

# **REGULATING EXCESSIVE EXECUTIVE COMPENSATION**

## **—WHY BOTHER?**

By

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“The thing that differentiates animals and man is money.”

Gertrude Stein

## **I**

### **INTRODUCTION**

Executive compensation at publicly owned companies has long been the target of corporate governance reformers. In the 1930s, those advocates attacked excess compensation in lawsuits which claimed that executives were breaching their fiduciary duties by allowing such payments. That effort was unsuccessful in curbing executive pay, as was an attempt by the Securities and Exchange Commission (“SEC”) to shame executives into accepting lower payments through its full disclosure regulations. In the 1980s, reformers focused on options as a means of aligning the interests of executives and shareholders through performance based incentive compensation. It was thought that this would incentive the executive to boost the company’s stock price and thereby benefit shareholders in the process. That effort was aided by Congress through tax incentives, but this initiative too proved to be a failure, a spectacular one.

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This article traces these reform efforts, describes how they failed and how, ironically, they actually encouraged abuses in executive compensation. It then describes the most recent set of reforms that followed those abuses and explains why they too will only encourage ever greater compensation. Finally, the article addresses the issue of whether executive compensation should be taken out of the hands of the reformers and left to the marketplace, ever how inefficient it might be.

## II

### **FIDUCIARY DUTIES AND FULL DISCLOSURE**

#### **Fiduciary Duties**

Corporate governance reformists have long focused their attention on executive compensation as a measure of abuse by management and loss by shareholders. This movement seems to have had its genesis in the landmark work of Adolf Berle and Gardiner Means in the 1930s.<sup>2</sup> They observed that public companies with dispersed shareholders were experiencing a separation of ownership and control, with control being vested in managers. Berle and Means were concerned that the managers would be tempted to manage for their own interests, rather than those of the owner-shareholders. A principal concern was that those managers would compensate themselves excessively whatever their performance as managers.

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<sup>2</sup> Adolf A. Berle Jr. and Gardiner C. Means, *The Modern Corporation and Private Property* (1932). The Hoover Institution has asserted that this was one of the most influential books published in the twentieth century. Jerry W. Markham, *A Financial History of Modern U.S. Corporate Scandals, From Enron to Reform*, 152 (2006) (hereinafter “Corporate Scandals”).

Economists of that era were also contending that limits should be placed on executive compensation, asserting that no man could be worth \$1 million per year. That pronouncement came after the stock market excesses of the 1920s, which had also witnessed a steep increase in executive compensation.<sup>3</sup> “By 1928, the executives of some of our largest companies were receiving compensation running as high as \$1,000,000 or \$1,500,000 annually.”<sup>4</sup> The fiduciary duty concept was used to challenge one particularly large compensation scheme during that era. In *Rogers v. Hill*,<sup>5</sup> the Supreme Court held that a compensation scheme could become excessive where it provided large, unexpected windfall profits to executives at the American Tobacco Company.

The American Tobacco Company plan attacked in that proceeding, which had been approved by shareholders, provided executives with a bonus of 10 percent of earnings increases over a bench mark amount. A steep increase in cigarette consumption led to large profits to the executives subject to the plan. The president received \$842,000 in 1930 as a bonus plus his salary of \$168,000. This payout came just as the Great Depression was settling on the country. Nevertheless, the Supreme Court struggled to determine what measure to use in determining that compensation was excessive. A subsequent challenge to that compensation scheme led a New York court to simply throw up its hands on the issue.<sup>6</sup>

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<sup>3</sup> Id. at 288.

<sup>4</sup> George T. Washington, “The Corporation Executive’s Living Wage,” 54 Harv. L. Rev. 733, 734 (1941) (hereinafter “Washington”).

<sup>5</sup> 289 U.S. 582 (1933). This case was accompanied by much scandal. Martin T. Manton, the judge on the Second Circuit who wrote an opinion upholding the compensation scheme, was convicted of bribery. He had accepted a “loan” of \$250,000 from the American Tobacco Company that was never repaid. David Margolick, “Deleted From Book: Gifts to Alfred E. Smith,” N.Y. Times, May 22, 1985, at A1.

<sup>6</sup> *Heller v. Boylan*, 29 N.Y.S.2d 653, 669 (Sup.), *aff’d*, 32 N.Y.S.2d 131 (App. Div. 1<sup>st</sup> Dept. 1941).

Another high profile challenges to executive pay was directed at Bethlehem Steel in 1931.<sup>7</sup> The executive at the center of that storm was Charles M. Schwab. He had helped Andrew Carnegie with the sale of his steel mills to U.S. Steel as the Twentieth Century began. U.S. Steel then became the first \$1 billion company and the largest business enterprise in the world. As a reward for his efforts, Schwab was made the head of that giant enterprise at then unbelievable annual salary of \$1 million. Schwab was a big spender known for his appearances at casinos at Monte Carlo. He built a house on New York's Riverside Drive at a cost of nearly \$4 million. That residence included its own swimming pool, gym and power plant.<sup>8</sup>

After quarrelling with his board at U.S. Steel, Schwab took control of Bethlehem Steel Co., and turned it into an industry giant.<sup>9</sup> Schwab created a bonus system at Bethlehem Steel that paid executives over \$6 million between 1911 and 1929. Those payments were challenged by shareholders as being excessive and in breach of the board's fiduciary duties.<sup>10</sup> That effort met only limited success through a settlement.<sup>11</sup>

Another high visibility attack on excess executive pay occurred in 1934. This was a challenge to the compensation paid to the chief executive officer ("CEO") at the National City Bank, Charles Mitchell, who had been paid \$1.4 million in 1928 as a bonus.<sup>12</sup> Mitchell was somewhat infamous by the time of this challenge, having been charged with income tax fraud for using a stock buyback scheme with his wife. That bit of legerdemain allowed him to evade paying taxes on over \$1 million in income in 1929.

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<sup>7</sup> Washington, *supra* n. 4 at 737-741.

<sup>8</sup> Dero A. Saunders, "Sixty Years Ago in Forbes," *Forbes*, Feb. 16, 1981, at 143.

<sup>9</sup> II Jerry W. Markham, *A Financial History of the United States, From J.P. Morgan to the Institutional Investor (1900-1970)* 12-13 (2002) (hereinafter "Institutional Investors").

<sup>10</sup> Washington, *supra* n. 4 at 738.

<sup>11</sup> *Id.* at 737-741.

<sup>12</sup> *Id.* at 748-752.

That case went to the Supreme Court, and Mitchell avoided jail but did have to pay taxes on the sales.<sup>13</sup>

Mitchell was carrying other baggage. Before being promoted to lead the National City Bank, Mitchell had headed its broker-dealer subsidiary that became infamous for high pressure sales programs that were promoting worthless securities. Those operations led to the passage of the Glass-Steagall Act that required the separation of commercial and investment banking.<sup>14</sup> Mitchell was also responsible for legislation strengthening the Federal Reserve Board in Washington after he defied their efforts to raise interest rates to cool the stock market bubble in the 1920s.<sup>15</sup> Yet, despite his reputation, the challenge to Mitchell's pay at the bank was successful only in establishing that certain incentive compensation had been wrongly computed.<sup>16</sup>

In the wake of these cases, one professor noted that, while it was being said that “no man can be worth \$1,000,000 a year.’ Perhaps this is true. Perhaps not. In any event, it is hardly a matter for courts and lawyers to settle.”<sup>17</sup> This professor also noted that, by 1941, the courts had declined to determine what level of compensation was appropriate:

In effect, they put aside the problem of ‘reasonableness’ and simply ask: ‘Is this corporation being honestly and fairly run by its directors, with observance of the formal requirements of the law?’ If the answer is in the affirmative, the judgment of the directors as to the amount of compensation which should be paid to the executives will be allowed to control.<sup>18</sup>

Another challenge to executive compensation was mounted in the 1950s at the Fairchild Engine and Airplane Corp. There, the founder of the company successfully

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<sup>13</sup> Institutional Investors, *supra* n. 9 at 182.

<sup>14</sup> *Id.* 115-117, 179-180.

<sup>15</sup> *Id.* at 152-153, 167.

<sup>16</sup> Washington, *supra* n. 4 at 748-752.

<sup>17</sup> *Id.* at 759.

<sup>18</sup> *Id.* at 758-759.

challenged a large payout to the chairman. That success was not achieved through a lawsuit. Rather, a proxy fight was waged that was successful in ousting the chairman. However, that was an expensive campaign in which the shareholders ended up paying the expenses of both sides and such efforts were not widely repeated.<sup>19</sup> In fact, claims over excessive compensation seem to have been pretty much removed from the courts until a recent challenge that involved the payment of \$130 million to Michael Ovitz by the Walt Disney Company.

Ovitz received that payment even though he was terminated after only fourteen months on the job. The Delaware Supreme Court could find no breach of fiduciary duties by the Walt Disney directors in negotiating the employment contract that provided for that massive severance payment for so little work.<sup>20</sup> Of course, this was not the only case of excessive compensation at Walt Disney. Michael Eisner at Walt Disney Co. was paid over \$750 million while he was making some colossal management blunders as head of the company.<sup>21</sup> Another executive, Jeffrey Katzenberg, was paid \$285 million by Disney to settle his compensation claims.<sup>22</sup>

### **SEC Full Disclosure**

The federal securities laws are premised on the theory that disclosure will not only allow an informed business judgment but will also deter abusive practices by corporate managers.<sup>23</sup> In the famous words of Louis Brandeis “sunlight is said to be the

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<sup>19</sup> Rosenfeld v. Fairchild Engine and Airplane Corp., 128 N.E.2d 291 (N.Y. 1955).

<sup>20</sup> Brehm v. Eisner, 2006 Del. LEXIS 307 (Del. 2006).

<sup>21</sup> Corporate Scandals, *supra* n. 2 at 32.

<sup>22</sup> *Id.* at 32.

