

## The Answer to Excessive Executive Compensation Is Risk, Not the Market

Charles M. Elson

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## The Answer to Excessive Executive Compensation Is Risk, Not the Market

WHEN I WAS IN LAW SCHOOL IN 1983, THERE WAS A SECTION in our corporations class on compensation. At the time, Dean Saul Levmore was teaching corporations and used to tell us not to worry too much about executive compensation because the courts tended to stay out of it due to the market's self-correcting nature.<sup>1</sup> I thought that was a pretty good answer. When I first started teaching, I used to say the same thing. Then all of a sudden, the world changed. Now, compensation crises and controversies are in the news all of the time.<sup>2</sup>

There are two main problems with excessive executive compensation. The first problem with excessive compensation is that it is stealing.<sup>3</sup> This is a real problem from a shareholder's standpoint.<sup>4</sup> Number two, excessive executive compensation is demoralizing to the other workers in the organization.<sup>5</sup> After all, everyone else in the organization is not going to cut costs if they see the executives taking and walking off with everything that they thought they were saving.

Professor Markham argues that it is time to stop worrying about executive misuse of corporate jets.<sup>6</sup> They are executives' toys.<sup>7</sup> Most of them earned it, so let

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\* Edgar S. Woolard Jr. Chair in Corporate Governance and the Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware; Member of the Advisory Council of the National Association of Corporate Directors.

1. *Heller v. Boylan*, 29 N.Y.S.2d 653, 679–80 (N.Y. Sup. Ct. 1941) (“Courts are ill-equipped to solve or even to grapple with these entangled economic problems.”), *aff’d*, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941); see also *Seitz v. Union Brass & Metal Mfg. Co.*, 189 N.W. 586, 587–88 (Minn. 1922) (explaining that courts should proceed with care when determining whether salaries are excessive or unreasonable). See generally Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 81–83 (1992); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–55 (1983).

2. Lawton W. Hawkins, *Compensation Representatives: A Prudent Solution to Excessive CEO Pay*, 72 BROOK. L. REV. 449, 449 (2007) (stating that “[t]he *New York Times* alone printed 339 stories dealing with executive compensation in 2006”); see, e.g., Patrick McGeehan, *Executive Pay: A Special Report*, N.Y. TIMES, Apr. 6, 2003, § 3, at 1 (discussing executive compensation packages in the wake of corporate scandals).

3. See Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 951–66 (1993) [hereinafter Elson, *Executive Overcompensation*].

4. See *id.*

5. Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675, 702 (2005).

6. Jerry Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 344 (2007).

7. *Id.* at 345.

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them play with it.<sup>8</sup> Moreover, much business is accomplished on the golf course and at expensive sporting events where these jets have a tendency to travel.<sup>9</sup>

My three-year-old son likes to say, "Yikes." I said "Yikes!" when I read that viewpoint. After all, corporate jets are not executives' toys. Corporate jets are business tools.<sup>10</sup> Frankly, using jets for personal purposes is a misuse of shareholder assets.<sup>11</sup> Sure, a lot of executives argue, "Oh, a lot of business is conducted on the golf course." The only kind of business that takes place on the golf course is not good business. Corporations have to be really careful because if they ignore an executive's misuse of business tools for personal pleasure, then all kinds of things begin to happen within the organization itself.<sup>12</sup> In fact, excessive compensation is a misuse of corporate assets. The question is how to solve the problem of excessive compensation.

Just like Professor Markham, I believe that the tax-based,<sup>13</sup> disclosure-based,<sup>14</sup> and judicial-based<sup>15</sup> solutions are not the way to solve excessive executive compensation.<sup>16</sup> However, unlike Professor Markham, I believe that leaving excessive executive compensation to the marketplace is problematic because the market has never understood excessive executive compensation.<sup>17</sup> In fact, the market traditionally has not done anything about it because excessive compensation did not dramatically

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8. *Id.*

9. *Id.* See generally Mark Maremont, *Frequent Fliers: Amid Crackdown, the Jet Perk Suddenly Looks a Lot Pricier*, WALL ST. J., May 25, 2005, at A1 (explaining that the Securities and Exchange Commission (SEC) proxy filings revealed that at least thirty-three executives received more than \$200,000 worth of personal plane travel from their companies); Mark Maremont, *JetGreen: The CEO's Private Golf Shuttle*, WALL ST. J., Oct. 1, 2005, at A1 (discussing executives' use of corporate jets for personal purposes).

10. David A. Lombardo, *Bizav Will Weather Economic Turbulence*, AVIATION INT'L NEWS, Aug. 2001, at 36 (explaining that corporate aircraft are tools).

11. See David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 648 (2005) (concluding that personal use of corporate jets by executives decreases shareholder value).

