Negotiating Executive Compensation in Lieu of Regulation

URSKA VELIKONJA*

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* O’Connor Fellow, Arizona State University, Sandra Day O’Connor College of Law; Research Fellow, Harvard Law School. J.D., LL.M. Harvard Law School; LL.B. University of Ljubljana, Slovenia. I would like to thank Robert Bordone for his advice and comments. Any mistakes are my own.
INTRODUCTION

“[T]he only way to avoid stalemate, reduce the need for litigation, and restore the credibility . . . is to generate agreement on how to handle the problems that confront us.”

How much a public company should pay its chief executive should be “an issue of modest importance for most companies.” Yet few issues in the history of the modern corporation have attracted as much attention as executive compensation.

Public outrage at outsize payments to executives, especially those receiving federal bailouts and loan guarantees, has made executive compensation a political issue. In addition, there is concern that compensation practices may have led to the current financial crisis. There is tremendous pressure on the President, Congress, and federal regulatory agencies to regulate executive pay. Finally, there is little evidence that large pay packages improve corporate performance.

1 LAWRENCE SUSSKIND & JEFFREY CRUIKSHANK, BREAKING THE IMPASSE: CONSENSUAL APPROACHES TO RESOLVING PUBLIC DISPUTES 13 (1987). Note that Susskind and Cruikshank are referring to disputes over public policy. Id. But, given the central role that public corporations play in today’s economy, the numerous stakeholders affected by corporate behavior—including employees, creditors, customers, suppliers, and the community—and corporations’ power to self-regulate, corporate disputes today are more akin to public disputes than private disputes.


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The universe of solutions proposed to date includes federal and state action. Change is likely, but federal regulation of compensation is not the best solution. Federal regulation will disappoint shareholders, executives, employees, and the public. It may stifle innovation, and, arguably, corporate performance for years to come. Instead of focusing on their core business, executives may spend time devising schemes to avoid the reach of federal regulators. The federal government already adopted strict rules for compensation of executives in firms that received federal assistance under the Troubled Asset Relief Program (TARP). But TARP rules apply only to companies that have not yet repaid the assistance received, prompting most to pay the balance as soon as they could, and in some cases sooner. More broadly applicable federal rules are still under consideration.

Professors Bebchuk and Fried proposed amending state corporate laws, giving shareholders the power to propose charter amendments, corporate reorganizations and combinations, and expanding their rights to nominate directors. However welcome, the focus of these changes is both too narrow and too broad. The focus is too narrow because Bebchuk and Fried focus solely on executives’ incentives and shareholder voting, and yet the evidence suggests that the power of shareholders to affect corporate behavior is very limited. The focus on expanding voting rights is too broad because the power to control executive pay would also make it easier to direct firms myopically to focus on short-term share-price appreciation at the expense of long-term growth.

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6 Alternately, congressional regulation might just further increase CEO pay, as did the cap on deductibility of golden parachutes and non-performance related pay in excess of $1 million. See Jensen et al., supra note 3, at 30.

7 For example, there is evidence that subjecting only recipients of TARP funds to compensation oversight encouraged banks to pay back the government as soon as they could, instead of when repayment would be optimal.


10 This is not the case for large shareholders that can and do affect corporate policy, through informal channels rather than formally.

11 See, e.g., Judith F. Samuelson & Lynn A. Stout, Are Executives Paid Too Much?, WALL ST. J., Feb. 26, 2009, at A13 (arguing that executive pay packages are the “over-arching cause” of the financial crisis). Samuelson and Stout state:
Although executive compensation does not generate many formal disputes, it generates substantial conflict between executives and shareholders, employees, the public at-large, and the government. Corporate directors, who are expected to negotiate executive pay on behalf of the shareholders, have noted that they “are having trouble controlling the size of CEO compensation.” Shareholders have filed lawsuits, voted to oust directors who have approved excessive executive pay packages, and proposed shareholder resolutions, all without much effect. Employees have, for the most part, protested in silence, except for a few labor unions that have, as shareholders, challenged executive compensation. The public at-large, represented to some extent through the media, has been keenly interested in the issue. Yet media reports alone have not been effective in curbing executive pay either. Congress responded by regulating aspects of executive pay, by limiting the deductibility of non-performance-related pay on the corporate tax return, and by overseeing pay in corporations receiving financial assistance from the federal government, but Congress remains ineffective when it comes to resolving particular controversies. An alternative approach to fixing executive compensation is to expand the use of