<sup>23</sup> This theory proved to be a failure in preventing the market bubble that occurred at the end of the last century. The bursting of that bubble revealed accounting manipulations on a massive scale that were mostly designed to boost company stock prices and performance based payouts that were tied the stock price. *Id.* Executives were also finding other ways to profit from jumps in their company’s stock price. A 2006 study sponsored by the *New York Times* found that 41 percent of the companies merging over the prior twelve

best of disinfectants, electric light the most efficient policeman.”<sup>24</sup> As also noted by Felix Frankfurter, one of the architects of the Securities Act of 1933,<sup>25</sup> that legislation was intended to have an “*in terrorem*” effect on corporate managers and that:

The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening.<sup>26</sup>

Thus one of the principal targets of reform through the federal securities laws was excess executive compensation. That effort was spurred by corporate executives who increased their salaries to compensate for reduction in profit based bonuses after the Stock Market Crash of 1929. Those increases came while thousands of employees were being laid off and rendered destitute.<sup>27</sup> Congress then ordered the Federal Trade Commission and the Internal Revenue Service to conduct a survey and collect data on executive compensation, which was then published annually. As will be seen, taxes were also increased greatly. Companies paying executives more than \$17,500 were denied certain government contracts, and the Reconstruction Finance Corporation (“RFC”) was prohibited from making loans to companies that were deemed to be over-paying their executives.<sup>28</sup>

As another effort to curb executive excesses, the Securities Act of 1933 was intended to make full disclosure mandatory in public offerings. The statute included

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month experienced unusual trading activity in their stock before the public announcement of the merger. Gretchen Morgenson, “Whispers of Mergers Set Off Bouts of Suspicious Trading, N.Y. Times, Aug. 27, § 1, at 1.

<sup>24</sup> Louis D. Brandeis, *Other People’s Money and How the Bankers Use It* 4 (1914).

<sup>25</sup> 48 Stat. 74 (May 27, 1933), *codified at* 15 U.S.C. § 77a *et seq.*

<sup>26</sup> Felix Frankfurter, “Securities Act—Social Consequences,” *Fortune*, August 1933, at 55.

<sup>27</sup> Washington, *supra*, n. 9 at 734-735.

<sup>28</sup> *Id.* at 735, 765.

schedules setting forth disclosures required to be included in prospectuses.<sup>29</sup> Section 14 of Schedule A (for domestic companies) required disclosure of the compensation of officers and directors for the prior year and the year following the offering if such compensation was in excess of \$25,000.<sup>30</sup> Section 10 of that schedule also required the identification of any options on the company's stock and the identity of the holders.<sup>31</sup> As originally enacted, the Securities Exchange Act of 1934 additionally required companies traded on stock exchanges to disclose the compensation of officer and directors and persons other than directors and officers exceeding \$20,000 per year.<sup>32</sup> Bonus and profit sharing arrangements had to be disclosed,<sup>33</sup> as well as options issued on the registrant's stock.<sup>34</sup>

In 1938, the SEC adopted executive compensation disclosure requirements for proxy statements.<sup>35</sup> The SEC, thereafter, periodically adjusted its various compensation disclosure requirements.<sup>36</sup> In 1978, for example, it required disclosure of all direct and indirect compensation in tabular form, including options. In 1980, the agency amended its rules to require disclosure of the amounts of unexercised options. In 1983, the SEC acted again on executive compensation, adopting a narrative approach to such disclosures. The amendments required disclosure only of the net value realized from the exercise of options.<sup>37</sup>

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<sup>29</sup> 48 Stat. 74 (May 27, 1933).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> 15 U.S.C. § 78I(D) & (E) (1934).

<sup>33</sup> 15 U.S.C. § 78I(F) (1934).

<sup>34</sup> 15 U.S.C. § 78I(G) (1934).

<sup>35</sup> 71 Fed. Reg. 6542, n. 40 (Feb. 8, 2006).

<sup>36</sup> These disclosure rules were amended in 1942, 1952, 1978, and 1983. 71 Fed. Reg. 6542, n. 40 (Feb. 8, 2006). In addition five interpretative releases on executive compensation disclosures were issued between 1977 and 1981. 48 Fed. Reg. 44467, n.2 (Sept. 29, 1983).

<sup>37</sup> Disclosure of Executive Compensation, 1983 SEC LEXIS 718 (Sept. 23, 1983).

In 1992, the SEC adopted significant revisions to its disclosure requirements that moved from narrative disclosure approach to formatted tabular disclosures. The SEC also joined the then ongoing executive compensation reform crusade and tried to discourage excessive compensation through disclosures that would presumably shame executives from seeking large payouts. The rules adopted by the SEC, among other things, required disclosure of the compensation of the CEO and the other top four highest paid managers. The compensation committee was also required to describe the performance factors it used in setting the compensation of the CEO and a discussion of its policies with respect to other executive officer compensation. The company had to disclose the hypothetical value of option grants using the Black-Scholes model or some other valuation method. In addition, the performance of the company's stock had to be compared to that of an index of stocks such as the S&P 500 Composite Price Stock Index.<sup>38</sup>

The SEC's disclosure regulations did not curb executive compensation packages. Rather, they only encouraged competition for ever larger packages, and disclosure actually made legitimate even the most excessive payments, *i.e.*, because it was disclosed there was no wrongdoing.<sup>39</sup> One study noted that during the period 1993 to 2003 executive:

pay has grown much beyond the increase that could be explained by changes in firm size, performance and industry classification. Had the relationship of compensation to size, performance and industry classification remained the same in 2003 as it was in 1993, mean compensation in 2003 would have been only about half of its actual size.<sup>40</sup>

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<sup>38</sup> 57 Fed. Reg. 48125 (Oct. 21, 1992).

<sup>39</sup> Corporate Scandals, *supra* n. 2 at 30.

<sup>40</sup> Lucian Arye Bebchuk & Yaniv Grinstein, "The Growth of Executive Pay," 21 Oxford Rev. of Econ. Policy 283 (2005).

As will be seen, the SEC's full disclosure system also corrupted a large portion of corporate America as executives sought to meet the expectations of financial analysts and boost stock prices so that those executives could reap large profits from incentive programs.

### III

## TAX LAWS AND OPTIONS

### The Tax Laws

Another method used for attacking excessive compensation has been the federal tax laws, which after the adoption of the Sixteenth Amendment, allowed the use of "progressive" income taxes. The first tax under that amendment was levied in 1913 at a rate of 7 percent on those few Americans with incomes of over \$500,000.<sup>41</sup> However, tax rates on the wealthy were raised during the administration of Franklin D. Roosevelt until they were virtually confiscatory. Roosevelt used the income tax as a part of his effort to conduct class warfare, using a populist attack against wealthy executives as the core of his campaign platform and legislative programs. The top tax rate was raised in 1932 from 63 percent from 25 percent. A tax bill introduced in 1935, called the "soak-the-rich" bill, raised the top rate to 79 percent.<sup>42</sup> That legislation and other attacks on business by the Roosevelt administration sent the country back into another depression, just as it seemed to be recovering from the horrors of prior years.<sup>43</sup>

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<sup>41</sup> <http://www.taxfoundation.org/taxdata/show/151.html>.

<sup>42</sup> <http://www.huppi.com/kangaroo/Timeline.htm>.

<sup>43</sup> Corporate Scandals, *supra* n. 2 at 609. Roosevelt's attacks included efforts to bring criminal charges against wealthy opponents of his administration. One target was Moses Annenberg, a newspaper publisher who had been attacking Roosevelt's economic programs. Roosevelt wanted Annenberg "for dinner" and his administration threatened criminal charges that would result in prison sentence of 147 years. Annenberg, who was dying from a brain tumor, responded that, like Nathan Hale, he did not "have enough years to give to my country." Annenberg did plead guilty after the government threatened to also indict his son, Walter.

The top tax rate reached 91 percent at the end of World War II but was lowered to 70 percent in 1963.<sup>44</sup> That reduction was part of a “reform” effort by President John F. Kennedy who thought that lower rates would remove incentives for tax avoidance and evasion and allow the closing of loopholes used by the wealthy to reduce their taxes. Ironically, Republicans, including former President Dwight D. Eisenhower opposed the Kennedy cuts, claiming that they were irresponsible in light of large budget deficits.<sup>45</sup> However, even after the Kennedy reductions, executives had little incentive to take risks to increase their wealth. Where risks were taken successfully, the resulting high tax rates were avoided or evaded by many wealthy individuals through abusive tax shelters, foundations and other means.<sup>46</sup> The “death” tax, or “estate” tax as it is called by proponents, was another effort to seize the wealth accumulated by executives during their careers on which they had already been taxed at near confiscatory rates. The death tax seized fifty percent of the decedent’s estate in excess of specified amounts.<sup>47</sup> It too was avoided by various schemes. Still another tax, the alternate minimum tax (“AMT”), was passed to assure that executives paidt least a minimum amount of tax whatever tax shelters might be available. That tax was passed after it was revealed that twenty one

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Conrad Black, Franklin Delano Roosevelt, Champion of Freedom 394-396 (2003). However, Roosevelt failed in his efforts to jail Andrew Mellon, another wealthy opponent. A grand jury refused to indict Mellon on tax fraud, possibly because the Treasury Department thought he was owed a refund. A civil suit brought by the Roosevelt administration on this tax claim resulted in the “notorious ‘Mellon Tax Trial’ of 1935-1936,” but it too was a failure. Steve Forbes, “The Man Who Made the Twenties Roar,” Wall St. J., Oct. 6, 2006, at W4.

<sup>44</sup> <http://www.huppi.com/kangaroo/Timeline.htm>.

<sup>45</sup> Theodore C. Sorenson, Kennedy, 427-433 (1965).

<sup>46</sup> For example, the oil depletion allowance could be used legally to reduce taxable income in the amount of \$100,000 to \$10,000. Herbert S. Parmet, George Bush, The Life of a Lone Star Yankee 69 (1997). Other shelters were more questionable. III Jerry W. Markham, A Financial History of the United States, From the Age of Derivatives Into the New Millennium (1970-2001) 145 (2002) (hereinafter “Age of Derivatives”). Most recently, Congress has been investigating tax shelters called such things as BLIPS and FLIPS sold by accounting firms that sheltered billions of dollars from taxes. Corporate Scandals,, *supra* n. 2 at 480.

<sup>47</sup> See Barbara Redman, “Rethinking the Progressive Estate and Gift Tax,” 15 Akron Tax J. 35 (2000) (describing the estate and gift tax).

millionaires had paid no taxes in 1967.<sup>48</sup> Of course, like many financial “reforms,” there were unintended consequences. The AMT is now increasing the tax burden on many middle class households.<sup>49</sup>

Unfortunately for the reformers, the high rate of income tax set by the Roosevelt and succeeding administrations offended Ronald Reagan, the Hollywood actor who rose to become President of the United States. He touched off a movement to roll the top marginal tax rates back, and this effort has become a pillar of the Republican Party.<sup>50</sup> Reagan believed in “supply side” economics which posits that lower taxes will spur greater economic activity. These theorists also point to the “Laffer curve” to support the argument that lower taxes can even result in more tax revenues through increased economic growth. They further note that with lower tax rates there will be less incentive to avoid or evade taxes<sup>51</sup> Under Reagan, personal income taxes were cut by 25 percent and capital gains taxes went from 28 percent to 20 percent.<sup>52</sup>

George H.W. Bush, who succeeded Reagan, was removed from office by voters after he failed to keep his pledge (“read my lips”) not to raise taxes and experienced a recession that tax cuts might have mitigated.<sup>53</sup> Although Reagan’s views on taxes had many adherents, large spending deficits led to the successful effort by the administration of William Clinton to raise taxes. That increase appeared to have little effect on a booming economy and stock market until it crashed in 2000.

