *see also* Harvard Planned Giving, http://www.haa.harvard.edu/pgo/ (follow "Who Manages Your Gift?" hyperlink; then follow "HMC Annual Results Letter" hyperlink) (last visited Jan. 10, 2006) (posting letter from Harvard Management Co. describing recent performance); Zachary M. Seward, *HMC Salaries Fell Last Year*, THE HARVARD CRIMSON, Nov. 23, 2004, *available at* www.thecrimson.com/article.aspx?ref=504718 (discussing the university's response to the protesting alumni and reporting on responses by the University Treasurer, Vice President for Alumni Affairs and Development, and the head of the Harvard Management Company). Indeed, Harvard did revise its compensation formula downwards in response to the protests. For 2004 results, see Charles Stein, *Harvard Pays 2 Top Money Managers $25M Endowment's Salaries Down from Last Year; Critics Call System Lavish*, BOSTON GLOBE, Nov. 23, 2004, at D1; *Compensation Controversy, Continued*, HARV. MAG., Mar.-Apr. 2005, at 60 (comparing compensation payments and performance to benchmarks). The denouement was the 2005 departure of the Harvard investment management team for greener hedge fund pastures.

4. Some observers speculated that although the compensation of top managers declined, other managers received substantially more, since superior returns were allocated among several sectors. *See* Seward, *supra* note 3.

5. Indeed, Harvard uses the superior results to attract planned gifts. *See, e.g.*, Harvard Planned Giving, http://www.haa.harvard.edu/pgo/ (follow "Who Manages Your Gift?" hyperlink; then follow "Performance History" hyperlink) (last visited Jan. 9, 2006) (comparing performance of Harvard-managed charitable

particularly stellar results for their respective portions of the endowment, and their compensation is rigorously performance-based. Their fixed annual compensation is $400,000; additional compensation is proportional to performance above their sectoral benchmarks, and the compensation formula includes a "clawback" of previously received compensation for subpar subsequent performance to discourage excessive risk-taking.

Some alumni objected that these compensation levels were nevertheless excessive—"inappropriate, indefensible, and corrosive to the values of the University"[6]—and called for compensatory measures in financial aid and loan forgiveness. In responding to the alumni, Harvard observed that there is a robust market for successful investment managers and that the university was only meeting the market price. This claim seems validated by the well-reported moves of highly compensated superstar traders from both Wall Street firms and Harvard itself to hedge funds, which presumably are paying even more.[7] As Harvard also noted, in-house management is cheaper than the alternative, which is to outsource investment management to a firm that will pay the managers $35 million or more. This will, of course, only camouflage the high level of compensation.

The public objections to Harvard's $35 million (or $25 million) salaries are unfathomable on the Bebchuk and Fried account. Yet surely it is the absolute level, not the concern over the pay and performance nexus, that has agitated the Harvard alums. It is the absolute level of the compensation that puts Stephen Jobs and Michael Eisner on the covers of magazines. Yes, we react if pay is outsized and the performance subpar, but the public's reaction is not necessarily proportionate to—and originates in a different concern from—the shareholders' welfare.

Notice how this potentially confounds a significant part of the Bebchuk and Fried argument: what if the camouflage is designed to hide pay levels not from the board or the shareholders but from the public? If so, this undercuts their evidentiary case. Similarly, Bebchuk and Fried claim that conventional options—the ones without some sort of indexing—provide managers with "the best of high rents and low outrage."[8] Yet the huge payoffs occasionally produced by this strategy have generated considerable popular outrage and are widely cited in the reformers' case. It is not the Black-Scholes value of the options that is reported on the magazine covers but rather their realization upon exercise. Shifting to a system that tightens the pay and performance nexus could well produce more of the outrage-inspiring covers for CEOs who perform well. No matter how stellar the performance, how much is any manager worth?

The more general point is that executive compensation operates in at least two

remainder trust with market benchmark).

6. *Extraordinary Bonuses*, *supra* note 3.

7. *See Endowment Gains: Last Hurrah?*, HARV. MAG., Nov. 2004, at 56-57. On the other hand, Yale's Chief Investment Officer, who has overseen endowment returns that exceed even Harvard's over the past decade, earned less than $1 million in fiscal year 2004. *See* Jeff Muskus, *Ivies Pay Different Salaries: Investment Managers at the University Earn Less Than Their Cambridge Counterparts*, YALE DAILY NEWS, Oct. 22, 2004, *available at* http://www.yaledailynews.com/article.asp?AID=26885; *see also* Jeff Muskus, *Harvard Alums Criticize Money Managers' Salaries*, YALE DAILY NEWS, Dec. 8, 2004, *available at* www.yaledailynews.com/article.asp?AID=27656 (reporting on Yale versus Harvard comparisons in money management and compensation and Harvard alumni and faculty objections to Harvard's compensation system).

8. BEBCHUK & FRIED, *supra* note 1, at 162.

different worlds: one that focuses on maximizing shareholder value, the other that responds to concerns about the social implications of wealth and power. Strategies that may be desirable for one world may not suit the other. A system of simultaneous constraints may generate conflicting institutional results.

III. EVIDENCE

An analysis of Bebchuk and Fried's marshalling of the evidence starts with this premise: even if we assume that the exclusive consideration in setting executive compensation is shareholder welfare, we do not know, in the abstract, what the right level of executive compensation is. We have given up the medieval idea of a "just price" for market-traded goods and so too in the market for executive services. This injects a certain level of ambiguity in the interpretation of some of the evidence.

Here is a concrete problem: what is the right level of *fixed* compensation in this market? Bebchuk and Fried start with a particular conception of the pay and performance link: performance (and thus compensation) should be evaluated exclusively in terms of how much the CEO's current effort and decisionmaking adds to the value of the firm. This view assumes that the major point of compensation is to reward the current managers in accordance with their marginal revenue product. Bebchuk and Fried therefore regard high levels of fixed compensation as suspect, noting as well that such payoffs are often camouflaged through arcane pension formulas and deferred compensation. But a respectable body of labor economics sees CEO compensation as part of the prize for winning a competition, a "tournament," among other managers for the CEO job, and understands that prize, including its rewards for prior effort, as producing decades of striving among executives throughout the organization.[9] Tournaments arise in situations where it is difficult (i.e., costly) to measure exactly individual performance among a cohort of employees; instead, the firm promises to promote the "best," which is easier to determine. Employees exchange some part of their current implicit wage in exchange for the chance to compete in the next round for a better job with higher income.

9. On "tournament theory," see, e.g., Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981); Ronald G. Ehrenberg & Michael L. Boganno, *Do Tournaments Have Incentive Effects?*, 98 J. POL. ECON. 1307 (1990); EDWARD P. LAZEAR, PERSONNEL ECONOMICS 25-37 (1995). For applications to law firms, see, e.g., MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM (1991) (generally discussing tournament theory with respect to law firms); David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets Of Elite Law Firms*, 84 VA. L. REV. 1581 (1998). A popular account of tournament theory is provided in ROBERT H. FRANK & PHILLIP J. COOK, THE WINNER-TAKE-ALL SOCIETY (1995). The tournament literature is also invoked in Iman Anabtawi, Overlooked Alternatives in the Pay Without Performance Debate 33-36 (Jan. 2005) (unpublished manuscript, on file with author), *available at* http://www.law.ucla.edu/docs/213253232005anabtawi.pdf.

Tournament theory is conventionally employed to explain the internal labor market for CEOs, which might seem to make it an incomplete account of a market that looks to external candidates for approximately 25% of CEO hires. *See* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 46-47, 245 n.54 (2002). Yet if many CEOs are promoted from within and if most CEO candidates spend the substantial part of their careers at a single firm, then the tournament set-up could influence the general structure of payoffs in the relevant market.

So it is easy to imagine that an optimal CEO pay package might well consist of a large fixed payout (for prior effort) as well as an incentive-based component (for current effort), not so different, at least in form, to present arrangements. In other words, the relevant measure of performance for executive compensation is not only what the CEO delivers here and now, but how the organization performs over time because of this prize. On this view, the retirement packages and other fixed compensation elements may not have the evidentiary weight that Bebchuk and Fried suggest in showing the breakdown of arm's-length bargaining.

The prime exhibit in their case, however, is the proliferation of the conventional stock option, which they say is insufficiently performance-based. If a pay and performance nexus were truly the goal, boards would design a much better instrument that did not reward managers for general market appreciation or other windfalls; for example, an option that rewards performance net of general market returns or performance net of sector returns. They see the widespread use of incentive-defective options as evidence that boards are not bargaining at arm's-length. There are problems with this view, both at the level of theory and the counter-evidence.

A. Stock Options Critique: Theory-Based Concerns

First, the Bebchuk and Fried picture is insufficiently appreciative of performance-based possibilities using conventional stock options. Let us start with a simple example involving no stock options, such as a fixed salary of $2 million, irrespective of performance. Now add a simple provision: the contract is for a one-year term, so that compensation in the following year could increase, decrease, or, most importantly, could end if the CEO is terminated. The contingencies associated with this apparently "100%-fixed" pay package add a significant performance linkage, an important element of firm-specific option value.