This collective myopia had many causes. One cause . . . was the demands of the very shareholders who are now suffering most from the stock market’s collapse. It is extremely difficult for an outside investor to gauge whether a company is making sound, long-term investments by training employees, improving customer service, or developing promising new products. By comparison, it’s easy to see whether the stock price went up today. As a result, institutional and individual investors alike became preoccupied with quarterly earnings forecasts and short-term share price changes, and were quick to challenge the management of any bank or corporation that failed to “maximize shareholder value.”

Id.

12 CORPORATE BOARD MEMBER & PRICEWATERHOUSECOOPERS, WHAT DIRECTORS THINK 8 (2007).


14 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 8211 (1993). Under the Act, only $1 million in compensation for each of top five executive officers of the corporation is deductible as a business expense. Pay in excess of $1 million is deductible only if incentive based, if certain conditions are met. See IRC §§ 162(m)(4)(B)–(C) (1995); see also Lucian Bebchuk, Congress Gets Punitive on Executive Pay, WALL ST. J., Feb. 17, 2009, at A15.
negotiation in designing executive pay by involving stakeholders in the process.\textsuperscript{15}

This Article argues, very much like Norman Veasey, former Chief Justice of the Delaware Supreme Court, that executive compensation “is all about \textit{process}.”\textsuperscript{16} This article analyzes the process for setting executive pay—in particular how the existing process is ineffective and consistently leads to suboptimal outcomes. Corporate governance generally and executive compensation in particular are novel topics of study for dispute systems design, which to date has mostly focused on organizational disputes and consensus building.\textsuperscript{17}

Therefore, in Part I, this Article provides a brief history of executive compensation and describes how the process for setting executive pay consistently leads to overpayment. Overpayment of executives, particularly at a time when the firm has underperformed, usually creates resentment within the corporation and generates conflict.

In Part II, the Article focuses more specifically on disputes about executive compensation. It briefly presents the existing regime for resolving disputes over executive pay, demonstrates that the vast majority of disputes are never brought to light (i.e., latent disputes), and elaborates on the costs of the existing regime for setting executive pay. The costs include both the direct costs of overpayment and the costs of conflict generated by overpayment.

Because conflict over executive pay is common, and the costs of conflict significant, one would expect that corporate executives, shareholders, directors, and other parties would have already negotiated about improving executive pay practices. The fact that corporations have not come up with

\textsuperscript{15} In response to public outrage about paying almost $17 billion in bonuses for 2009, Goldman Sachs recently attempted to negotiate shareholder support for their proposed plan. Although Goldman Sachs’ ultimate goal was to receive endorsement of its proposed plan and not shareholder input, it nevertheless modified slightly the pay packages it would provide to its top-paid executives. See Jenny Anderson, \textit{Goldman Sachs Alters Its Bonus Policy to Quell Uproar}, \textit{N.Y. Times}, Dec. 10, 2009, available at http://www.nytimes.com/2009/12/11/business/11goldman.html/.

\textsuperscript{16} E. Norman Veasey, \textit{State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors}, 28 J. CORP. L. 441, 447 (2003) (emphasis added). It is unlikely that Justice Veasey was thinking about what dispute systems design (DSD) could do for compensation setting practices, but if process is what matters, then DSD, as a discipline that helps design appropriate processes for different types of decisions, could be helpful.