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<sup>48</sup> David Wessel, “U.S. Scores Some Prominent Wins Against Abusive Tax Shelters, Wall St. J., Aug. 31, 2006, at A1.

<sup>49</sup> Jonathan Weisman, “Senate Passes \$70 Billion in Tax Cuts Over 5 Years,” Wash. Post, Feb. 3, 2006, at A06.

<sup>50</sup> Age of Derivatives, *supra* n. 45 at 179.

<sup>51</sup> Steven F. Haward, The Age of Reagan, The Fall of the Old Liberal Order (1964-1980), 524-526 (2001).

<sup>52</sup> Robert V. Remini, The House, The History of the House of Representatives 466-467 (2006).

<sup>53</sup> Age of Derivatives, *supra* n. 45, at 207. George H. W. Bush had also termed Reagan’s supply side views as “voodoo economics when running against him for the presidency. Herbert S. Parmet, George Bush, The Life of a Lone Star Yankee 294 (1997).

Learning from his father's experience, George W. Bush successfully ran for President on two occasions by seeking tax cuts for the wealthy, as well as others. He was opposed by Democratic candidates who sought to engender class warfare by seeking more taxes on wealthy corporate executives.<sup>54</sup> Bush overcame those opponents and has been particularly successful in pushing back tax rates that have fallen chiefly on wealthy executives. He even achieved a phase out, albeit a temporary one, of the death tax.<sup>55</sup> Despite some rocky times, including a near recession that he inherited from the Clinton administration, the 9/11 attacks and corporate scandals, the economy has remained strong under his administration. Many point to the tax cuts as having assured that result.

Bush was supported by the fact that the wealthy pay more than their proportionate share of taxes. The top one percent of taxpayers (those making over \$313,000 annually) paid 37.4 percent of federal income taxes in 2000 but collectively received only about twenty-one percent of the Nation's adjusted gross income. The top five percent of income earners were paying fifty-five percent of personal federal income taxes while receiving only thirty-four percent of adjusted gross income.<sup>56</sup>

Those statistics suggest that wealthy businessmen are being punished enough under the tax code. That fact and the current political environment will make tax increases a hard sell by reformers seeking to curb excessive compensation through increased taxes. However, even if higher taxes could be passed, it is likely, as seen from

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<sup>54</sup> Howard Dean, the former governor of Vermont and at one point the leading Democratic contender for the presidency in 2004 claimed that the Bush administration was "of the corporations, by the corporations, for the corporations." Senator John Kerry who was the eventual Democratic candidate in that camp was seeking higher taxes on the wealthy even though his multi-millionaire wife was using every available tax loophole to keep her tax rate below 12.5 percent. *Corporate Scandals*, *supra* n. 2 at 561.

<sup>55</sup> *Id.* at 525, 536-37.

<sup>56</sup> *Id.* at 524.

past efforts, that they will be avoided or evaded. It is also noteworthy that other efforts to regulate compensation by taxes have proved to be failures.

### **Golden Parachutes**

After failing in the courts and losing the battle over progressive tax rates, corporate governance reformers looked elsewhere for a means to limit executive compensation. “Golden parachutes” were one subject of their attacks. These were large payouts to corporate executives in the event their company was taken over. The theory in support of these payments was that the executive would be too worried about his future from the threat of a potentially hostile takeover to concentrate on the business. Presumably, the golden parachute would remove that concern. In actual practice, these payments acted as a deterrent to hostile takeovers since, if pulled, the executives would leave the company with their golden parachutes, robbing it of needed management and draining the treasury in the process.

Bowing to the reformers, Congress amended the Internal Revenue Code in 1984 to prohibit the deduction of golden parachutes where the payments totaled more than three times the executive’s average annual compensation. A 20 percent excise tax was also imposed on the executives receiving such payments.<sup>57</sup> There was, however, more than one way to milk a cow. Executives were allowed to make huge profits from their stockholdings in negotiated mergers, which they proceeded to do after adopting other poison pills to ward off unwonted suitors.

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<sup>57</sup> James R. Repetti, *Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 *Cardozo L. Rev.* 697, 703-705 (1997).

Steve Ross at Warner Brothers pocketed almost \$200 million in its merger with Time Inc. in 1989.<sup>58</sup> More recently, a scheduled payout to James Kilts of over \$180 million after the merger of Gillette and Proctor Gamble raised howls of outrage.<sup>59</sup> Carly Fiorina received a \$42 million severance package after it appeared that the merger she had engineered between Hewlett-Packard Co. and the Compaq Computer Corp. was faltering.<sup>60</sup> Wallace Barr, CEO at Caesars Entertainment was paid \$20 million after his company was taken over by Harrahs. That amount seemed paltry as compared to other such payments but was criticized anyway in the press.<sup>61</sup>

## **Options**

The 1980s witnessed another reform effort that sought to align shareholder interests with those of management through options grants.<sup>62</sup> Led by Michael Jensen at the Harvard Business School and Kevin Murphy at University of Rochester, these theorists believed that options would provide management with an incentive to work harder in order to increase the price of the stock, thereby benefiting shareholders. This theory was premised on the belief that managers being paid only a large salary would have no incentive to work hard and would spend their days on the golf course.<sup>63</sup> Despite the possibility that they might be induced to cut their time on the links, this theory met widespread acceptance even among corporate executives. The SEC thus noted in 1992 that options were one of the

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<sup>58</sup> Thomas Lee Hazen & Jerry W. Markham, *Corporations and Other Business Organizations, Cases and Materials*, 1023 (2d unabridged ed. 2006) (hereinafter "Hazen & Markham").

<sup>59</sup> Brett Arends, "Whiny Kilts Puts Boston on Notice; Gillette Head Slams Hub, Warns Critics," *The Boston Herald*, Sept. 9, 2005, at 005.

<sup>60</sup> Hazen & Markham, *supra* n. 58 at 374. Despite the size of that package, Fiorina remained bitter over her removal. Carly Fiorina, *Tough Choices* (2006).

<sup>61</sup> *Corporate Scandals*, *supra* n. 2 at 563.

<sup>62</sup> *Corporate Scandals*, *supra* n. 2 at 30-31.

<sup>63</sup> *Id.* at 31.

most rapidly growing areas of executive compensation. Recent studies indicate that more than 90% of the leading 200 American industrial and service corporations, respectively, compensate their executives through awards of stock options.<sup>64</sup>

Options, at least until recent years, had another advantage for executives. Unlike a salary, these awards were not treated as an expense on the company's books. This meant that option grants had no effect on earnings, no matter how large the profits received by the executive from the options upon their exercise. This was significant because earnings drive stock prices. If compensated in cash, those earnings would be hurt by the associated expense. Compensation schemes at public companies were soon restructured to cap salaries at \$1 million and use options as the principal basis for executive pay. The result was that about 80 percent of executive compensation was being paid in options as the this century began.<sup>65</sup>

The employment of options as the primary basis for compensation did not curb the amount of compensation being paid to executives. Indeed, overall executive compensation increased by 450 per cent in the 1990s.<sup>66</sup> At the CEO level, compensation witnessed an even more startling increase of 2,500 percent during that period.<sup>67</sup> CEOs were increasingly being given "mega-grants" of options and when those ran out they were replaced by "reload" options, and when stock prices dropped their exercise price was "reset" to a lower level.<sup>68</sup> To name a few benefiting from mega-grants, Larry Ellison, the head of Oracle Corp., made \$706 million on his options. Sanford Weill at Citigroup

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<sup>64</sup> 57 Fed. Reg. 29582 & N. 32 (July 2, 1992).

<sup>65</sup> Corporate Scandals, *supra* n. 2 at 561.

<sup>66</sup> *Id.* at 32.

<sup>67</sup> *Id.* at 30. See generally Tod Perry and Marc Zenner, "CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation," 35 Wake Forest L. Rev. 123 (2000) (describing the growth of executive compensation in the 1990s).

<sup>68</sup> Susan J. Stabile, "Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?" 2 U. Pa. J. Lab. & Emp. L. 227 (1999).

was paid a total of almost \$1 billion, and Michael Dell of Dell Computer was \$233 million for a single year of labor.<sup>69</sup>

In order to limit this money grab, reformers sought to require public companies to expense option grants. This would have had the effect of reducing earnings and would have adversely affected stock prices, making it harder for executives to profit from large option grants.<sup>70</sup> This idea caught the attention of the Financial Accounting Standards Board (“FASB”), which floated a proposal that would have required options to be expensed. The options expensing idea met stiff resistance, however, especially from the so-called dot.com companies of that era that were using option awards to attract and retain talented employees. Claims were also made that it would be difficult to value the options for purposes of expensing. This controversy led to:

a public rally to demonstrate the grassroots support for stock options. Kathleen Brown, the California treasurer and daughter of a storied Democratic governor, shouted to a cheering crowd, ‘Give stock a chance!’ (It was, presumably, the first mass rally against an accounting standard since the birth of double-entry bookkeeping).<sup>71</sup>

The United States Senate also passed a resolution condemning the proposal to expense options in May of 1994 by an overwhelming majority.<sup>72</sup> That opposition led the FASB to retreat from that proposal.

### **Option Scandals**

Congress sought to aid the corporate governance options movement through the Omnibus Revenue Reconciliation Act of 1993.<sup>73</sup> That legislation prohibited corporations

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<sup>69</sup> Corporate Scandals, *supra* n. 2 at 32.

<sup>70</sup> The effect of expensing would have been dramatic for many companies. Cisco Systems’ profit of \$4.6 billion in one year would have been a \$2.7 billion loss if options had been expensed. Yahoo Inc.’s of \$71 million in one year would have had a loss of \$1.3 billion if stock options had been expensed. *Id.* at 31.

<sup>71</sup> Robert J. Schiller, *The New Financial Order, Risk in the 21<sup>st</sup> Century*, 15 (2003).