Now turn to conventional options and think of the contingent elements built into such plans: the number of options the board granted this year, the number that might be granted next year, the vesting schedule for this year's grant, and then for next year's. Performance-based grants or vesting add another layer. Then there is the contingency already noted, the possibility of CEO termination, which would mean no more option grants and perhaps a forfeiture of granted but unvested options. Viewed in the light of these contingencies, the payoff from a conventional options contract begins to have a powerful firm-specific performance nexus.

Second, there may be good reasons for the board to use conventional options, apart from the historically-favored accounting and tax treatment. Drafting nonconventional options is costly, not just in the scrivener's sense but also in their uncertain incentive effects. Indexing the option price to the S&P 500 may insufficiently reward a management team in a slow-growing sector. Yet identifying the appropriate sectoral index, or fashioning one from a group of comparable companies, will be a source of negotiation, uncertainty, and potentially perverse effects, giving managers incentives to deploy assets in ways that arbitrage between the index in their options and higher growth

opportunities.[10]

Tailoring options to reward only firm-specific performance raises what might be called the Enron problem: namely, the increasing temptation to manipulate earnings as compensation becomes more sensitive to stock price performance. With conventional options, managers have incentives to increase the firm's share price but also have downside risk as well. If they cheat and get caught, they lose their participation in general market appreciation. With an indexed option, one hundred percent of the managerial upside comes from firm-specific factors; "average" performance means no payoff. Managers receive the full benefit of aggressive accounting and have less to lose if they are caught. Moreover, if we assume that managers will receive more of the indexed options to compensate them for the lost value of conventional options, then we have given managers high-powered incentives to increase the stock price by any means necessary.[11] The mitigation of this problem will impose additional monitoring costs both internal and external to the firm, and additional public enforcement costs.[12]

In short, a board bargaining at arm's-length could couple conventional options with firm-specific performance elements to create a synthetic indexed option functionally similar to Bebchuk and Fried's ideal but perhaps less subject to uncertainties of design and implementation. In other words, it may be cheaper and as effective to create an option from simple menu elements. Looking at the form of the option could lead us to

10. Some compensation consultants are skeptical about the sectoral approach, especially for smaller firms. To paraphrase one particular reaction: For Fortune 100 firms, generating a peer group for a measure of comparative performance is feasible, though controversial. For S&P 1500 firms, it's much harder.

11. Here is an example: Assume that (1) general market returns are 10% in the period, (2) without earnings manipulation the company would report "average" earnings that would yield a 10% return, but (3) with earnings manipulation the company would report "high" earnings that would yield a 15% return. With conventional options, management still gains substantially from honest reporting and only marginally from manipulation. With indexed options, management gains nothing from honest reporting but hugely from manipulation.

12. *See* Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003) (describing the strong complementarity between high-powered monitoring and high-powered incentives); *see also* John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005). Core and his colleagues defend conventional options as appropriate precisely because they deliver significant compensation not tied to the firm's performance. *Id.* at 1179. More generally, they argue that executive incentives in the United States are principally structured through "portfolio incentives" based on effects of firm performance on CEO wealth (meaning on the CEO's stock-related portfolio) rather than "pay incentives" based on the effects of firm performance on annual compensation. *Id.* at 1169-74. Thus, the "pay for performance" rhetoric may divert attention away from focusing on the sensitivity to CEO wealth to firm performance. As the CEO's ownership in the firm increases—as wealth sensitivity increases—the CEO must receive an increasing amount of cash or other compensation to offset the increasing risk. This compensation may be readily delivered through conventional options. *See id.* at 1178-79. Their intriguing argument has a certain Ponzi scheme element to it, however. The more firm-specific compensation that managers obtain in period one, the more non-firm specific compensation they can justify in period two. At no point is there a sense that since managers are playing with "house money," they may not need dramatic compensation for risk-bearing. I have elsewhere argued that setting the right level of stock-based compensation has an "impossibility theorem" quality about it. *See* Gordon, *Governance Failures*, *supra*, at 1129-31. Adjusting CEO's risk preferences to match that of the diversified public shareholders does not fit comfortably with the use of stock-based compensation to provide incentives and to reward for superior performance.

mistaken judgments about the board's conduct and effectiveness. Moreover, the use of indexed options (or the synthetic substitute) is not a cost-free substitution because of the new "moral hazard" problems created by this new form of option compensation. The efficient compensation package must be determined in light of the monitoring and enforcement opportunity set.

B. Counter-Evidence

There are several pieces of evidence contrary to Bebchuk and Fried's view that managerial rent extraction plays a commanding role in executive compensation. This counter-evidence relates to the board-CEO relationship and to the heavy use of conventional stock options in compensating non-top executive employees.

1. Increasing Board Power

Perhaps the strongest contrary evidence is the paradoxically positive correlation between corporate governance improvement and higher managerial payouts during the 1990s. In the wake of the hostile takeover movement of the 1980s, boards became more independent and engaged monitors.[13] Board behavior shifted in part because of legal prodding, as the Delaware courts required stronger indicia of board independence and diligence as the price of board veto power over hostile bids. More importantly, activist institutional investors pressed boards to assume a vigorous monitoring role otherwise performed by the control market. As a result, corporate boards generally became more focused, more attentive, and more engaged, as reflected by a number of high profile CEO firings throughout the 1990s. There is a widespread consensus that, whatever their failings, corporate boards of the mid-to-late 1990s were much more effective in monitoring managers than boards of previous decades. So if managerial power is the principal explanatory variable for escalating pay, the timing is odd.

2. Increasing CEO Turnover

The managerial power story also fits uncomfortably with the increased rate of CEO turnover and the shortening of average CEO tenure during the period. A study by Booz Allen Hamilton of CEO turnover in the 1995 to 2001 period for the 2500 largest companies worldwide shows a near doubling of the rate of CEO turnover from 1995 to 2000 and a tripling of the rate of explicitly performance-related turnovers.[14] The number of firings may not be large, 25 in 1995 (1%) versus 80 in 2000 (3%), but the shockwaves of a CEO termination are powerful and the three-fold increase over a short period of general prosperity illustrates the board's increasingly quick and decisive judgments.[15] Moreover, there is ample evidence that the terminations were sensitive to poor

13. *See generally* Jeffrey N. Gordon, The Rise of Independent Directors, 1950-2005: Towards a New Corporate Governance Paradigm (Oct. 9, 2005) (unpublished manuscript, on file with the author).

14. Chuck Lucier et al., *Why CEOs Fall: The Causes and Consequences of Turnover at the Top*, STRATEGY+BUSINESS (SPECIAL REPORT), 3rd Q. 2002, at 4-5, *available at* http://www.boozallen.com (follow "strategy+business" hyperlink).

15. *Id.* (calculation based on the number of companies surveyed (2500) and percentages shown in Ex. 2).

performance, both in industry relative terms and absolute terms.[16] With these higher turnover rates, average CEO tenure during the 1995 to 2000 period shrank from 9.5 years to 7.3 years, and the average tenure of fired CEOs shrank from 7.0 years to 4.6 years.[17] Using a different methodology, Rakesh Khurana comes to a similar conclusion about the increasing fragility of CEO tenure, estimating that "a CEO appointed between 1990 and 1996 is three times more likely to be fired than a CEO appointed before 1980 for the same level of corporate performance."[18]

This evidence of the increased rate of CEO turnover and firings shows the increase in the board's power vis-à-vis the CEO during the period. Moreover, the evidence makes it clear that the termination threat is indeed an implicit contract provision and thus adds a critical pay-for-performance element.[19]

3. Belief in the Value of a Superstar CEO

There is, of course, an alternative explanation for extraordinarily high CEO pay: that boards drank the 1990s Kool-Aid of believing that superstar CEOs could deliver super-sized performance improvements. Rakesh Khurana has a good book title that sums up the phenomenon: *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*.[20] If the board starts from that mindset—that a particular CEO candidate can make the best decisions and create an especially innovative and productive environment within the firm—then high pay levels should not be a surprise.

4. Alternative Explanations for Use of Conventional Stock Options

An important piece of evidence about conventional stock options is their widespread use outside of the top management context. This phenomenon is inconsistent with the view that managerial rent extraction explains their proliferation. A recent Jensen and Murphy paper reports that for the typical S&P 500 firm during the 1992 to 2002 period, the overwhelming share of employee stock options, both by value and number, were granted to employees other than the top five senior executives.[21] In 2002, a typical year

16. *Id.*

17. *Id.* at 3.

18. KHURANA, *supra* note 9, at 60.

19. The shorter tenure and quicker firings may independently explain why CEO compensation has increased. If the "prize" necessary to promote the tournament remains constant but the time period over which it can be paid out becomes shorter, then compensation will increase. If termination severely diminishes a CEO's human capital (few fired CEOs ever subsequently become CEOs at other firms), then even large severance payments can be seen as compensatory. A large severance payment can make it easier for a board that wants to treat the CEO "fairly" (if only to make it easier to recruit a capable successor) to terminate the CEO.