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

13. Markham, *supra* note 6, at 293–94. Under the tax-based solution, section 162(m) of the Internal Revenue Code disallows deductions for compensation exceeding \$1 million per executive unless it is "performance based." *Id.* One of the requirements for "performance based" compensation is that the material terms of the amount in excess of \$1 million be approved by a majority of the shareholders in a separate vote. *Id.*

14. *Id.* at 284–87; see Bill Roberts, *CEO Pay Under the Microscope*, ELEC. BUS., June 2006, at 48 (describing the SEC's proposed disclosure requirements for executive compensation and related matters). The proposed regulations are designed to provide clearer and more complete disclosure of the compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers, and the directors. Executive Compensation & Related Party Disclosure, Exchange Act Release No. 33,8655, Fed. Sec. L. Rep. (CCH) ¶ 87,517 (Jan. 17, 2006).

15. Markham, *supra* note 6, at 280–84.

16. Charles M. Elson, *Executive Overcompensation*, *supra* note 3, at 951–66 (critiquing numerous proposed solutions to the problem of executive compensation).

17. Hawkins, *supra* note 2, at 457–58. *But see* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1263, 1283 (1982) (noting market constraints on executive compensation); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975–78 (1980) (arguing that excessive compensation is controlled by market forces).

affect earnings per share.<sup>18</sup> In reality, however, excessive executive compensation seriously impacts an organization.

Frankly, the solution requires us to go back to the basics of the corporation and to the basics of agency theory, having the directors as principals as opposed to agents of the shareholders.<sup>19</sup> We have to go back to pre-Berle and Means to a board that is the appropriate fiduciary of the shareholders as shareholders themselves.<sup>20</sup> Thus, the solution is two-fold. First, the directors must be independent of management. Second, the directors must have real ownership in the corporation, a la equity. I think you will begin to see a long-term shift as there is an increase in negotiation between boards and managers. In the end, it is really dangerous to ignore the board and simply throw this problem into the marketplace.<sup>21</sup>

If you look at compensation itself, it has been averaging an annual increase at double digits. Compensation is growing at maybe 15 to 25 percent a year.<sup>22</sup> This growth is not the result of the growth in the Standard & Poor's Index, or the growth of a company's individual value. Rather, the growth of executive compensation generally is the result of two things, the "ratcheting up" of executive compensation due to an overreliance by boards on compensation "banding," and the lack of negotiation between directors and management.

First, excessive executive compensation is partly caused by an unusual phenomenon that has created a nonperformance based growth in CEO pay.<sup>23</sup> Typically, in determining compensation levels, boards rely heavily on data presented by compensation consultants showing where a CEO's pay falls relative to his or her peers. The consultant reviews the compensation in terms of percentiles—from the 10th percentile, signifying low pay relative to others, up to the 90th percentile, which reflects generous pay relative to what others receive—this process is commonly

18. See Kathleen Rehbein, *Explaining CEO Compensation: How Do Talent, Governance, and Markets Fit In?*, PERSPECTIVES, Feb. 2007, at 76.

19. See Lynn A. Stout, *The Mythical Benefits Of Shareholder Control*, 93 VA. L. REV. 789, 804–05 (2007).

20. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119–25 (The Macmillan Co. 1940) (1932) (explaining that the rise of management's domination of large corporations is due to a separation of ownership from control).

21. *But see* GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 242 (rev. ed. 1992) (noting that Mikhail Gorbachev, the former leader of the Soviet Union, conceded that there is no substitute for a free market).

22. See Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 51 (2003) (noting the increase in CEO compensation between 1992 and 2000); Richard J. Dalton, Jr., *This Time around, It's Not so Lonely at the Top: 15% More Execs at LI's Big 100 Get Paid Multimillions*, NEWSDAY, June 26, 2006, at D02; David R. Francis, *You Deserve a Refund for Fat CEO Pay*, CHRISTIAN SCI. MONITOR, July 25, 2005, at 17; *see also* Eric Dash, *C.E.O. Pay Keeps Rising, and Bigger Rises Faster*, N.Y. TIMES, Apr. 9, 2006, § 3, at 5. This problem is not just a problem in America, but it exists abroad as well. *See, e.g.*, Nicholas Timmins, *Escalating Pay Gap Is Socially Divisive and Economically Harmful, Says TUC Chief*, FIN. TIMES (London), Nov. 6, 2006, at 2 (discussing the rise in executive pay in the United Kingdom).

23. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 71–72 (2004). *But see* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 503 (2007) (arguing that value of continuity leads to increased executive compensation).