<sup>72</sup> Janice Kay McClendon, “Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders’ Interests and Promote Corporate Long-Term Productivity,” 39 *Wake Forest L. Rev.* 971, 1020-1021 (2004).

from deducting more than \$1 million for the salary of a CEO or for the salary of four other of the highest compensated employees without shareholder approval.<sup>74</sup> Performance based compensation was excluded from the prohibition on deductions of over \$1 million in salary.<sup>75</sup> This was intended to push executives toward options as compensation and thereby align their interests with those of shareholders. However, as the present SEC chairman recently and ruefully noted: “[t]his tax law change deserves pride of place in the Museum of Unintended Consequences.”<sup>76</sup> This was because, while it had the predictable effect of steering executives into options because they were performance based and exempt from the \$1 million salary limitation on deductibility, it had the unexpected effect of inducing massive accounting manipulations.

Ironically, the reason for the overhaul of the SEC’s executive compensation disclosure rules in 1992 was its view that:

contemporary focus is increasingly on long-term compensation to provide management with incentives to create shareholder value. This trend toward increased use of long-term stock compensation reflects the commonly held view that ‘real ownership builds commitment and risk on the part of executives and positively influences long-term decision-making.’ Recently, these changes have accelerated, with long-term incentive compensation overtaking the more traditional fixed salary and bonus to become the largest single component of the total mix of the typical executive pay package. The growing use and multiplicity of these plans have made executive pay packages extremely complex, and have led to reporting of compensation that many shareholders find incomprehensible.<sup>77</sup>

In fact, executives were becoming increasingly focused on short term management of quarterly earnings reports in order to meet analysts’ expectations. Stock

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<sup>73</sup> Pub. L. No. 103-66, 107 Stat. 312 (1993), codified at 26 U.S.C. §162(m).

<sup>74</sup> A deduction in excess of \$1 million is not allowed even with shareholder approval if the bonus would have been paid regardless of the outcome of that vote. *Seinfeld v. Barrett*, Fed. Sec. L. Rep. (CCH) ¶ 93,840 (D. Del. 2006).

<sup>75</sup> Ryan Miske, “Can’t Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code,” 88 Minn. L. Rev. 1673, 1684-1687 (2004).

<sup>76</sup> Eric Dash, “Congress is Urged to Hold Off Acting on Options and Pay,” N.Y. Times, Sept. 7, 2006, at C3.

<sup>77</sup> 57 Fed. Reg. 29582 (July 2, 1992) (footnotes omitted).

prices thus had to rise before executives could profit from their option grants. Those stock price increases were largely dependent on the views of financial analysts that followed the company. Those analysts focused on the company's quarterly financial reports.<sup>78</sup> A failure to meet even one quarter's "consensus" earnings estimates by analysts caused a sharp decline in a company's stock, which undercut the profit on executive stock options.

This constant demand for quarterly increases in earnings had the undesirable effect of focusing management's attention on short term goals rather than long range initiatives that might be a drag on earnings for some considerable period of time before becoming profitable. This problem was not widely recognized until July 2006, when the Business Roundtable Institute for Corporate Ethics called for the end of quarterly guidance given by executives to analysts. That body stated that quarterly earnings goals had become an obsession and was diverting attention from long range goals and planning at public companies.<sup>79</sup> This fact should have been recognized even earlier.<sup>80</sup> Enron Corp. thus advised its shareholders in 2000, the year before its sensational collapse, that the company was "laser focused on earnings per share."<sup>81</sup> There was good reason for that

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<sup>78</sup> The quarterly reports were introduced in 1970 by the SEC. Previously, only annual and semi-annual reports were required. Securities Exchange Act Release No. 9004 (Oct. 28, 1970).

<sup>79</sup> Francesco Guerrera, "Call to End Quarterly Guidance 'Obsession,'" *Fin. Times* (London), July 24, 2006.

<sup>80</sup> The head of Time Warner, Richard Parsons, had noted after the fall of Enron that:

This is a tension that as managers we have to deal with. We're not a quarter horse. I read somewhere that the quarter horse is the fastest animal in the world in a quarter of a mile. Because of lots of dynamics, increasingly the marketplace is demanding quarter by quarter performance that has the potential to undermine the long term.

Ken Auletta, *Media Man, Ted Turner's Improbable Empire* 131 (2004).

<sup>81</sup> Lawrence E. Mitchell, "The Fault, Dear Investors, Lies in Ourselves," *Wash. Post*, March 31, 2002, at B01.

focus. In the year 2000, over 200 executives at Enron were paid more than \$1 million in compensation. In total, the Enron executives received \$1.4 billion that year.<sup>82</sup>

Large businesses cannot be run on the premise of continually quarterly earnings. There will be up quarters as the business grows over the years. Yet, financial analysts demand constant quarterly growth. “Momentum” investors will shed a company’s stock on the first occasion that analysts’ quarterly consensus estimates are not met. This focused management on short term accounting ploys and operations at the loss of long term strategic goals. This did not align shareholder values with those of management. Rather, it produced unimaginable profits for management in the short term and massive losses to investors in the long term.

The use of options as the principal basis for executive compensation had other drawbacks. If the stock price did not go up, executives would have much reduced compensation. That was not a major problem during the market run up in the latter part of the 1990s, but where there was occasional pause in performance executives were often given the opportunity to reset their option exercise prices at lower value.<sup>83</sup> When that failed, company accounts were manipulated in order to meet analysts’ expectations. Those manipulations involved such things as “cookie jar reserves” and “channel stuffing” as a means to “smooth” earnings.<sup>84</sup> The restatement of company accounts became a daily occurrence as these schemes fell apart in the market down turn at the end of the century.<sup>85</sup>

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<sup>82</sup> Corporate Scandals, *supra* n. 2 at 68.

<sup>83</sup> Susan J. Stabile, “Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?” 2 U. Pa. J. Lab. & Emp. L. 227 (1999).

<sup>84</sup> Matthew A. Melone, “United States Accounting Standards - Rules or Principles? The Devil Is Not in the Details,” 58 U. Miami L. Rev. 1161, 1180-1192 (2004).

<sup>85</sup> Arthur Acevedo, “How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgment, and Materiality of the Auditor’s Report,” 4 DePaul Bus. & Comm. L.J. 1, 5 (2005). One study found 723 restatements between 1997 and 2000. Corporate Scandals, *supra* n. 2 at 213.

Option grants to executives were at the center of the Enron Corp., WorldCom, Inc. and other financial scandals that rocked the financial world after that downturn.<sup>86</sup> Enron's death spiral was completed after it announced that it was resting its earnings for 1997 to 2001 in the amount of \$586 million.<sup>87</sup> Waste Management Inc., announced a more spectacular reduction of \$1.32 billion.<sup>88</sup> At WorldCom, the CEO and chief financial officer inflated revenues by \$1 billion in the third quarter of 2000 and \$800 million in the fourth quarter. Hundreds of millions of dollars were added in future quarters through "close the gap" exercises before that company finally collapsed.<sup>89</sup>

Other companies involved in massive manipulations of their accounts included Nortel Network Corp., Lucent Technologies, Qwest Communications International Inc., Global Crossing Ltd., AOL Time Warner, Inc., HealthSouth Corp., Fannie Mae, Freddie Mac, Hollinger International, Vivendi Universal SA, Royal Ahold NV, and Parmalat Finanziaria SpA.<sup>90</sup> Charles Wang, CEO at Computer Associates International, was paid \$700 million in compensation tied to that company's stock price, a record at the time. However, it was later revealed that the company had engaged in a massive manipulation of its accounts, adding over \$2.5 billion that did not exist.<sup>91</sup>

The Enron and other scandals resulted in a new wave of reform in executive compensation after it was revealed that Kenneth Lay, the head of Enron, had received

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<sup>86</sup> Jerry W. Markham, "Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws," 28 N.C.J. Int'l L. & Com. Reg. 725, 727-728 (2003).

<sup>87</sup> Corporate Scandals, *supra* n. 2 at 83.

<sup>88</sup> *Id.* at 213.

<sup>89</sup> United States v. Ebbers, 453 F.3d 110 (2d Cir. 2006).

<sup>90</sup> Corporate Scandals, *supra* n. 2 at 311-376. See also Andre Douglas Pond Cummings, "'Ain't No Glory in Pain': How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets," 83 Neb. L. Rev. 979, 998-1001(2005) (describing some of these scandals and blaming them on Republicans).

<sup>91</sup> Corporate Scandals, *supra* n. 2 at 22-223.

\$217 million in compensation between 1998 and 2001.<sup>92</sup> His protégée, Jeffrey Skilling, received \$104 million during that same period.<sup>93</sup> Much of that compensation was in the form of options. Bernard Ebbers, the head of WorldCom, received the largest grant of options received by any executive during the five year period before that company collapsed.<sup>94</sup>

The FASB jumped in by revisiting the options expensing proposal after the Enron era scandals and was able to adopt it after the opposition was weakened by those scandals. That too did little to stem the growth of executive compensation. Although a number of firms did stop granting options,<sup>95</sup> a study at the University of Michigan concluded that this requirement did not reduce the number of firms granting options to executives, and grants were up some 24 percent.

The Sarbanes-Oxley Corporate Reform Act of 2002 was signed into law on July 30, 2002.<sup>96</sup> That legislation created a new government oversight board over the accounting industry and sought to strengthen internal management controls.<sup>97</sup> The Sarbanes-Oxley Act prohibited loans by public companies to management.<sup>98</sup> This provision was added after the disclosure of a “co-borrowing” arrangement between Adelphia Communications and its controlling stockholders, the Rigas family of Coudersport, Pennsylvania. The Rigas family took down some \$3 billion under that

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<sup>92</sup> *Id.* at 119.

<sup>93</sup> *Id.* at 116.

<sup>94</sup> *Id.* at 334.

<sup>95</sup> Among those dropping options as compensation was Microsoft Inc.. Tom Abate, “Silicon Valley Loses Fight on Stock Options; Companies Must Deduct Perk’s Value When Figuring Profit,” San Francisco Chronicle, December 17, 2004.

<sup>96</sup> 107 Pub. L. 204, 116 Stat. 745 (2002).

<sup>97</sup> See Roberta S. Karmel, “Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance,” 30 Del. J. Corp. L. 79 (2005). This new regulator was named the Public Company Accounting Oversight Board. William W. Bratton, “Shareholder Value and Auditor Independence,” 53 Duke L.J. 439 (2003).