It is also the case that boards have increasingly turned to outsiders as replacement CEOs and paid them more than inside candidates, which may suggest greater board vigilance and the functioning of a market in CEO services. *See* Mark Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265, 2278-80 (2001) (showing data on the increase in outside replacements); Benjamin E. Hermalin, *Trends in Corporate Governance*, 60 J. FIN. 2351 (2005) (using a model to show that CEO pay and selection of outsiders for the CEO position should increase as boards become more vigilant).

20. KHURANA, *supra* note 9.

21. Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here*,

for example, 91% of the value of the grants (using Black-Scholes) and 81% of the total number of options were granted to this lower tier of employees. This skew in favor of non-senior management employees increased throughout the 1990s.

There are two explanations that may fit this pattern better than the managerial rent extraction hypothesis. First, boards may believe conventional options are valuable in motivating employees to increase efficiency and value. To be sure, the effort and decisions of lower level managers and other employees will ordinarily have minimal effect on the stock price. Nevertheless, in making the share price a focal point, conventional options may help coordinate employee effort around a common goal.[22] This is because "raw" stock prices are a credible and common indicator of the firm's business prospects. Publicly reported financial information is often hard to interpret, in part, because as even a casual reader of financial statements can see, the adjustments, assumptions, and footnotes are a barrier to straightforward interpretation. The stock price distills information, reduces management's capacity to spin the facts, and communicates whether the firm is doing relatively well or poorly. It may be that an "indexed" or "filtered" stock price would make the signal less observable and verifiable; this could be particularly important for employees with less financial sophistication.

A second explanation for widespread use of conventional options outside of the top management is that boards may believe that the role of stock options is to help "share" enterprise gains with the firm's principal stakeholders, the employees. This explanation turns Bebchuk and Fried's argument for using indexed options on its head. Conventional options are better than indexed options precisely because much of the value consists in market appreciation, a "bonus" for option-receiving employees deriving from general economic factors rather than firm-specific performance. Earnings growth was higher in the 1980s than the 1990s, but prices exploded in the 1990s because of a marketwide decline in the equity premium. Stock options were the vehicle through which employees (including executives in disproportionate ways) shared in the bonanza. This view also fits Kevin Murphy's observation that boards generally "perceived" that the cost to shareholders of conventional stock options was small, given favorable accounting treatment.[23] If so, and if stakeholders collect on a conventional option only if the shareholders also benefit (unlike an indexed option), why not share the bounty with employees?[24]

What Are the Problems, and How to Fix Them 37-38 figs.6, 7 (Harv. Bus. Sch., Working Paper No. 44/2004, July 2004), *available at* http://ssrn.com/abstract=561305.

22. *See* Jeffrey N. Gordon, *Employee Stock Ownership in Economic Transitions: The Case of United Air Lines*, *in* CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH (Klaus Hopt, Mark Roe & Eddy Wymeersch, eds., 1998).

23. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 859-60 (2002) (analyzing the compensation of top executives in large U.S. companies).

24. An alternative regulatory arbitrage hypothesis is more in keeping with Bebchuk and Fried. Until 2003, the stock exchanges exempted "broad-based" stock option plans from shareholder approval requirement, so top managers who wanted to minimize shareholder oversight of executive stock options simply expanded the size of the option pie. Still, the ethos of employee stock ownership is likely to have exerted independent force, since it runs through the contribution of employer stock to 401(k)s and was prominently featured as part of the Silicon Valley success story.

The belief in the value (or virtue) of stock options and conventional options in particular may explain widespread business support for legislative proposals that would have limited the mandatory expensing of options to those granted to the top managers, not to the rank-and-file employees. Putting aside the merits of such legislation more generally, it does suggest sincere belief in the value of conventional options that transcends narrow managerial interests.[25]

5. Egregious Cases and Typical Cases

Part of what fuels the sense that the executive compensation-setting process is seriously flawed are the high-profile cases of exceptionally large payouts or mega-stock option grants, particularly where the firm's subsequent performance is subpar, if not disastrous. The generic egregious case is option repricing, in which the firm's declining stock price has pushed the option grant so far out of the money that the only way to give the options significant value is to reset the exercise price. Thus Bebchuk and Fried seem to regard repricings as the poster child of "pay for non-performance."[26] Indeed, this view has been so widely shared that the accounting rules were changed in 1998 to require the expensing of repriced options.[27]

Failing managers grasping for more is surely the dark side of option repricing. But at least in theory, this practice may also have a bright side in which option repricing is a tool to retain key managers and valued employees in tough times. A recent paper by financial economists Chidambaran and Prabhala looks systematically at the repricing phenomenon and suggests there is more to the bright side than Bebchuk and Fried's account would suggest.[28] They find that the typical repricer is a young, rapidly growing firm facing a sudden shock to growth and profitability. Repricing firms are also likely to experience high CEO turnover, more so than a control firm with similar shortfalls in performance.

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25. The case for expensing all options is theoretically compelling, yet I can see opportunistic, even redistributivist, reasons for favoring the line-drawing in the proposed legislation. Managers certainly believe that markets will evaluate expensed options differently from non-expensed but fully-disclosed options; the income statement has manna that a footnoted balance sheet does not. The consequence of expensing options is likely to be a cutback for many employees of real compensation—many fewer options (or a substitution of many fewer shares of restricted stock), but with no offsetting increase in cash compensation. A relevant example is the widespread cutback in post-retirement health benefits in anticipation of the 1993 effective date of Statement of Financial Accounting Standard (SFAS) 106, which shifted accounting treatment of such benefits from a cash flow basis ("pay as you go") to a charge that reflected the discounted present value of expected future costs. *See* Jensen & Murphy, *supra* note 21, at 40-41. Shareholders may have had a more accurate picture of the firm's financial position because of SFAS 106 (though cash payouts would not have changed had benefits remained constant), but employees and retirees lost benefits. For some evidence of the cutback in stock option grants to rank-and-file employees, see Eric Dash, *Time Warner Stops Granting Stock Options to Most of Staff*, N.Y. TIMES, Feb. 19, 2005, at C1 (discussing other firms as well).

26. BEBCHUK & FRIED, *supra* note 1, at 164-68.

27. Kevin J. Murphy, *Stock-Based Pay in New Economy Firms*, 34 J. ACCT. & ECON. 129, 131, 137 (2003) (noting the drastic decline in the number of repricings after the 1998 accounting rule change).

28. N.K. Chidambaran & N.R. Prabhala, *Executive Stock Option Repricing: Creating a Mountain Out of a Molehill?* (European Fin. Ass'n 2003 Annual Conference, Paper No. 797, Mar. 2004), *available at* http://ssrn.com/abstract=423463; Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. (forthcoming 2005).

Commonly the repricing is limited to non-CEO managers; indeed, in the median case, two-thirds of the repriced options are held by non-executive employees. In other words, this potentially abusive compensation practice is not driven, in most cases, by managerial rent extraction.

6. A Counter-History

The run-up in executive stock options has a history in some important respects inconsistent with the managerial power hypothesis. One strand relates to hostile takeovers, another, to the "dot-com" boom.

First, on the relevance of hostile takeovers: the large stock option grants of the 1990s were at least in part an accommodative mechanism to state law changes that gave managers and boards increasing power to resist hostile bids. In general, many believed that significant stock option grants would align shareholder and managerial interests and would thereby provide a substitute for the market for corporate control in limiting managerial agency problems and thus improving shareholder welfare. More specifically, stock options were folded into severance arrangements, or "golden parachutes," so that a "change in control" triggered the immediate vesting of options otherwise scheduled to vest over a multi-year period. Such a provision was seen as aligning managerial and shareholder interests at the crucial moment of an uninvited takeover bid. Beliefs about the desirable effects of stock options proved to be, at best, only partly correct, but this does not impeach the sincerity of the option proponents.

A second strand of counter-history is the influence on executive compensation of the 1990s high-tech/dot-com boom. Using large stock option grants in lieu of cash, so-called "new economy" firms, especially high-tech and dot-com startups, became increasingly successful at recruiting top managers from "bricks and mortar" companies. During the boom, these option grants were extremely valuable. The compensation practices of new economy firms had a strong influence on all other firms in the 1990s, as stock options became an increasingly large part of compensation packages.[29] Because of the accounting treatment, stock option grants seemed a cheaper way of enhancing compensation, and the competitive recruitment pressures pushed the size of stock option grants. The compensation-increasing influence of new economy firms in the 1990s is consistent with the fall in executive compensation after the collapse of the dot-com bubble in 2000. For CEOs in the S&P 500 firms, average compensation fell, and by 2002, the percentage of stock-related compensation fell as well.[30] Perhaps managerial pay should have fallen further, particularly as it became clear there were fewer lucrative new economy options, but this element of the history still reduces the role of managerial power in the story.

29. Murphy shows that new economy firms led the way with stock-related compensation in the 1990s with the old economy firms following. In a 1992 to 2001 time series of the stock-related percentage of compensation, he demonstrates that for both new economy and old economy firms the percentage of stock-related compensation was steadily increasing, but for any given year the new economy stock-related percentage was higher. *See* Murphy, *Explaining Executive Compensation*, *supra* note 23, at 849 tbl.1.