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known as “banding.” Generally, boards seek to set pay at the 50th percentile level or higher because awarding pay below the median would send a problematic message to the CEO, his or her underlings, and the marketplace as to the board’s general confidence in that manager. Obviously, if every board aims for the 50th percentile or higher this has the effect of ratcheting up general pay levels by double-digit levels each year. A rising tide floats all boats. In other words, all CEOs are moving up the median.<sup>24</sup> Obviously, every time a CEO moves up the median, the median goes up, “ratcheting up” executives’ compensation.<sup>25</sup> That is where the tremendous growth in executive compensation is coming from.

Second, executive compensation is not negotiated in the corporate setting.<sup>26</sup> Traditionally, shareholders were the board.<sup>27</sup> However, shareholdings became smaller as corporations became larger, precluding any shareholder from possessing enough stock to control the corporation.<sup>28</sup> Thus, management controlled the corporation and appointed independent board members.<sup>29</sup> Frankly, as an independent board member in a corporation where the managers controlled the proxy process, there was no easier way to get fired from a board than by acting independently.<sup>30</sup> The problem is that there is no real bargain when an executive negotiates with a board that is effectively beholden to the executive.<sup>31</sup> Therefore, this lack of negotiation creates the potential of overcompensation.

Please do not misunderstand me. I do not have any real argument with high compensation. Indeed, private equity firms pay a lot,<sup>32</sup> but it is their money. The numbers show us that there has been a 15 to 25 percent annual increase in the salaries of public corporation executives, without a corresponding increase in pro-

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24. BEBCHUK & FRIED, *supra* note 23, at 71–72.

25. *Id.*; see also Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 789–91 (2002) (discussing the “ratcheting-up” effect of CEO compensation).

26. BEBCHUK & FRIED, *supra* note 23, at 80–86. *But see* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 3 (2002).

27. PERCIVAL E. JACKSON, *CORPORATE MANAGEMENT* 158–59 (1955).

28. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 139 (1996) [hereinafter Elson, *Director Compensation*].

29. Elizabeth MacIver Neiva, *Are Directors Overpaid? What History Tells Us About Compensation*, in *DIRECTORSHIP—SIGNIFICANT ISSUES FACING DIRECTORS* 2–6 (1996).

30. See BEBCHUK & FRIED, *supra* note 23, at 26; Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998); Vincent A. Warther, *Board Effectiveness and Board Dissent: A Model of the Board’s Relationship to Management and Shareholders*, 4 J. CORP. FIN. 53 (1998).

31. Elson, *Director Compensation*, *supra* note 28, at 161–63; see Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 37 (1993) (arguing that boards rarely vote against the CEO); Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2028 (2007) (describing the negotiation of CEO’s compensation as “connivance between co-conspirators”); Hermalin & Weisbach, *supra* note 30, at 96–97 (stating that the CEO’s ability to choose board nominees increases with the duration of CEO’s tenure).

32. Matthew Bishop, *Capitalism’s New Kings*, *ECONOMIST*, Nov. 27, 2004, at 3–5; Andrew R. Sorkin & Eric Dash, *Private Firms Lure C.E.O.’s with Top Pay*, *N.Y. TIMES*, Jan. 8, 2007, at A1.

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ductivity or stock price accretion.<sup>33</sup> Something is wrong here, and I think it has to do with the ratcheting up of executive salaries and the lack of negotiation between executives and their boards.

The solution can be partly found by looking to certain aspects of pay in the private equity sector. This sector differs significantly from the public company arena in the form of CEO compensation.<sup>34</sup> Private equity typically compensates the executive with significant equity in the organization.<sup>35</sup> And, as mentioned above, pay decisions are not made by the agents, but by the principals—the actual owners of the corporation. Thus, there is risk.<sup>36</sup> If you fail, the equity ends up being worth nothing. Contrastingly, in the public company setting with large, nearly guaranteed packages, there is basically entrepreneurial return for a non-entrepreneurial risk.<sup>37</sup> Just like the private equity sector, public companies should require the executives to take a risk in exchange for their large compensation packages.<sup>38</sup> Additionally, boards who negotiate with executives need to be independent of those executives and hold personally meaningful equity stakes in the organization so that their own money is on the line. Boards need to decrease their reliance on “banding” and while market salary levels should not be ignored, they conversely should not be the primary basis in determining compensation levels. This is the ultimate solution to the compensation conundrum.

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33. See *supra* note 22.

34. JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 2.03(1) (1999).

35. Joseph E. Bachelder III, *Executive Compensation: Executive Pay Continues to Rise Despite 'Pay Reforms,'* N.Y.L.J., Mar. 29, 2007, at 3.

36. *Id.*

37. See SCHELL, *supra* note 34, § 2.03(1).

38. Elson, *Director Compensation*, *supra* note 28, at 164–73; Elson, *Executive Overcompensation*, *supra* note 3, at 981–83.