<sup>98</sup> 15 U.S.C. §78m(k).

arrangement to fund their extravagant lifestyle.<sup>99</sup> Another big time borrower from his corporation was Bernie Ebbers at WorldCom Inc. He received over \$400 million in loans from the company before its bankruptcy.<sup>100</sup>

Another provision in Sarbanes-Oxley required executives to forfeit their bonuses if their company has to subsequently restate its financial statements.<sup>101</sup> It was largely ignored.<sup>102</sup> The SEC was authorized to freeze “extraordinary” compensation payments at companies involved in accounting manipulations.<sup>103</sup> This too seems to have been inspired by Bernie Ebbers who received an extraordinary compensation package when he was terminated from WorldCom.<sup>104</sup>

In one case, the SEC sued Jean-Marie Messier, the former chairman of Vivendi Universal and forced him to give up a \$25 million termination package.<sup>105</sup> In another case, *SEC v. Yuen*,<sup>106</sup> a Ninth Circuit panel held that a payment of \$37.6 million in cash and 6.7 million shares of stock to two executives at Gemstar-TV Guide Inc. were not extraordinary, which meant that those payments could not be frozen pending an SEC action charging the executives with inflating accounts. That decision was reversed in an *en banc* decision of the Circuit Court.<sup>107</sup>

The Sarbanes-Oxley legislation caused public companies to incur massive costs but seems to have little effect on the integrity of the accounting at public companies. A new record was set in 2003 for the number of restatements of accounts in SEC filings,

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<sup>99</sup> Roger Lowenstein, “The Company They Kept, N. Y. Time Magazine, Feb. 1, 2004, at 28.

<sup>100</sup> Corporate Scandals, *supra* n. 2 at 336.

<sup>101</sup> 15 U.S.C. §7243.

<sup>102</sup> Corporate Scandals, *supra* n. 2 at 467, 469.

<sup>103</sup> 15 U.S.C. §78u-3(c).

<sup>104</sup> Corporate Scandals, *supra* n. 2 at 337).

<sup>105</sup> *Id.* at 456.

<sup>106</sup> 367 F.3d 1087 (9<sup>th</sup> Cir. 2004).

<sup>107</sup> 401 F.3d 1031 (9<sup>th</sup> Cir. 2005).

and accounting scandals continued to emerge.<sup>108</sup> One study found 2,319 restatements between 2003 and 2005.<sup>109</sup> The legislation also proved to be tremendously expensive and forced many foreign companies out of U.S. markets.<sup>110</sup> Yet, it did nothing to curb compensation for CEOs, which continued to rise. A survey of the compensation for the CEOs at sixty-nine of the largest companies in the United States in 2002 saw a rise of fifteen percent. Seventeen chief executive officers saw their restricted stock grants increase by seventy-three percent.<sup>111</sup>

A survey of compensation paid to chief executive officers in 2003 saw another increase, to an average of \$8.6 million in payments.<sup>112</sup> Some of those packages were particularly impressive. Reuben Mark at Colgate Palmolive Co. received \$141 million in 2003. Steven Jobs at Apple Computer received \$74 million and George David at United Technologies received \$70 million. John F. Antioco at Blockbuster Inc., was paid almost \$20 million in salary between 1999 and 2004 in addition to uncounted millions in stock

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<sup>108</sup> Corporate Scandals, *supra* n. 2 at 472-479.

<sup>109</sup> “GAO Identifies Cost, Expense Issues as Prevailing Causes of Restatements, 38 Sec. Reg. & L. Rep. 1382-1383 (Aug. 7, 2006).

<sup>110</sup> Francesco Guerrero, “Laws ‘Driving Companies to Foreign Listings’ Sarbanes-Oxley,” *Financial Times* (London), June 20, 2006, at 28; Alan Murray, “Panel to Seek Changes to Sarbanes-Oxley,” *Wall St. J.*, Sept. 12, 2006, at A2. Because of their expense, the SEC has delayed the effective date of some of the more onerous Sarbanes-Oxley requirements on smaller firms. David Reilly, “SEC Moves to Postpone Deadline on Safeguards,” *Wall St. J.*, Aug. 10, 2006, at C3.

One justification for the outsize payments to executives is the fact that any misstep will result in a mass of lawsuits, investigations and prosecutions. It seems that each day results in another scandal at a public company. *See e.g.*, Damon Darlin, “House Panel and U.S. Attorney Join H.P. Inquiry,” *N.Y. Times*, Sept. 12, 2006, at C1 (Hewlett-Packard was under numerous investigations after it was disclosed that company officials had improperly obtained phone records in the course of investigating leaks by board members to the press); Peter Waldman & Don Clark, “California Charges Dunn 4 others in H-P Scandal,” *Wall St. J.*, Oct. 5, 2006, at A1 (chairman of Hewlett-Packard indicted for that conduct); Laurie J. Flynn, “Dell Delays Financial Filing as Accounting Inquiry Grows,” *N.Y. Times*, Sept. 12, 2006, at C3 (Dell Inc. under investigation by SEC and U.S. attorney with respect to its accounting practices); Robert Matthews & Jeanne Whalen, “Glaxo Will Settle a U.S. Tax Case for \$3.4 Billion,” *Wall St. J.*, Sept. 12, 2006, at A1 (Glaxo settles huge tax case and noting other public companies making large tax settlements for similar conduct).

<sup>111</sup> Corporate Scandals, *supra* n. 2 at 469.

<sup>112</sup> *Id.*

options. Blockbuster lost \$3 billion during the period that he was receiving that remuneration.<sup>113</sup>

### **More Option Scandals**

The SEC reappeared in 2006 with more disclosure requirements for executive compensation.<sup>114</sup> That proposal arrived just in time to greet a new wave of options scandals that commenced after a study by the Center for Financial Research and Analysis that concluded that options were being backdated on a massive scale.<sup>115</sup> Executives at numerous public companies were caught up in scandals involving the backdating of their option grants.<sup>116</sup> Another study estimated that some 2,200 companies had been engaged in this practice.<sup>117</sup> Computer Associates admitted backdating back dating options for periods of up to two years.<sup>118</sup> Broadcom Corp. announced that it had under reported \$1.5 billion in expenses between 1998 and 2003 as the result of backdated options and was restating its accounts in that amount. Mercury Interactive Corp. announced a \$525

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<sup>113</sup> *Id.* at 469-470 There were even some big payouts at least one university. Harvard University paid the two managers of its endowment fund \$35 million each in 2003, but reduced their compensation by \$10 million each in 2004. *Id.*

<sup>114</sup> Eric Dash, "Pay Rules Adopted by S.E.C.," N.Y. Times, July 27, 2007, at C1.

<sup>115</sup> Al Lewis, "Backdating: a Scandal in Waiting," Denver Post, June 23, 2006, at C-01.

<sup>116</sup> Julie Creswell, "Investigations Are Sifting Good, Bad and Only Ugly," N.Y. Times, July 25, 2006, at C1. The chairman and chief financial officer at Power Integrations Inc. resigned after being found to have engaged in such practices. Broadcom Corp. announced a \$750 million charge against earnings over the last five years as a result options backdating. The SEC and the Justice Department were investigating these practices. Two executives at Brocade Communications Systems. Inc., including Gregory Reyes the company's CEO, were indicted for such practices. Floyd Norris, "Options Brought Riches and Now Big Trouble," N.Y. Times, July 25, 2006, at C1. *See also* Mark Maremont & Nick Wingfield, "More Questions About Options for Apple, ACS," Wall St. J., Aug. 7, 2003, at A3 (describing option grants to Apple executives just before big jumps in the company's stock price, suggesting that they were back-dated).

<sup>117</sup> Holman W. Jenkins Jr., "How Backdating is Like a 1980s 'Rockumentary,'" Wall St. J., Aug. 16, 2006, at A11; Carolyn Said, "Options Scandal Grew Out of 1990s Strategy," San Francisco Chronicle, July 30, 2006, at F1. Class action lawyers were having a difficult time in cashing in on this latest round of option scandals. Julie Creswell, "One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal," N.Y. Times, Sept. 5, 2006, at C4.

<sup>118</sup> Richard Waters, "Computer Associates Admits to Backdating Stock Options," Financial Times (London), Aug. 1, 2006, at 13.

million restatement as the result of such practices.<sup>119</sup> Cablevision Systems Corp. even awarded options posthumously to a vice president through a backdating scheme.<sup>120</sup>

More than 100 companies were under investigation for this practice by September 2006.<sup>121</sup> Three executives Comverse Technology Inc. were indicted for backdating options.<sup>122</sup> One of those executives made \$138 million over a fourteen year period from his options, of which about \$6.4 million was from backdating.<sup>123</sup> The SEC was also targeting members of the compensation committee at Mercury Interactive who had approved backdating options for an executive at that company.<sup>124</sup>

One study concluded that between 2000 and 2004 backdating increased the average executive's pay at 48 companies by a relatively miniscule 1.25 percent, translating to \$600,000. However, the market price of those companies stock dropped by an average of 8 percent or \$500 million after disclosure of those practices.<sup>125</sup> That probably reflects a shareholder base that is still spooked by the Enron era scandals. It is also evidence of the politics surrounding executive compensation that drives public opinion far more than its actual effect on company earnings.

The backdating scandal widened with the discovery that "spring loaded" options were being granted to executives just in advance of the announcement of good news by

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<sup>119</sup> Harles Forelle, "Broadcom Sees Bigger Options Hit," Wall St. J., Sept. 9, 2006, at A3.

<sup>120</sup> Peter Grant, James Bandler & Charles Forelle, "Cablevision Gave Backdated Grant to Dead Official," Wall St. J., Sept. 22, 2006, at A1.

<sup>121</sup> Jeremy Grant, "More than 100 groups face probe on options," Fin. Times (Londn), Sept. 7, 2006, at 1.

<sup>122</sup> One of these executives heightened this scandal when he became a fugitive from justice. Julie Cresswell & Wayne Arnold, "A Sighting, Perhaps, Of a Fugitive in High Tech," N.Y. Times, Aug. 28, 2006, at C1. He was arrested in Namibia where he had transferred his funds, but was released on bail pending extradition proceedings. Charles Forelle, Kara Scannell & Paul Davies, "A Fugitive's Haven in Africa Turned Out to be Anything But," Wall St. J., Sept. 28, 2006, at A1.

<sup>123</sup> Tom Hays, "3-Ex-Execs at Comverse Tied to Stock Option Scam, Rochester Democrat & Chronicle, Aug. 10, 2006, at 9D. Questions have been raised as to whether this practice is as pernicious as critics claim. Holman W. Jenkins, "The 'Backdating' Witchhunt," Wall St. J., June 21, 2006, at A13.

<sup>124</sup> Eric Dash, "Who Signed Off on Those Options," N.Y. Times, Aug. 27, §3, at 1.

<sup>125</sup> Eric Dash, "Report Estimates the Costs of a Stock Options Scandal," N.Y. Times, Sept. 6, 2006, at C4.

the company.<sup>126</sup> This practice was apparently widespread.<sup>127</sup> The *Wall Street Journal* also reported that some ninety public companies made large options grants to their executives just after the terrorist attacks on September 11, at a time when stock prices were reduced by the greatest percentage since the outbreak of World War II. The market recovered after that attack, generating huge profits to those executives.<sup>128</sup> Of course, that action would appear to reflect a confidence in the company and the economy that the more timid did not share and is commendable.