30. Jensen & Murphy, *supra* note 21, at 31 fig.3.

IV. A REMEDY

The determination of executive compensation will necessarily be problematic. As noted above, the distinctive market in CEO services is not deep or liquid. There is no spot market with published prices. In setting compensation levels, boards will inevitably look to comparable firm benchmarks and will rarely believe that a CEO they wish to hire or retain is less than average, or even just average. There are also positional elements, in that senior managers evaluate compensation in relative terms as well as absolute levels, within the firm and across other firms. Moreover, pay levels derive in part from the social construction of value, meaning that the parties' sense of appropriate compensation derives from positive and negative social responses.

A simple illustration of social signaling in the pay-setting process is the well-known example of the 1994 tax law change that denied the deductibility of non-performance related compensation above $1 million. The consequence of what was meant to be a tightening of "runaway" executive compensation was a general increase in straight salary, as the $1 million cap became a floor for many firms, and an explosion in conventional stock options, which qualified as "performance-related."[31] The legal "reform" gave salience and legitimacy to particular compensation levels and practices in a way that affected both managers and boards.

Bebchuk and Fried have generated a prima facie case that managerial power plays a significant role in the setting of executive compensation, especially CEO compensation, but I doubt they would reject the importance of market influences as well. Their point is that there is "too much" managerial power and thus significant rent extraction. Some of my earlier discussion is that this effect may not be as great as they think, though I would certainly not deny the grounds for their concern. Undoubtedly there are egregious cases of compensation excess in which managers have gotten the better of boards and shareholders. But is it necessarily the case that managerial rent extraction runs rampant across the broad range of public companies? Upon inspection, some potentially abusive practices may also have benign, even attractive, explanations. Thus, in addition to uncertainty about the "right" level for executive compensation, there may also be uncertainty about the level of managerial overreaching and board complaisance. This is where the question of remedy becomes critical.

In one sense, Bebchuk and Fried are conservative—namely, in their call for improved corporate governance to address the executive compensation issue. They propose a remedy internal to the firm, one that empowers shareholders, and, as such, they do not envision substantive government regulation of the level of executive pay.[32] On the other hand, their solutions are far-reaching, even radical, because the proposed empowerment of shareholders would change the governance of the firm quite significantly in areas unrelated to executive compensation. In addition to supporting

31. BEBCHUK & FRIED, *supra* note 1, at 72; *accord* Jensen & Murphy, *supra* note 21, at 30. Similarly, the proliferation of golden parachutes in the 1980s followed a tax law change that imposed an excise tax on parachute payouts above three times the yearly salary and bonus. *Id*. at 28-29.

32. In this regard I wonder what their view would be about recent tax law changes that tightened the rules on deferred compensation.

shareholder approval for specific problematic elements, such as equity-based plans or suspect compensation terms,[33] Bebchuk and Fried favor general expansion of shareholder power that makes directors directly dependent on shareholders. In particular, they favor a much broader shareholder role in the selection of directors.[34] These governance changes would affect shareholder welfare in a far more reaching way than just buttressing the board's capacity to bargain at arm's-length over executive compensation.

Before we embark on such a significant change, it is worth evaluating and perhaps strengthening the existing governance resources. The setting of executive compensation is part of a family of problems in corporate law, instances in which corporate fiduciaries (managers and directors) enter into contracts and transactions in which their interests diverge from the corporation's. Indeed, presumably the CEO's compensation contract is already subject to the standard corporate law provisions, such as Delaware section 144, that govern contracts between a director and the firm. Such statutes typically contain three process-based building blocks: board approval, disclosure, and shareholder ratification. "Fairness" is a backstop when the procedural mechanisms have failed. In my view, giving greater definition to each of these process elements, with relatively modest adjustments to existing rules of state and federal law, would significantly enhance accountability in the setting of executive compensation. In particular, board process would be strengthened by greater vigilance from state courts, particularly Delaware, in the working out of appropriate fiduciary practices. Disclosure should be buttressed by amendment to current SEC rules to better report the "bottom line" amounts of various sources of compensation, particularly retirement benefits and deferred compensation, and to update disclosure in light of the anticipated effects of the expensing of options. In particular, the SEC should require inclusion in the proxy materials of a Compensation Discussion and Analysis (CD&A), signed by members of the compensation committee, that presents bottom line compensation summaries for the senior managers and that provides explanation and justification.[35]

A. Board Approval

The board approval process has been fashioned in largely ad hoc ways within firms. Beginning with the corporate governance renaissance of the 1970s, boards increasingly have devolved the responsibility for executive compensation to a specific compensation committee. Over time, the compensation committee has become the province of independent directors.[36] Indeed, post-Enron reform has pushed in the direction of requiring a compensation committee consisting entirely of independent directors.[37] What

33. BEBCHUK & FRIED, *supra* note 1, at 196-98.

34. *Id.* at 206-16.

35. The analogy is to "Management's Discussion and Analysis" required in an issuer's annual Form 10-K and quarterly Form 10-Q. *See* SEC Regulation S-K, Item 303, 17 C.F.R. § 229.303 (2005) (requiring management's discussion of the issuer's "financial condition, changes in financial condition and results of operations").

36. *See generally* Gordon, Independent Directors, *supra* note 13.

37. Such a committee is mandated for firms listed on the NYSE. *See* NYSE, INC., LISTED COMPANY MANUAL § 303A.05 (2004). NASDAQ does not require a compensation committee, but does require that compensation decisions be approved by a majority of the independent directors. NASDAQ, INC., MANUAL

counts as good compensation committee practice has been much less developed, however. In significant measure this is because of the failure of the Delaware courts to take seriously the policing of the executive compensation process. By contrast, for example, in the sale of the company to a group that includes management or to a controlling shareholder, the Delaware courts developed over the course of the 1980s and 1990s a set of best practices and legal obligations that inform board and special committee behavior.[38] Similarly, in assessing target defensive measures, Delaware courts imposed an enhanced business judgment standard that particularly scrutinizes the role of independent directors. In both instances the Delaware courts recognized that an inherent conflict required special judicial vigilance. In elaborating on "fiduciary duty," the Delaware courts devised the process protections of decisionmaking by independent directors or by "special committees," or through special shareholder voting rules (e.g., "majority of disinterested minority"), and often imposed substantive standards (e.g., "entire fairness") as a backstop to failed process.

Yet despite the increasing size and controversy over compensation packages, which in some cases included stock option "mega-grants" that would materially dilute the ownership interests of public shareholders, the Delaware courts did not undertake comparable vigilance prompted by the inherent conflicts in this area.[39] This policing failure was the result of three interacting choices. First, in 1979 the Delaware Supreme Court actually relaxed the standard of review in a key area of executive compensation, shifting from "reasonableness" to "waste" in the vetting of stock option plans that had been ratified by shareholders.[40] Thus, the substantive test became whether a board could have made a good faith judgment that compensation was justified, even if upon examination the arrangement was one-sided and excessive.[41] This change undoubtedly

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RULES § 4350(c)(3) (2004). The Internal Revenue Code also has pushed public firms toward an independent compensation committee, since the deductibility of compensation greater than $1 million depends upon prior approval of "performance-based" compensation by a committee that consists solely of two or more "outside" directors. I.R.C. § 162(m) (West 2005).

38. *Compare In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004), *with In re* Cysive, Inc. S'holders Litig., 836 A.2d 531 (Del. Ch. 2003). *See generally* William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055 (1990). The Delaware courts might well have been stimulated and guided by the SEC's going-private regulation, Rule 13e-3 and Schedule 13E-3, which require considerable disclosure and an option on "fairness" for such transactions.

39. *See generally* Randall S. Thomas & Kenneth J. Martin, *Litigation Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569 (2001). In fairness to the Delaware courts, the American Law Institute had similar myopia. *See id*. at 593-95.

40. *Compare* Michelson v. Duncan, 407 A.2d 211 (Del. 1979) (waste), *with* Beard v. Elster, 160 A.2d 731, 737 (Del. 1960) (reasonableness), *and* Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652 (Del. 1952) (reasonableness). *See also* Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (tracing the history of the standard of review).

41. *See Lewis*, 699 A.2d at 335-36. The sense of judicial hand-tying was extraordinary. *See, e.g., In re* 3COM Corp. S'holders Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999).

> [T]o find the plaintiff's claim sufficient I must be satisfied that the alleged facts establish a complete *failure* of consideration, and not merely the insufficiency of the consideration received. A complete failure of consideration is difficult to show since the acts alleged have to be so blatant that *no* ordinary business person would ever consider the transaction to be fair to the corporation.

reflected the increasingly common use of stock option plans as an important feature of executive compensation and concerns about valuation methodology.

Second, the Delaware courts did not take seriously the potential conflicts in the compensation setting process. Instead, they granted a presumption of regularity, even for very large compensation packages.[42] In the eagerness to avoid the thicket of judicially determined compensation levels, the Delaware courts missed the separate question of the adequacy of board process in light of management's self-interest and influence in compensation setting.