## IV

### MORE REFORMS

#### The War on Perks

A particular area of concern with compensation has been the perquisites given to executives that range from the free use of the corporate jet to tickets to sporting events. In the 1970s, Henry Ford II was lambasted in the press after it was revealed that he was using company aircraft to ferry his wife and the family's cats and dogs to various exotic destinations.<sup>129</sup> More entertaining is the case brought in 1980 by the SEC against Playboy Enterprises, Inc. the publisher of a skin magazine and one time proprietor of night clubs featuring scantily clad hostesses called "bunnies."<sup>130</sup> The SEC charged that Playboy, was allowing Hugh Hefner, its founder and majority shareholder, to live at the company's mansions in Chicago and Los Angeles without disclosing that Hefner was paying only a

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<sup>126</sup> Steve Syre, "A Step in the Right Direction," *Boston Globe*, July 27, 2006, at D; Floyd Norris, "They Deceived Others. Who Cares?" *N.Y. Times*, Oct. 6, 2006, at C1.

<sup>127</sup> Gretchen Morgenson, "Still Addicted to Options," *N.Y. Times*, June 18, 2006, at BU1.

<sup>128</sup> Charles Forelle, James Bandler and Mark Maremont, "Executive Pay: The 9/11 Factor," July 15, 2006, at A1.

<sup>129</sup> *Age of Derivatives*, *supra* n. 45 at 121.

<sup>130</sup> 1980 SEC LEXIS 911 (S.E.C. Aug. 13, 1980).

nominal of rent and that most of his living expenses were being picked up by the company.

The SEC's complaint against Playboy describes these luxurious accommodations in detail, including the fact that the Chicago mansion had a dormitory that housed up to thirty playboy bunnies. Hefner was also charged with having used the corporate jet, named the "Big Bunny" for personal trips. The odd thing is the SEC must have been the only male dominated organization in the country that was unaware of the fact that Hefner's life style at the mansions was being subsidized by Playboy and that the company was using that life style as a giant publicity machine.

The Enron era scandals reached even greater heights. Dennis Kozlowski, the CEO at Tyco International, became infamous after it was disclosed that the company had purchased and furnished a luxury apartment for him in Manhattan, including an instantly famous \$6,000 shower curtain. Tyco also paid \$2.1 million for a birthday party for Kozlowski's wife on the island of Sardinia, complete with Jimmy Buffett for entertainment. Kozlowski was convicted and jailed for looting corporate funds after these excesses were revealed.<sup>131</sup>

Another world class party thrower was Lord Conrad Black who headed the Hollinger International chain of newspapers. Lord Black used corporate funds for a birthday party for his wife at New York's La Grenouille restaurant where eighty celebrity guests were treated to Beluga caviar and 69 bottles of expensive wine. Lord Black also

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<sup>131</sup> Corporate Scandals, *supra* n. 2 at 240-242. David Wittig, the CEO for Westar Energy Inc. was another first class receiver of corporate perks which included \$6.5 million to renovate his office, including a television cabinet that cost \$29,000. He received several million dollars in relocation expenses but never moved. Instead, he used more corporate funds to renovate his house in Kansas. Those renovations included a \$1,200 bronze alligator. *Id.* at 470.

spent \$28,000 on dinner parties for Henry Kissinger, the former Secretary of State.<sup>132</sup> The government is seeking \$1.4 billion in damages from Black and his colleagues for their alleged looting at Hollinger. A Canadian judge also found a way to curb Lord Black's spending. The judge ordered that Black and his wife spend no more than \$50,000 Canadian per month pending the outcome of the litigation against them.<sup>133</sup>

The Rigas family who controlled Adelphia Communications Corp. also made headlines with their prerequisites. Among other things, they were charged with using corporate funds to pay for an African safari and with using corporate jets for shopping trips and two pick up a Christmas tree. The latter errand actually required two trips because the first tree was too short. John Rigas was given a 15 year prison term for his role in that scandal, effectively a death sentence for that octogenarian cancer victim.<sup>134</sup>

Bernie Ebbers at WorldCom lived a laid back life style, but he owned a 130 foot yacht, a 164,000 acre ranch and a hockey team that he moved the Mississippi where WorldCom's headquarters were located.<sup>135</sup> Ebbers was convicted of fraud for his role in the accounting manipulations at WorldCom and was sentenced to 25 years in prison, which was a probable death sentence since he was suffering from heart problems. The Second Circuit Court of Appeals in New York affirmed Ebbers conviction even though,

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<sup>132</sup> *Id.* at 370. Parties are a long-time tradition for moguls. During the Gilded Age one party involved a dinner served indoors with the diners in formal attire seated on horses and served by liveried attendants. I Jerry W. Markham, *A Financial History of the United States, From Christopher Columbus to the Robber Barons (1492-1900)* 351 (2002). A party thrown at Sherry's restaurant in New York at the beginning of the Twentieth Century was reported to have cost \$200,000 and was so extravagant that it was thought the sponsor must have been looting funds from an insurance company he controlled. Its actual cost was \$13,000 but that did not lessen the scandal. Patricia Beard, *After the Ball* 4, 126 (2003). That scandal resulted in an investigation and laws that restructured the insurance industry in New York. Institutional Investors, *supra* n. 9 at 18-20.

<sup>133</sup> Richard Siklos, "Judge Delivers a Dollop of Austerity to Lord Black's Household," *N.Y. Times*, September 4, 2006, at C1.

<sup>134</sup> *Corporate Scandals*, *supra* n. 2 at 329.

<sup>135</sup> *Id.* at 334-335 (2006).

as the court noted that: “Twenty-five years is a long sentence for a white collar crime, longer than the sentences routinely imposed by many states for violent crimes, including murder, or other serious crimes such as serial child molestation.”<sup>136</sup>

Jack Welch the venerated head of General Electric Co. (“GE”), was embarrassed when it was revealed in his divorce proceedings that he was given many perks as a part of his retirement package, including tickets to sporting events, use of a jet, and a car and driver. The SEC sued GE for failing to disclose those perks in its financial reports even though their total value was only some \$2.5 million.<sup>137</sup> Corporate jet use even became the subject of two front page articles in the *Wall Street Journal* that carefully charted the use of such aircraft for executive golf outings in Florida. Barry Diller appeared to be the leading jet set executive, running up an \$832,000 tab on the corporate jet in 2004.<sup>138</sup> The Internal Revenue Service and Congress have tried to make it more difficult to deduct the use of corporate jet for personal use but that effort has not slowed executive travel.<sup>139</sup>

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<sup>136</sup> *United States v. Ebbers*, 453 F.3d 110 (2d Cir. 2006). Terrorists fared better than Ebbers. Ahmed Ressam, the “Millennium Bomber” who was arrested at the Canadian border with 100 pounds of high explosives that he planned to use to blow up the Los Angeles airport, was sentenced to only 22 years. John Walker Lindh, the American Taliban captured in Afghanistan while trying to kill American soldiers, was given only 20 years. The relatively younger ages of those terrorists and eligibility for early release further reduced the severity of their sentences. Jerry W. Markham, “How the Feds Stacked the Deck Against Enron,” *Chicago Sun Times*, May 7, 2006, at B2. This disparity may be due to a “moral panic” that broke out after the Enron and WorldCom Scandals. *See* Jose Gabilondo, “Financial Moral Panic! Sarbanes-Oxley, Financier Folk Devils, and Off-Balance-Sheet Arrangements,” 36 *Seton Hall Law Review* 781 (2006) (describing this phenomenon).

<sup>137</sup> *Corporate Scandals*, *supra* n. 2 at 484-485. GE had other accounting problems of a far greater magnitude. It had to restate \$2.2 billion in revenues for 2002 and 2003. *Id.*

<sup>138</sup> Mark Maremont, “JetGreen: The CEO’s Private Golf Shuttle --- Corporate Planes, Meant to Save Time, Also Ferry Executives to Top Courses,” *Wall St. J.*, Oct., 2005, at A1; Mark Maremont, “Frequent Fliers: Amid Crackdown, the Jet Perk Suddenly Looks a Lot Pricier --- For CEOs, Personal Flight Costs Can Reach Six Figures; Their Tax Bill Stays Low --- Barry Diller’s Plane in Africa,” *Wall St. J.*, May 25, 2005, at A1.

<sup>139</sup> Some government officials are also addicted to corporate jets. Eliot Spitzer, the New York Attorney General who has been a prime critic of the misuse of corporate funds, has been conducting his campaign for governor on a jet owned by a lobbyist with interests in New York thoroughbred racing and who is seeking a gambling license in New York for an Indian tribe. Spitzer was being charged only a nominal cost for the use of the jet. “Travels With Eliot,” *Wall St. J.*, Sept. 13, 2006, at A18.

Corporate perks remain front page news, as evidenced by a *Wall Street Journal* report that News Corp. was paying \$50,000 a month to rent an apartment for Rupert Murdoch, its chairman. However, Murdoch was also being paid \$25.7 million and could have doubtlessly demanded more in lieu of this \$600,000 perk.<sup>140</sup>

### **Alternate Compensation**

After the options scandals, reformers began suggesting that longer term incentives are needed. Some companies began experimenting with restricted stock.<sup>141</sup> Such grants require executives to remain with the company for some period of time and provide an incentive to increase the value of the company's stock over the long term. However, such reforms are being circumvented by sophisticated financial tools. For example executives at public companies were using "prepaid variable forward contracts" to sell their stock holdings and gain tax advantages. In one such transaction, Don Ackerman, chairman of WCI Communities, Inc., received \$14 million from an investment banker for a base amount of 500,000 shares of his company's stock to be delivered three years later. The number of shares to be delivered would be reduced if their share price increased but would not have to deliver more if share prices fell.<sup>142</sup>

In another reform effort, the SEC broadened its efforts to curb executive compensation in 2006. Those requirements sought to, once again, attack excess compensation through more disclosure. The topic was a hot one, as evidenced by the over 20,000 comment letters received by the agency on its proposed changes. The amendments as adopted expanded the executives whose compensation must be disclosed

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<sup>140</sup> "What's New." *Wall St. J.*, Sept. 8, 2006, at A1.

<sup>141</sup> Rob Wells, "Senate Panel Hears Testimony on Stock-Option Pricing Abuses," *Wall St. J.*, Sept. 7, 2006, at A8.

<sup>142</sup> Serena Ng, "Tracking the Numbers -- Street Sleuth -- Filing Footnote: This Insider Sale Helps Hedge Bets," *Wall St. J.*, May, 15, 2006, at C1.

to include the principal executive officers, principal financial officers, other high paid executives and members of the board of directors.<sup>143</sup> The agency ran into controversy after it was noted that, as originally proposed, the rules would have required disclosure of the salaries of high paid anchor men and women at the television networks and sport stars. This was quickly dubbed the Katy Kouric amendment, but the agency backed off to require only disclosure of those employees with executive responsibilities.<sup>144</sup>

The SEC's demand for full disclosure of executive salaries is a really bad idea, as well as counter-intuitive. What is one of the most closely guarded secrets in the corporate world? The answer is the compensation of non-hourly employees. Why is that? It is because disclosure would reveal inequities in pay brought about by hard work, brilliance, management skills, seniority, mentors or just plain unfairness. Disclosure would result in a loss of morale as each employee would compare and view his or her self as being unfairly treated. Some employees would quit, others would demand more pay and others would simply lose interest in their job. The result would be increases in pay as each employee demanded more than being received by another employee. The only solution for compensation at lower executive levels would be a stratified compensation structure for those employees provide that would provide no incentive for hard work, brilliance or management skills and undermine the advancement of business.

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<sup>143</sup> Securities Act Release No. 33-8732 (Aug. 24, 2006). In adopting the amendments, the SEC stated that: The amendments to the compensation disclosure rules are intended to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors. Closely related to executive officer and director compensation is the participation by executive officers, directors, significant shareholders and other related persons in financial transactions and relationships with the company. We are also adopting revisions to our disclosure rules regarding related party transactions and director independence and board committee functions.

*Id.*

<sup>144</sup> Eric Dash, "Pay Rules Adopted By S.E.C." N.Y. Times, July 27, 2006, at C1.

As it is at the upper executive level full disclosure has already touched off a wave of competition for ever higher amounts of compensation. As noted in the *New York Times*, the SEC's executive compensation disclosure requirements only encourage competition for larger compensation packages.<sup>145</sup> Certainly, the expansion of those who must disclose under the SEC's recent rule amendments will only widen the demands for ever increasing compensation and prerequisites. Disclosure had failed in the past why did the SEC think it would now succeed. A study found that the five highest paid executives at the 1500 largest publicly owned firms were paid \$122 billion between 1999 and 2003. In 2003, those payments were equal to almost 10 percent of those companies' net income.<sup>146</sup> Moreover, average CEO compensation rose 27 percent in 2005 from the prior year.<sup>147</sup> Another study found that CEOs were paid 432 times more than the average worker in 2004, up from 142 times the average worker in 1994.<sup>148</sup>

If further proof is needed that executive compensation is spiraling up notwithstanding SEC full disclosure consider the fact that the *Forbes* magazine list of 400 richest Americans did not include a single millionaire in 2006. They were all billionaires.<sup>149</sup> Gross cases continued. Hank McKinnell, the head of the Pfizer pharmaceutical company was paid almost \$150 million in pay and pension benefits during a period when the stock price dropped by 43 percent.<sup>150</sup> A front page story in the

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<sup>145</sup> Stephen Labaton, "Spotlight on Pay Could Be a Wild Card," N.Y. Times, April 9, 2006, at BU1.

<sup>146</sup> Jack Ramus, "Executive Pay in the U.S.: CEOs Take the Money and Run," Z Magazine, April 19, 2006.

<sup>147</sup> Eric Dash, "C.E.O. Pay Keeps Rising, And Bigger Rises Faster," N.Y. Times, April 9, 2006, at BU5.

<sup>148</sup> Rana Foroohar & Barrett Sheridan, "Are They Worthy?; Despite the Shocking Extremes, New Studies Claim CEO Pay Matches Performance, and Increasingly So," Newsweek, Aug. 14, 2006, at Bu0.

<sup>149</sup> Vinnee Tong, "Forbe's Richest Americans List Has Room Only for Billionaires This Year," Naples Daily news, sept. 22, 2006, at E1.

<sup>150</sup> Gretchen Morgenson, "McKinnell Fumbled Chance to Lead," N.Y. Times, Aug. 6, 2006, § 3, at 1.

*New York Times* in May 2006 showcased the \$245 million paid by Home Depot to its CEO, Robert Nardelli whose company's stock price was stagnating.<sup>151</sup>

## V

### WHY BOTHER

#### What is Excessive?

The real issue in the debate over executive compensation is how to determine whether compensation is excessive. That was the issue the court floundered over in the *Rogers v. Hill*<sup>152</sup> litigation. The current furor over the \$187 million paid to Richard Grasso, while he was the head of the New York Stock Exchange (“NYSE”), is a case in point. In addition to that package, six other NYSE executives had received annual compensation over a five year period that exceeded \$140 million. That is a lot of money.<sup>153</sup> However, unlike Michael Ovitz who contributed very little for his \$140 million compensation package for fourteen months work, Grasso was a long time employee of the NYSE who worked his way through the ranks without even the benefit of a college education.

Grasso kept the NYSE competitive in the face of severe threats from Nasdaq, electronic communications networks and international trading. Despite that competition,

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<sup>151</sup> Julie Creswell, “With Links to Home Depot Board, Chief Saw Pay Soar as Stock Fell, N. Y. Times, May 24, 2006, at A1. One executive, Sumner Redstone at Viacom, had his salary reduced and his deferred compensation of nearly \$10 million was changed to a performance based arrangement. Geraldine Fabrikant, “Redstone Takes a Cut in His salary,” N.Y. Times, Sept. 26, at C1. Apparently he had money to spare since his wealth was then being valued at \$7.5 billion. Matthew Miller, “Entertainment, One of America’s Largest Exports, Serves as a Global Platform for Profit for these Moguls,” Forbes, Oct. 9, 2006, at 194.

<sup>152</sup> 289 U.S. 582 (1933).

<sup>153</sup> Corporate Scandals, *supra* n. 2 at 498.

NYSE market share in the stocks it listed for trading was eighty-five percent in 2001.<sup>154</sup> Nasdaq lost 30 percent of its volume to electronic communications networks while the NYSE lost only 7 percent.<sup>155</sup> The NYSE provided its specialist members with profits of \$2.12 billion between 1995 and 2000.<sup>156</sup> The price of NYSE memberships nearly doubled during Grasso's tenure and average daily trading volume increased from 179 million shares in 1991 to about 1.4 billion shares in 2000. Grasso had also forcefully in reopening the NYSE after the September 11 attacks.<sup>157</sup>

Some studies suggest that large compensation packages correlate to the market capitalization of many public companies, *i.e.*, the larger the company the greater the pay. That makes some sense since the manager's skills are tested by assembling and managing a large enterprise.<sup>158</sup> Another way to judge value is to compare pay at non-public companies. That private (non-public company) sector provides a comparative base where self-interest would presumably preclude excessive compensation. Yet, James Simmons, a hedge fund manager, was paid an incredible \$1.5 billion in 2005.<sup>159</sup>

In August 2006, VNU NV announced that it was hiring the vice chairman of the General Electric Co. for a compensation package valued at \$100 million. This was not another instance of the looting of a public company. VNU is owned by private equity

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<sup>154</sup> Aaron Lucchetti, "A Verdict on Grasso's Legacy," Wall St. J., Aug. 24, 2006, at C4.

<sup>155</sup> Ken Hoover, "NYSE Specialists Face Criticism As Anachronism In 21st Century; NYSE Defends System," Investor's Business Daily, Oct. 2, 2003, at A01.

<sup>156</sup> Corporate Scandals, *supra* n. 2 at 500.

<sup>157</sup> Aaron Lucchetti, "A Verdict on Grasso's Legacy," Wall St. J., Aug. 24, 2006, at C4.

<sup>158</sup> Rana Foroohar & Barrett Sheridan, "Are They Worthy?; Despite the Shocking Extremes, New Studies Claim CEO Pay Matches Performance, and Increasingly So," Newsweek, Aug. 14, 2006, at Bu0. Studies also show that some underperforming companies are over-paying their executives. Gretchen Morgenson, "The Best and the Worst in Executive Performance," N.Y. Times, Sept. 17, 2006, §3, at 1. However, that is but a statement of the obvious. Those managers are managing for themselves and not for shareholders, so the stock price drops.

<sup>159</sup> Adam Shell, "Some Hedge Funds Hit a Slump This Year," USA Today, Sept. 19, 2006, at 1B, 2B.

firms and that money was coming from the pockets of those sophisticated investors.<sup>160</sup> In fact, the *Financial Times* reports that executives at public companies are becoming hiring targets for private equity. That newspaper reported that:

Kohlberg Kravis Roberts, the buy-out firm, says more than a third of its 29 top managers have experience as chief executive or chief financial officer of a public company. Marc Lipschultz, a KKR partner, said: ‘When they join private equity-backed companies these executives can spend much more of their time on long-term business building rather than on quarterly earnings.’<sup>161</sup>

This talent search will no doubt remove the best of the managers from public companies. At private equity firms they no longer have to worry about Sarbanes-Oxley and SEC regulations that have sapped executive time, resulted in enormous expense, driven foreign listings offshore, discouraged initial public offerings and caused executives to abandon risk in favor of caution that will turn their companies into mere bureaucracies. Private equity firms are even now raiding public companies and taking them private. Those shrewd investors see nothing amiss in allowing the managers of those companies to profit handsomely from the buyout and then award those same executives with equity stakes in the acquired firm that will provide opportunity for even greater profits.<sup>162</sup>

The marketplace can decide what is excessive and what is not. To be sure, the market efficiency advocates are taking a beating from the behavioral school that posits

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<sup>160</sup> Kathryn Kranhold & Joann S. Lublin, “\$100 Million Helps Lure Away General Electric Veteran,” *Wall St. J.*, Aug. 24, 2006, at B1.

<sup>161</sup> Francesco Guerrera, “Private equity talent search leaves listed groups trailing,” *Financial Times* (London), Aug. 30, 2006, at 1. Not all private equity pays so well since many of these entrepreneurs forgo salary for large profits when they sell off assets. Nevertheless, the average employee at such firms was being paid \$777,000 in 2005. Rebecca Buckman, “Venture Firms Are Doling Out Large Pay Deals,” *Wall St. J.*, Sept. 14, 2006, at C1.