Third, and perhaps most crucially, the Delaware courts erected significant procedural barriers to their becoming aware of procedural and substantive concerns in compensation setting practices. This filtering-out came through enforcement of the "demand" requirement to the maintenance of shareholder derivative litigation. Suits challenging executive compensation were deemed to be derivative, not direct, because the injury of putatively excessive compensation was to the corporation itself or to all shareholders as a group.[43] The shareholder-plaintiff was thus obliged to "demand" that the corporation undertake the lawsuit, unless demand was excused as futile.[44] Demand futility required a credible allegation that the board was either not disinterested or not independent, or an allegation that the underlying transaction could not survive business judgment scrutiny because in the context of executive compensation the transaction constituted waste.[45] In light of the presumption of director independence in this area and the protective waste standard, few, if any, cases involving large public firms were heard on the merits.[46] Indeed, in so potentially troubling a case as the Ovitz-Disney saga, the Delaware Supreme Court initially in February 2000 affirmed the dismissal of a derivative suit on familiar procedural grounds.[47] The procedural barriers meant that the Delaware

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> The company would literally have to get nothing whatsoever for what it gave. Under this standard I am *not* to examine the allegations to see whether consideration, once received, was excessive or lopsided, was proportional or not, or even whether it was a "bad deal" from a business standpoint. If I were to do so I would not be deferring to the board's business judgment, as I am required to do here.

Id.

42. *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996) (holding that the board of directors did not breach its duty when it entered into an employment contract that provided severance benefits of up to $20 million).

43. *See* Kramer v. W. Pac. Indus., 546 A.2d 348, 353 (Del. 1988) (stating that a shareholder's claim is derivative in nature when it is based on a deterioration in the value of his stock).

44. *E.g.*, Pogostin v. Rice, 480 A.2d 619, 623-24 (Del. 1984).

45. *See* Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984) (holding that a stockholder's demand was not excused because the stockholder failed to allege demand futility).

46. For cases excluded on procedural grounds, see Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997) (dismissing derivative suit challenging retroactive option grant to retiring CEO because of failure to make pre-suit demand); Kovacs v. NVF Co., 1987 WL 17042, at *1 (Del. Ch. Sept. 10, 1987) (dismissing the suit because shareholders failed to make pre-suit demand); Kaufman v. Beal, Civ. A. Nos. 6485, 6526, 1983 WL 20295, at *1 (Del. Ch. Feb. 25, 1983) (same); Stotland v. GAF Corp., 469 A.2d 421 (Del. 1983) (dismissing a stockholder's appeal from dismissal of a derivative suit as moot due to the stockholder's intervening demand for board action).

47. Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (dismissing a shareholder derivative suit because plaintiffs failed to state with particularity facts that were essential to a claim of director misconduct).

courts blinded themselves to the developing problems in the area, in particular the de facto constraints on board independence in compensation setting.

The contrast between judicial monitoring of the executive compensation process with judicial monitoring of board behavior in hostile takeovers or going-private transactions is striking. In the latter situations, the Delaware courts demonstrated that standard setting does not necessarily require a finding of liability, only judicial suggestions about best practices and the possible implications for the next case that fails to adopt them. The Delaware courts' deep familiarity with the relevant management, board, and shareholder problems that came through the educative process of discovery and hearings was crucial to their ability to set standards. That courts lacked business expertise to evaluate particular transactions was not offered as an excuse against developing process expertise on how a board faced with conflicts in these areas could manage the situation, i.e., what procedures would enhance and protect the board's decisionmaking capability. By contrast, in the executive compensation area the Delaware courts moved too quickly from the lack of obvious substantive standards for evaluating executive compensation to the assumption that the process by which boards addressed the problem could not benefit from judicial oversight. Requiring a board to show the reasonableness of its compensation setting process is entirely consistent with the court's avoidance of an "appraisal" of the compensation amount.[48]

I believe this judicial blindness significantly contributed to the CEO-dominated compensation setting process about which Bebchuk and Fried complain. But courts are now in the process of catching up. Delaware courts have become much more aware of the centrality of compensation concerns, if only because of the fear of further federal encroachment on traditional state domains.[49] The Disney litigation, revived in the post-Enron environment,[50] has become, regardless of outcome, an extended morality tale on

48. Some might argue that the courts were right in focusing their limited resources on transactions in control, which entail final period problems, rather than compensation setting, which ought to be subject to the firm's ongoing accountability mechanisms. This argument misses the difficulties in shareholder monitoring of compensation arrangements, and thus the way that shareholders are unusually dependent on the board. Even if some elements of compensation are put to shareholder vote, certain stock option plans, such as executive-specific packages, are not voted on. Nor do shareholders approve, even in concept, the many other compensation mechanisms ranging from loans to life insurance to retirement provisions. Moreover, the limited disclosure of the entire compensation package adds to the monitoring burden. Therefore, this issue has been an area of severe information asymmetry between shareholders and boards, and thus an area where the integrity of board process is particularly important.

49. *See, e.g.*, William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 971-72 (2003) (discussing Sarbanes-Oxley's prohibition on officer and director loans); Charles Elson, mod., *What's Wrong with Executive Compensation?*, 18 HARV. BUS. REV. 68, 76-77 (Jan. 2003) (comments of Chief Justice Veasey of the Delaware Supreme Court).

50. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (sustaining second amended complaint, which alleged that directors had failed to exercise any business judgment in decisions regarding compensation and severance of Disney President Ovitz); *see also* Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. 20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004) (citing the Walt Disney Co. Derivative Litig. throughout) (sustaining fiduciary breach allegations regarding executive compensation and loans and holding that because the action was brought by a creditors committee of a bankrupt company, there were no procedural impediments).

the board's responsibility to monitor executive compensation. Indeed, the Chancellor's recent opinion chastises the Disney directors at length for their shortfalls from "best practice" before dismissing the shareholders' challenge to Michael Ovitz' approximately $140 million severance package.[51] Boards of large public corporations are likely to be much more careful on the process end. Perhaps the outcome will be nothing more than better "papering" by an essentially passive compensation committee, but Disney-shock is likely to produce more significant changes as well. Drawing from new practices of audit committees influenced by Sarbanes-Oxley,[52] as well as the learning from going-private cases,[53] compensation committees may well insist on independent compensation consultants and perhaps independent counsel.[54] In short, board process is likely to improve considerably, and the courts are likely to provide more vigilance in ways that will sustain process improvements.[55] These process improvements could make a significant difference in compensation practices.

B. Disclosure

Disclosure of existing compensation arrangements has been a mixed bag. On the one hand, a great deal has been disclosed pursuant to the applicable SEC proxy regulations, particularly after the 1992 reforms. Indeed, most of what we now know about executive compensation—particularly salary, bonus, stock, and stock option grants—comes from

51. *In re* Walt Disney Co. Derivative Litig., No. Civ.A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005). The Disney litigation offers a route around the prior procedural barriers in appearing to allow a shareholder plaintiff to plead such extreme neglect by directors as to violate the "good faith" precondition for director exculpation under Del. Gen. Corp. Law § 102(b)(7) and to exceed business judgment rule protection. Once in court, a shareholder plaintiff could also seek to void an excessive contract as inconsistent with the board's fiduciary duty. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 50-51 (Del. 1994).

In the post-Enron era, the Chancery Court has also encouraged shareholder plaintiffs to use their "books and records" inspection rights under Del. Gen. Corp. Law § 220 to generate the facts necessary to successfully plead derivative claims based on excessive executive compensation. *See In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 279 (Del. Ch. 2003); *see also* Haywood v. AmBase Corp., No. 342-N, 2005 WL 2130614 (Del. Ch. Aug. 22, 2005) (holding that a facially excessive compensation package provides a basis for inspection of corporate books and records for evidence of waste and mismanagement related thereto).

52. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-76 (amending 15 U.S.C. § 78j-1 to include standards relating to audit committees).

53. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV 785, 835-37 (2003) (describing ways for board committees to strengthen independence).

54. For a useful guide for compensation committees, see JAMES F. REDA ET AL., COMPENSATION COMMITTEE HANDBOOK (2d ed. 2005).

55. In my view compensation contracts with the CEO should receive business judgment deference (i.e., the "waste" standard of review) only where the board can adequately demonstrate independence and ratiocination. As I describe below, the basis for the board's decisionmaking should be set forth in a CD&A statement included in a public issuer's proxy statement.

Heightened judicial vigilance would probably not mean a rash of new litigation nor the imposition of personal liability on outside directors. The standards of good board practice will quickly evolve and entrench themselves. Moreover, the stakes will rarely justify costly litigation; the magnitude of the Disney contract is an outlier. The remedy may well be equitable adjustment of the contract in question rather than damages, and except for egregious cases, safe harbor statutes like Del. Gen. Corp. Law § 102(b)(7) will shield outside directors from personal liability, even apart from director and officer liability insurance.

this mandatory disclosure.[56] With the possible exception of the United Kingdom, the U.S. disclosure system provides a more comprehensive account of executive compensation than any other jurisdiction.[57] On the other hand, disclosure has obviously been incomplete. It is very hard, if not impossible, to figure out the total compensation package of a senior officer, especially the CEO, taking into account the present value of all forms of stock-based compensation, deferred compensation, retirement benefits, and concessionary loans.[58] There are similar difficulties with determining the sensitivity of CEO pay (and total wealth) to corporate performance.[59] To some extent this is because particular information—for example, actuarial assumptions in retirement benefits or interest rate assumptions—has not been disclosed. In other respects, important information is scattered throughout a company's proxy statement or in the footnotes to its Form 10-K annual report. Cash and stock-related compensation is in one table in the proxy statement; retirement plan information is in another table; loans are discussed in another section; and Black-Scholes option values can sometimes be determined only from the Form 10-K. The disclosure of "perks" is also incomplete. This is demonstrated in the recent SEC enforcement action against General Electric following revelation (in divorce proceedings) of exceptional retirement benefits for former CEO Jack Welch.[60] Even sophisticated analysts, let alone more typical investors, have trouble producing

56. The particular rules for disclosure are set forth in the provisions of the SEC's Regulation S-K, specifically, Item 402 (Executive Compensation), Item 403 (Security Ownership), and Item 404 (Related Party Transactions). 17 C.F.R. §§ 229.402-.404 (2005).

57. *See* Guido Ferrarini et al., *Governance Matters: Convergence in Law and Practice Across the EU Executive Pay Faultline*, 4 J. CORP. L. STUD. (forthcoming 2005) (manuscript at 19), *available at* http://ssrn.com/abstract=498362. Indeed, in a majority of European Union countries, the compensation of the top management group is reported as an aggregate, rather than individualized. These disclosure differences appear to be inversely correlated with two variables, ownership concentration and the strength of social democracy. Where ownership concentration is high, individualized disclosure provides fewer benefits because large blockholders can control managerial rent extraction. Where social democracy is strong, more disclosure may increase resentment against high compensation packages and lead to suboptimal arrangements from the shareholder point of view. The examples of the United Kingdom (high disclosure) versus Germany (low disclosure) are instructive.

The European Commission has begun a campaign to push for detailed disclosure of executive compensation throughout the European Union. *See* Hannah Karp & Andrew Wallmeyer, *EU Wants Pay on the Table: Higher CEO Compensation Prompts Call for Countries to Tighten Disclosure Rules*, WALL. ST. J. (EUR.), Oct. 6, 2004, at M1.

58. The SEC apparently agrees. *See* Jesse Eisinger, *Follow the CEO's Money*, WALL ST. J., Feb. 16, 2005, at C1 (quoting SEC Chairman William Donaldson and other SEC officials).

59. Some argue that wealth/performance measures are the crucial measure and, indeed, that this sensitivity is the most common form of incentive compensation in the United States. *See* Core et al., *supra* note 12, at 1172-77.

60. *See In re* Gen. Elec. Co., SEC Admin. Proc. File No. 3-11677, Securities Exchange Act of 1934 Release No. 50426 (Sept. 23, 2004); *see also In re* Tysons Food, Inc. & Donald Tyson, SEC Admin. Proc. File No. 3-11917, Securities Exchange Act of 1934 Release No. 49666 (Apr. 28, 2005). Perks, although they stimulate public response, are unlikely to be at the core of the compensation disclosure problem. *See also* Alan L. Beller, Director, Sec. and Exch. Comm'n, Div. of Corp. Fin., Remarks Before Conference of the National Association of Stock Plan Professionals, the Corporate Counsel, and the Corporate Executive (Oct. 20, 2004), *available at* www.sec.gov/news/speech/spch102004alb.htm. (emphasizing the need for clear and concise disclosure of compensation to top executives, whether or not specifically required, in light of the requirement to disclose material information without which overall disclosures would be misleading).

compensation package totals.

Some compensation experts estimate that with the newly mandated expensing of stock options[61] and the end of variable accounting of performance-based stock, a large fraction of stock based compensation will move away from options toward performance-stock.[62] Yet the proxy rules will provide inadequate disclosure since disclosure is required only for the number of *vested* shares, but not for the number that might potentially vest or the criteria for vesting. This will add to the difficulty in determining compensation arrangements.

The SEC should revisit compensation disclosure in two respects. First, the disclosure itself should be made clearer and more complete. This is a technical task that requires awareness of current compensation practices that have grown up in part to evade disclosure and awareness of the impact of new accounting rules on the expensing of options and other stock-related compensation. It also requires awareness of the need to provide information that bears on managerial incentives, including the sensitivity of pay to performance and the sensitivity of managerial wealth to performance.[63]

Second, and equally important, the compensation committee (or the independent directors that have taken on that role for companies without a compensation committee) should prepare and include in the proxy statement their "compensation discussion and analysis." This CD&A should (1) explain the firm's philosophy of executive compensation; (2) collect, itemize, and summarize the elements of the compensation packages received by the five most highly compensated officers; (3) provide a justification for the compensation paid; and (4) be signed by the members of the

61. On December 16, 2004, the Financial Accounting Standards Board (FASB) promulgated the final version of FASB Statement 123(R), which requires the expensing of stock options.

62. Performance-based shares will be valued (and expensed) as of the initial grant day, not, as under variable accounting, as of their vesting day, i.e., when actually earned by the employee at which time their value would presumably have increased. *See* Fin. Accounting Standards Bd., Statement of Fin. Accounting Standards No. 123(R), ¶ 21 (rev. 2004).

63. In a recent interview with the *Wall Street Journal*, the new SEC Chairman Christopher Cox seemed to promise an ambitious disclosure agenda:

> Q: What are your thoughts on the current state of executive compensation and whether the SEC needs to act in this area?
>
> A: Since 1933, disclosure of executive compensation has been required by federal law and rules. It's at the heart of our disclosure mission at the SEC. Compensation packages for executives have changed dramatically since 1992, when the Commission last addressed this topic in rule. It is important that we stay up to date and even more important that investors and consumers have all the information they need in order to obtain the best possible services from executives and managers at the lowest possible price. Over time, the prevalent forms of compensation have migrated away from what is transparent to what is opaque. In many cases, the lion's share of an executive's compensation might come in forms that almost entirely elude disclosure. That clearly needs to be addressed.
>
> Q: Do you have any intention of dictating what companies can pay their executives?
>
> A: The market is capable of disciplining excessive compensation, provided that the market has adequate information. Too often in recent days, however, shareholders have been surprised to learn after the fact what their executives are being paid.

SEC's New Leader Shares His Views On Range of Issues, WALL ST. J., Sept. 19, 2005, at A13.

committee (or the independent directors, as the case may be). In other words, for each identified executive, the CD&A should provide a bottom line assessment of the different compensation elements that are scattered throughout the proxy statement and annual report, separately and as a total, and then provide a justification for the compensation in light of the demands of the job, the particular industry, the actual performance, and other factors deemed relevant—in short, an explanation of why the compensation committee thinks the compensation is warranted. The report should be signed as part of the mechanism by which the compensation committee takes ownership of the compensation setting process.

This kind of disclosure is important for two reasons: first, to increase accountability to shareholders in a domain of general board prerogative, and second, to facilitate social feedback in the setting of executive compensation. The board, in the exercise of its business judgment, ought to be the final arbiter of particular executive compensation packages.[64] The board, not the shareholders, is responsible for the management of the corporation, and the determination of executive compensation is a critical part of that oversight role. Where the board has made executive compensation decisions in good faith, judicial interventions should be rare. But the board needs to be accountable for its decisions, particularly in light of the positional conflicts. Even if the directors are disinterested and independent in the full sense of the word, they will almost always feel part of the CEO's "team." Ironically, the greater the directors' involvement with the firm, the more is their complicity in and identification with the firm's business decisions.[65] Up until the painful moment when the board must fire the CEO, he or she is "their guy." This is why what, at first blush, may seem like high stakes disclosure, is an appropriate accountability mechanism.

Bebchuk and Fried want director accountability to shareholders as well, and thus favor opening up possibilities for shareholder nomination of directors. A CD&A would achieve accountability in a different way, one more precisely targeted to the problem at hand. It would oblige specifically named individuals, the members of the compensation committee, to say publicly, "This is what we are paying these executives, it is justified, and this is why."[66] The liability risk ought to be nil, since the CD&A itself is evidence of

64. This statement means to distinguish between general forms of compensation, like stock option plans that require shareholder approval, and specific compensation decisions, such as the number of options granted to a particular executive.

65. Professor Brudney noticed this tension in the role of independent directors some time ago. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 633 (1981).

66. Compare section 906 of Sarbanes-Oxley, codified at 18 U.S.C. § 1350, which requires the CEO and the CFO to certify in writing that a particular 1934 Act filing, to their knowledge, "fairly presents, in all material respects, the financial condition and results of operations of the issuer." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 906, 116 Stat. 745, 806. Although most observers believe that the signed certificate requirement does not add to a CEO's or CFO's actual risk, since the conduct addressed by section 906 would already create criminal liability under other antifraud provisions of the federal securities law and general criminal law, the signing requirement makes the liability risk more salient and thus may affect primary behavior.