<sup>162</sup> Henny Sender & Dennis K. Berman, “In Some Deals, Executives Get a Double Payday,” *Wall St. J.*, Sept. 8, 2006, at C1.

that markets are affected by inefficiencies and even non-rational behavior.<sup>163</sup> One behavioralist has thus noted that:

Although a number of factors might affect CEO behavior, such as CEO age, tenure, education, and socioeconomic background, I theorize that CEO overconfidence is in important ways a product of corporate governance. Corporate governance structure and practice in the United States is likely to lead to CEO overconfidence in two key ways. The first relates to executive compensation. A large executive compensation package gives positive feedback to a CEO and signals that the chief executive is a success. Studies show that positive feedback and recent success build confidence. In this view, the very process of winning the tournament to become the top executive probably makes a CEO more confident. Indeed, highly confident individuals presumably self-select into the tournament to become CEO in the first place. The leading theoretical approaches to executive compensation--which generally break down into the so-called 'optimal contracting approach' and the 'managerial power approach'--try to explain the size and design of executive compensation, while other approaches focus on whether the size of CEO pay is 'just' or 'fair' as compared to what the average worker receives. Stressing the possible link between CEO pay and CEO overconfidence offers a new 'behavioral approach' to executive compensation that is more concerned with the psychological consequences of executive pay--namely, the risk of bad business decisions, particularly overinvestment, rooted in growing CEO confidence--than with the incentive effects or fairness concerns associated with how and how much CEOs are paid.<sup>164</sup>

The problem with this over-confidence theory is that critics of the behavioral school contend that those theorists are too pessimistic in their analyses.<sup>165</sup>

In all events, the issue of whether the market is as efficient as the Chicago school claims or as inefficient as the behaviorists posit is theoretical only. The market is like a democratic government. Everyone is allowed to express their views in a democracy by voting at the ballot box. In a similar manner, market participants vote with their feet by

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<sup>163</sup> Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: The Problem of Market Manipulation," 74 N.Y.U. L. Rev. 630 (1999). *See generally* Margaret M. Blair & Lynn A. Stout, "Trust, Trustworthiness and the Behavioral Foundations of Corporate Law," 149 U. Pa. L. Rev. 1735 (2001) (discussing how internal pressures affect corporate decision making).

<sup>164</sup> Troy A. Paredes, "Corporate Decisionmaking; Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance," 32 Fla. St. U.L. Rev. 673, 678-679 (2005) (citations omitted).

<sup>165</sup> Gregory Mitchell, "Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of the Law," 43 Wm and Mary L. Rev. 1907 (2002).

selling or buying the stock (“the Wall Street rule”).<sup>166</sup> In a democracy, some bad presidents and members of congress are elected, bad laws are passed and inefficiency abounds. This is because human beings are involved, and human beings make mistakes. The market is no different. There will be periods of “irrational exuberance”<sup>167</sup> and depressions because of errors on the part of market participants. However, to paraphrase Winston Churchill on democracy, it is the worst possible system except for any other.<sup>168</sup>

Certainly, the reformists and the SEC have proved that they cannot outperform the market when it comes to executive compensation. A company that is overpaying its executives will eventually fail or be crippled. A company that underpays will lose the executives that made it efficient, and it too will suffer. So what happens to the investor in the interim? Actually, nothing, if the investor is sufficiently diversified. Diversification will bring both underpaying and overpaying companies into the portfolio as well as those who have it just right.

Of course, this approach does not deal with the envy, jealousy or even outrage that arises at each disclosure of a giant compensation package. There are a couple of ways to deal with those emotions. One is to view it as if the CEO won the lottery. Those executives took huge risks and, beyond the lottery winner, worked hard and battled with sometimes Byzantine corporate politics to reach the pinnacle where they last on

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<sup>166</sup> Participation in democracy is limited to a relative few voters, while everyone votes in the market with their dollars. Voting in the market may be weighted in some cases by those having more dollars and in other cases by those having less dollars individually but more collectively.

<sup>167</sup> For the benefit of future generations, this was a famous remark by Alan Greenspan, chairman of the Federal Reserve Board, made in reference to the euphoria that was driving up the stock market in 1996. In retrospect, Mr. Greenspan was a bit premature because the market did not break until 2000. Jerry W. Markham, *A Financial History of Modern U.S. Corporate Scandals, From Enron to Reform* 34-35 (2006).

<sup>168</sup> *Corporate Scandals*, *supra* n. 2 at 650-651. Churchill also stated that:

Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful see it for what it really is - the strong horse that pulls the whole cart.

[http://www.brainyquote.com/quotes/authors/w/winston\\_churchill.html](http://www.brainyquote.com/quotes/authors/w/winston_churchill.html).

average only four years.<sup>169</sup> If we do not resent lottery winners, why not treat the executive the same way.<sup>170</sup>

The government and reformers should, in any event, remove themselves from the business of trying to regulate executive compensation. This means that the SEC's executive compensation rules should be chucked. That would lessen the demand for ever higher pay packages. Even in government disclosure of the income and assets of officials is expressed only in terms of broad ranges under the Ethics in Government Act of 1978 that are almost meaningless.<sup>171</sup> If disclosure is required at all for executive pay, it should be in the form of total executive compensation and not focus on individuals. This will allow shareholder monitoring to the extent there is such a thing. After these restrictions are removed, compensation committees will be free to consider a broad range of incentives.

Returning compensation to the marketplace would also mean the removal of the limitation on deductibility of salaries. That would encourage increased salaries that will allow the executive to focus on longer term strategies and lessen dependence on options that are valued by short term quarterly earnings. The executives will be taxed on those salaries and there is no reason why they should not be deductible.

Congress is finally waking to the fact that encouraging options over salaries through their deductibility was a mistake. Incredibly, however, the focus in Congress is to

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<sup>169</sup> . "The Un-Imperial CEO," Wall St. J., Sept. 16-17, 2006, at A8.

<sup>170</sup> In fact, most CEOs are self made, having neither the advantage of family wealth nor even an ivy league education. Carol Hymowitz, "Any College Will Do," Wall St. J., Sept. 18, 2006, at B1.

<sup>171</sup> See Robert G. Vaughn, "Ethics in Government and the Vision of Public Service," 58 Geo. Wash. L. Rev. 417, 438 (1990) (describing these disclosure requirements).

limit deductibility of both rather than remove the restriction on salaries.<sup>172</sup> Apparently some congressional members seem to think this would act like a cap for all compensation, further structuring public companies as government bureaucracies that accept lower pay in exchange for job security. At the same time, those bureaucrats will eschew all risk and accountability.

Congressman Barney Frank has introduced a “Protection Against Executive Compensation Abuse Act” that would preclude deductions for executive compensation in excess of more than 25 times the lowest amount paid to any employee. The present average amount is more than 400 times the average worker.<sup>173</sup> Such a limitation would certainly drive anyone with any entrepreneurial skills away from the management of a public company. In fact, limiting the deductibility of both options and salaries will seem result in a tax increase on the shareholders because executives will still pay themselves amounts far in excess of \$1million.

On the plus side, executives may increase salary compensation since there would no longer be a tax incentive to pay options instead of salaries, leading to more balanced pay packets. For example, executive compensation *could* include a salary significant enough to secure the allegiance of the executive and allow that executive to focus on the long term goals of the company. That executive could also be given restricted stock to secure those same goals and provide even greater incentive to manage in the long term.

Another part of a more balanced pay package could be options in an amount that would also assure that the executive that a good quarter will be rewarded without pulling

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<sup>172</sup> Charles Forelle & Kara Scannell, “Revisiting Executive-Pay Law,” Wall. St. J., Sept. 6, 2006, at C1. Government regulators were more circumspect, urging Congress to defer such action. Eric Dash, “Congress is Urged to Hold Off Acting on Options and Pay,” N.Y. Times, Sept. 7, 2006, at C3.

<sup>173</sup> Rana Foroohar & Barrett Sheridan, “Are They Worthy?; Despite the Shocking Extremes, New Studies Claim CEO Pay Matches Performance, and Increasingly So,” Newsweek, Aug. 14, 2006, at Bu0.

that executive from long term strategic plans. Of course, the particular mixture of compensation will be in the hands of the executive committee. That committee will be in a much better position to negotiate the appropriate compensation package if unencumbered by artificial restrictions and unneeded disclosures.<sup>174</sup>

## VI

### CONCLUSION

Corporate reformers have attacked executive compensation over the years through the “progressive” income tax code. Tax levels were almost confiscatory for several decades but those taxes were largely avoided or evaded through a number of means. Tax levels have now been lowered to more reasonable levels that have had the seemingly incongruous result of raising tax collections. Corporate reformers have also held a dream that limiting excessive executive compensation can be dealt with by first the stick in the form of litigation than the carrot in the guise of options. Congress assisted in that misguided effort by punitively taxing salaries over \$1 million. That approach failed, as witnessed by the orgy of compensation paid out to executives during the market run up in the 1990s.

The SEC weighed in with the reformers but sought to use full disclosure as a way to shame executives into not seeking excessive compensation. Both the SEC and the reformers failed in curbing excessive compensation. Indeed, if anything, those efforts

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<sup>174</sup> Arguing against more balanced payment schemes such as the one in text is that the faltering Ford Motor Company was using such an approach to recruit a new CEO, Alan Mulally, from Boeing Co. Since Ford has operated as a bloated bureaucracy for years, it is difficult to trust their judgment in matters of compensation. In the event, Mulally will receive a \$2 million salary, a \$18.5 million signing bonus and compensation for loss of options at his old employer, 600,000 shares of restricted stock and 4 million options. John D. Stoll, “Ford’s New CEO to Get \$2 million in Base Salary,” Wall St. J., Sept. 9, 2006, at A3.

only spurred the ever increasingly large compensation packages. Undaunted, the SEC has once again demanded more disclosures as a way to curb excesses. That effort no doubt will also fail.

Finally, it is time to stop worrying about executive misuse of the corporate jet. It is their toy. Most of them earned it, so let them play with it. Moreover, much business is accomplished on the golf course and at expensive sporting events where those jets have a tendency to travel. Corporate perks make great headlines, but are they really a serious issue? They are not a large part of most compensation packages. Tyco might be an exception but even the celebrated apartment bought by the company for Kozlowski's use was sold for a profit.<sup>175</sup> In any event, corporate executives will simply demand an increase in their compensation if they are taxed on those perks. So why bother?

It is time for the SEC and reformers to remove themselves from the compensation picture. The market must decide these issues. The market is of course not perfect and there will continue to be excesses. However, market discipline will at least provide some checks on the excesses, unlike the efforts of the SEC and the reformers who have only encouraged abuses. To the extent there is actual looting by executives, criminal prosecutions should be sufficient punishment and deterrence for others.

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<sup>175</sup> William Newman, "Tyco to Sell Ex-Chief's Apartment for \$21 Million," N.Y. Times, Oct. 9, 2004, at C1.