Existing rules require a proxy statement description of the compensation committee's role and a compensation committee report, which "shall be made over the name of each member of the . . . compensation committee." SEC Regulation S-K, item 402(k), 17 C.F.R. § 229.402(k) (2005). A CD&A would collect and

a business judgment having been made. But the reputational risk may be substantial; that's where the potency lies. Reputation is at stake in at least two respects. First, the directors bear the risk that the informed audience for their report will think they were "taken" by the CEO and the other executives.[67] This may undermine their reputation for acumen and possibly probity. Second, directors who approve what some shareholders regard as an excessive or unjustified compensation may be targeted by a "just vote no" campaign aimed against their reelection. Being singled out in this way, much less a substantial negative vote, would be significantly embarrassing.

As to the value of this sort of disclosure in addressing the compensation problem, a thought experiment regarding Richard Grasso's compensation by the NYSE is instructive. After disclosure of Grasso's compensation, only one member of the board seemed willing to defend the arrangement publicly. Under the CD&A proposal, a compensation committee that endorses a pay package that shareholders regard as excessive will see various forms of shareholder pushback. This, in turn, will influence future decisions not only by a particular committee, but at other firms as well.[68] More generally, in a corporate governance system that depends on independent directors to address principal-agent problems in preference to direct shareholder initiative, it is important to strengthen the mechanisms of director independence.[69] The CD&A proposal is one such mechanism.

The second reason this CD&A disclosure is important relates to the social construction of the appropriate level of executive compensation for the highly paid individuals in a public firm. As I argued previously, there is no spot market for executive services. The "market" is influenced by many factors, including a sense of value-added and social desert. Although most executives want "more," few want to appear greedy or gouging to their relevant communities. To be sure, additional disclosure—here, bottom line amounts—has a potential downside: it can contribute to escalation of executive compensation precisely because it adds transparency to a domain figured by one-upmanship, or it may heighten social resentments in ways that constrain optimal compensation arrangements. (The "outrage constraint" is not necessarily set at efficient levels.[70]) Yet disclosure through a CD&A brings another dimension to the process, the idea of explanation and justification. In the same way that the CD&A provides accountability to shareholders, it provides accountability to the relevant public, which is another audience for its report, and which may be eager to know why a particular compensation level is deemed warranted. This justification, if persuasive, informs the idea of social desert and helps create the sense of "appropriate" compensation.

Two recent examples illustrate this point about social construction and public

disclose more bottom line information, provide a more detailed justification, and would be signed and presented as signed. Yes, much of the "analysis" might well be lawyer's boilerplate, but not necessarily, since the directors are taking responsibility for the compensation paid.

67. Conceivably some of the audience will think, with a smirk, that the directors were doing their job of fleecing the shareholders for management's benefit.

68. For example, in the 2004 proxy season CalPERS ran a targeted "just vote no" campaign against audit committee members who approved non-audit work by the issuer's auditors.

69. *See generally* Gordon, Independent Directors, *supra* note 13.

70. BEBCHUK & FRIED, *supra* note 1, at 64-67.

accountability. In the compensation controversy over Grasso and the NYSE, as the particulars of Grasso's compensation were disclosed, the Wall Street community turned against the NYSE compensation committee (and against Grasso) because it felt that the payout could not be justified.[71] Senior Wall Street executives reportedly were outraged that the compensation was entirely cash-based and accumulated via a high guaranteed rate of return. The *New York Times* reported one such reaction: "Dick is an all-star; he is a strong, solid guy . . . [b]ut he was never at risk."[72]

The Harvard endowment management compensation controversy is a more complicated case for disclosure. To quell the controversy after the revelations in the IRS filings, university officials provided relatively detailed explanations of the compensation arrangements of the highest paid portfolio managers and a justification in terms of the outside options for both Harvard and the managers in question.[73] Not everyone was satisfied by this justification, but the accounting made the broader public aware of the enormous rents earned by hedge fund managers, for good or ill, and the issue seemed to simmer down (which suggests that the initial controversy might have been somewhat lessened by better preemptive disclosure regarding the compensation formula, including the "clawback" provisions). Yet key Harvard endowment managers decamped in January 2005 to set up a hedge fund, influenced in part, it seems, by Harvard's embarrassment from the public objections to their compensation. In the words of the senior manager, "It would be disingenuous to say that I wouldn't mind dropping a little bit out of the public spotlight . . . . Things at Harvard do get a lot of attention, and the annual compensation story is not one I will miss."[74] On the other hand, it could also be that Harvard's salaries were simply not competitive, since the best hedge fund managers make over $100 million annually.[75]

Some may argue that disclosure of executive compensation is double-edged, that the potential benefits of transparency and greater accountability are offset by an odd pairing of costs. First, given the peculiarly positional features of compensation, better disclosure may lead to "me too" demands that will ratchet compensation levels even higher. Conversely, better disclosure may stoke nascent populism and "outrage" in a way that constrains compensation to levels that are too low. Harvard is the loser if it sacrifices superior investment returns or ends up paying higher fees to private managers. But perhaps the culture of a not-for-profit is the exception that proves the rule that superior performance properly disclosed and explained will not trigger an uproar.[76] However one

71. *See, e.g.*, Landon Thomas, Jr., *A Pay Package that Fat Cats Call Excessive*, N.Y. TIMES, Aug. 29, 2003, at C3.

72. *Id.*

73. *See* sources cited *supra* notes 3–6.

74. Stephanie Strom, *Investment Managers to Exit Endowment at Harvard*, N.Y. TIMES, Jan. 12, 2005, at C1; *see also Money Manager Transition*, HARV. MAG., Mar.-Apr. 2005, at 59-61.

75. *The New Money Men*, THE ECONOMIST, Feb. 17, 2005 (quoting Institutional Investor survey); Charles Stein, *Harvard's High Paid Star Investor Leaving*, BOSTON GLOBE, Jan. 12, 2005, at A1 (quoting Alpha magazine survey reporting a figure of more than $200 million).

76. Rachel Zimmerman, *Harvard Dropouts: Endowment Chief to Leave with Others*, WALL ST. J., Jan. 12, 2005, at C1 (quoting other endowment managers questioning whether the culture of a university or other not-for-profit would support such large payouts).

sorts out the conflicting vectors, the fact is we have already chosen a disclosure-based regime for public companies.[77] We need to make it work well and eliminate the potential distortions from partial disclosure.

C. Shareholder Ratification

A classic means to resolve conflict problems that implicate both managers and the board is shareholder approval after full disclosure. In the executive compensation area such "ratification" could fall into at least three different categories: (1) shareholder *approval* of *specific* compensation agreements, in whole or in part, *before* they become effective; (2) shareholder *approval* of *general* compensation plans (such as stock option plans) *before* they become effective; or (3) shareholder *endorsement* of *specific* compensation agreements *after* they become effective. Under current arrangements, shareholder voting on executive compensation is ordinarily limited to category two, approval of stock option and other stock-based plans before they become effective. Although category three approval has considerable appeal—in effect, a shareholder "confidence" vote, a system recently adopted in the United Kingdom—I think adoption of a CD&A requirement should have reform priority.

In assessing the current system of shareholder voting on stock option and other stock-based plans, it is important to note that approval ordinarily is addressed to the plan as a whole, not to the award of options or stock to particular employees. Plans typically give boards and compensation committees wide discretion in making such awards. Firms put plans to shareholder vote for various regulatory and corporate law reasons. For example, section 162(m) of the Internal Revenue Code requires shareholder approval of a stock option plan that would be regarded as "performance-based" and thus outside the $1 million deductibility cap on executive compensation. Section 303A.08 of the NYSE listing standards (and the parallel NASDAQ rule) requires a shareholder vote on all "equity-compensation plans and material revisions thereto."[78] From a corporate law perspective, some states require shareholder approval of stock option plans.[79] Plans that

77. It may be separately troubling that an increasingly large amount of economic activity is moving to private companies subject to minimal disclosure (permitted because the investors are "sophisticated"), and where fees (and thus executive compensation) may be much higher. Private equity funds are creating new-style conglomerates; hedge funds are creating new-style mutual funds.

78. This standard is considerably tighter than prior iterations. Until 1998, shareholder approval was not needed for plans that were "broadly-based." In 1998 the NYSE liberalized the definition of "broadly-based" to include plans that granted options to twenty percent of the employees, no more than half of whom could be officers or directors. Institutional investors raised a clamor that in the era of heightened corporate governance sensitivity, led to adoption of the present standard in 2003. *See* Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Options Plans*, 35 WAKE FOREST L. REV. 31, 46-51 (2000) (discussing shareholder voting on stock option plans); Chandler & Strine, *supra* note 49, at 972-73. Interpretive questions under the present standard have already spawned a fifteen-page FAQ posted on the NYSE website. NYSE, INC., LISTED COMPANY MANUAL § 303A, Corporate Governance Listing Standards, Frequently Asked Questions (updated as of Feb. 13, 2004), http://www.nyse.com/pdfs/section303Afaqs.pdf. The parallel NASDAQ requirement is found in NASD MANUAL R. 4350(i) (2005), http://nasd.complinet.com/ (follow "4000-7000" hyperlink; then follow "4300" hyperlink; and then the "4350" hyperlink on the left-hand side).

79. Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Directors*, 3 STAN. J. L. BUS. & FIN. 5, 13 (1997). The

require additional authorized shares ordinarily need shareholder approval of a charter amendment. Boards may also voluntarily submit plans for shareholder approval to obtain the benefits of the protective "waste" standard in a subsequent challenge.[80] Although institutional investors have become increasingly vigilant in monitoring stock option plans and occasionally have organized opposition, plans (or amendments) are rarely defeated.

Shareholder voting on stock option plans is a far cry from category one approval—review and approval of specific compensation packages before they become effective. Such detailed shareholder involvement would not be workable for public corporations. Imagine that the firm is seeking to recruit a senior executive from another firm. The inability to offer a definitive contract would significantly impair the recruitment efforts, both because of the uncertainty and the possible embarrassment of a negative shareholder vote. For an existing senior executive, shareholder rejection of a proposed compensation package would probably trigger the executive's departure, particularly for those whose reputation (and thus outside employability) is best.

In 2002, the United Kingdom adopted a category three approval, a shareholder vote on the "Directors' Report on Remuneration," a vehicle of mandatory disclosure analogous to a CD&A.[81] The shareholder vote, which is "advisory," amounts to a confidence vote on the work of the compensation committee, focusing in particular on the appropriateness of compensation levels in light of performance and other factors. Although a negative vote does not void any contracts or other compensation arrangements, the public force of such a negative expression may lead to a "voluntary" renegotiation and a shake-up in the firm's compensation setting process. Moreover, in the effort to avoid a public flap, companies may be more willing to consult large shareholders in the shaping of executive compensation and to avoid compensation proposals that would appear excessive.

The United Kingdom provides some famous examples of how such an advisory shareholder vote might function. A large golden parachute for the CEO of GlaxoSmithKline—estimated by shareholders at $35 million—triggered a shareholder revolt that led to a rejection of the remuneration committee's report.[82] The consequence

trend is against such independent state law shareholder voting requirements. New York, for example, recently eliminated such a requirement. N.Y. Bus. Corp. Law § 505(d) (McKinney 2003).

80. *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997).

81. The UK legislation did two things. First, it expanded disclosure of executive compensation beyond summary footnote disclosure to an extensive Directors Remuneration Report. *See* Companies Act, 1985, c.6, § 234B, sched. 7A (Eng.) (amended 2002). Second, it required an advisory shareholder vote on the Report. *Id.* § 241A. The Report must provide particularized disclosure, for each senior executive, of the various sources of compensation as well as an explanatory statement of the company's compensation policy (including the company's comparative performance). The Report must be signed by Remuneration Committee members and its quantitative elements must be audited. Although a shareholder vote is mandatory for every public company, "[n]o entitlement of a person to remuneration is made conditional on the resolution [required by this section] being passed . . . ." *Id.* § 241A(8). *See* Directors' Remuneration Report Regs., 2002, S.I. 2002/1986, explnt. para. 1; 2 PALMER'S COMPANY LAW ¶ 8.207.3 (Geoffrey Morse et al. eds., Sweet & Maxwell 2002); Jaclyn Braunstein, *Pound Foolish: Challenging Executive Compensation in the U.S. and U.K.*, 29 BROOK. J. INT'L L. 747, 787-88 (2004). The UK legislation came after a persistent unwillingness by the largest UK firms to voluntarily add such a shareholder vote, as had been recommended by the UK best practice code. *Id.* at 775-77.

82. *See* Gautum Naik, G*laxo Holders Reject CEO's Compensation Package*, WALL. ST. J., May 20, 2003,

was an overhaul of GlaxoSmithKline's remuneration committee, a shrinking by two-thirds of the CEO's golden parachute, and a toughening of terms on which options would vest.[83] In other cases, the shareholder vote on the report has amounted to a referendum not just on compensation levels but on the CEO's performance generally. In some cases pay packages have been renegotiated; two cases led to CEO turnover.[84] At least some UK firms have begun to discuss executive compensation with large shareholders as part of the compensation setting process.[85] It appears that the vote on the remuneration committee report may serve to mobilize UK institutional shareholders in a way similar to the "just vote no" campaigns against director reelection at underperforming firms in the United States. Targeting excessive compensation may draw a stronger institutional response "in part because it is what the press and the public understand."[86]

Should U.S. reformers press for a shareholder advisory vote on the CD&A as part of the effort to enhance accountability in executive compensation and perhaps performance more generally? The European Commission has recently adopted such a recommendation for EU countries,[87] and some U.S. commentators have previously made similar proposals.[88] Such a measure could be adopted by the NYSE and NASDAQ as a listing standard, by the SEC as a condition for the circulation of a proxy statement, by a state legislature as a matter of substantive corporate law, by a state court as a condition for "business judgment" review of compensation, or by shareholder initiative as a bylaw amendment. One question is how much additional accountability such a shareholder advisory vote would provide. That question needs to be answered while keeping in mind at least two important differences between the United States and the United Kingdom. First, shareholdings are more concentrated in the United Kingdom than in the United States; a relatively small number of UK institutional investors hold sixty percent of the publicly traded equity, and the UK regulations on collaboration by such shareholders are

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at D8; Heather Timmons, *Glaxo Shareholders Revolt Against Pay Plan for Chief*, N.Y. TIMES, May 20, 2003, at W1. The vote was narrow, 50.72% to 49.28%. *Id.* Two large institutional investors voting against the report were Isis Asset Management, a UK money manager with nearly $100 billion in assets, and CalPERS, a U.S. public pension fund with more than $150 billion in assets that is a notable proponent of corporate governance reform worldwide. *Id.*

83. *See* Julia Flynn & Naum Naik, *Glaxo Sets Plan to Better Link Pay to Performance*, WALL ST. J., Dec. 16, 2003, at D5. It appears that the original golden parachute was set to the U.S. standard of three times the annual salary and expected bonus.

84. *See* Ferrarini et al., *supra* note 57, at 14-15 & nn.64-66; Heather Timmons, *Chairman Leaves Amid Pay Dispute at Sainsbury*, N.Y. TIMES, July 2, 2004, at W1.

85. Siliva Ascarelli, *UK Firms Turn on the Charm*, WALL ST. J. (EUR.), Mar. 23, 2004, at M1.

86. Timmons, *Glaxo Shareholders Revolt*, *supra* note 82 (quoting Anita Skipper, head of corporate governance at Morley Fund Management). On the other hand, there have been only three actual "no" votes in two years. E-mail from Brian Cheffins, Professor of Law, Cambridge University (Jan. 14, 2005).

87. *See* European Commission Recommendation 2004/913/EC of Dec. 14, 2004, *Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies*, 2004 O.J. (L 385) 55-59, *available at* http://europa.eu.int/comm/internal_market/company/index_en.htm (follow "Directors' Remuneration" hyperlink; then follow the pdf hyperlink for the Dec. 14, 2004 recommendation).

88. Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 28 (2004); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1046-48 (1999).

much less burdensome than in the United States.[89] As a result, UK institutions have greater capacity to act collectively in informal and formal ways and have more experience at it.

The second difference is that U.S. institutions have already developed a practice to "just vote no" against director reelection where the goal is to object publicly to specific corporate behavior. For example, as noted above, a "just vote no" campaign has been aimed against the practice of audit committee approval of non-audit work by the auditors. It would be easy to run such a campaign against the members of a compensation committee for an unsatisfactory CD&A. In other words, if the goal of the shareholder advisory vote is strictly enhancement of shareholder voice, the institutional diffusion in the United States may undercut its effectiveness. If the goal is to provide a vehicle for broader mobilization of popular and elite opinion, the targeted "just vote no" option may be almost as effective. Thus, given the existing disclosure regime, the United States already has a shareholder vehicle that bears significant functional equivalence to the UK advisory vote. Add a CD&A and the functional equivalence is even stronger.

With these caveats, and in light of the recent European Union Commission action, the shareholder advisory vote on a CD&A may still seem superior because it entails annual shareholder scrutiny of the executive compensation issue. It requires no entrepreneurship by a concerned shareholder, which could be in short supply in a given year for a given firm. It gives greater shareholder legitimacy to inquiries about compensation and possible objections. If a CD&A requirement and other process reforms seem ineffective after a five-year trial period, the shareholder advisory vote on a CD&A is an attractive next step. Its appeal is greater than a general expansion of shareholder power to nominate directors.

V. CONCLUSION

Bebchuk and Fried have given us a valuable book that acutely focuses attention on the executive compensation problem. They masterfully marshal the evidence and the arguments. The issue is important for two distinct reasons. Poorly designed compensation arrangements may induce managerial behavior that reduces the efficiency and value of large public companies, thereby reducing shareholder wealth and social welfare. Excessive compensation—compensation that seems out of line with an executive's contribution to a firm's success—may have social demoralization costs even if it merely redistributes in favor of managers and against shareholders with no efficiency implications. Yet the "right" level and form of executive compensation in light of either concern is not easily determined. On the remedial side, I favor mechanisms to strengthen director independence targeted toward the compensation problem rather than general expansion of shareholder power. I also favor mechanisms that will give the directors input from shareholder and public constituencies. This leads me to a proposal for a "Compensation Discussion and Analysis" (CD&A) included in the issuer's proxy rather than sharply increasing shareholder power in the director selection process.

89. Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002, 2007-09 (1994).

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