\textsuperscript{17} See, e.g., \textsc{Cathy A. Costantino & Christina Sickles Merchant}, \textsc{Designing Conflict Management Systems: A Guide to Creating Productive and Healthy Organizations} (1996); \textsc{Susskind & Cruikshank, supra} note 1.
better solutions is sometimes used as evidence that the existing regime must be efficient. Relying on dispute resolution theory, this Article argues in Part III that this is not necessarily so.\textsuperscript{18} This Article notes that barriers to compromise will prevent corporations from initiating value-increasing negotiations and describes those barriers in more detail as they apply to disputes over executive pay. Finally, the Article proposes steps that a company interested in rethinking its process for negotiating executives’ salaries should take to reduce the overall costs of disputes over executive compensation, by increasing participation, and thereby improve the system for setting executive pay.

I. EXECUTIVE COMPENSATION: HISTORY, PRACTICES, AND PROBLEMS

Executive salaries have occupied a prominent place in the public debate over corporate responsibility for decades, but this was not always the case. The following sections on the history of executive pay and pay-setting practices explain how, when, and why executive compensation became a source of conflict.

A. History of Executive Compensation as a Source of Conflict

Executive compensation was not an issue until the early twentieth century when large corporations, such as General Electric, U.S. Steel, and International Harvester, began to dominate the economy.\textsuperscript{19} These corporations were so large that they required investment from many sources and could no longer be managed by their owners.\textsuperscript{20} Instead, corporate executives were hired to manage the new enterprises. Like owner-managers, they had authority and control over the corporation, including the ability to set the amount of their own pay. Unlike owner-managers, however, non-owner executives usually held only a tiny stake in the company they


\textsuperscript{19} DONALD P. DELVES, STOCK OPTIONS AND THE NEW RULES OF CORPORATE ACCOUNTABILITY: MEASURING, MANAGING, AND REWARDING EXECUTIVE PERFORMANCE 19 (2004).

\textsuperscript{20} \textit{Id.} at 19–20.
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As a result, it was in their interest to extract a high salary today, even if it came at the expense of lower firm value tomorrow.

The first recorded controversy over executive compensation dates from the 1920s. Bethlehem Steel Corporation disclosed that it paid its President, Eugene G. Grace, annual bonuses that “reached $1,000,000 to $1,500,000.” The New York Times charged that these were “unheard of sums as bonuses.” Since then, American business press has followed executive compensation, but executive pay truly became an “issue du jour” in the late 1980s.

Professor Clark noted in his 1986 treatise on corporate law that CEOs of large public corporations were paid “handsomely” and discussed whether a salary that is twenty-two to thirty-six times greater than a salary of a typical worker is “excessive.” In 1992, an election year, executive compensation became a favorite topic for politicians of both parties. During his campaign to become President, then-Governor Bill Clinton promised to tax excessive pay, and he did. There was less opposition to executive compensation during the bull years of the 1990s and 2000. Since then, congressmen, policymakers, and academics alike have raised concerns about executive pay, particularly because the percentage increase in executive pay has exceeded share-price increases, as well as GDP growth rates, commanding ever

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21 Id. at 20.
22 “[J]ournalists need to do a better job of making the distinction between people like Bill Gates or actual entrepreneurs who start something and build something, and then executives who are hired hands, essentially hired to serve at the shareholders’ bidding.” Matthew Bishop et al., The Media and Executive Compensation: A Panel Discussion, 30 J. CORP. L. 795, 800 (2004).
23 Steel Merger Plot Is Alleged in Suit, N.Y. TIMES, June 26, 1930.
24 Id. (internal quotations omitted).
26 Id. at 28.
28 See id. at 191–94.
30 See id.
31 See supra note 6 and accompanying text.
32 Real GDP grew between 2.1% and 3.1% between 2003 and 2007 (and declined in 2009), while the Dow Jones Index grew by 25% in 2003, by 3.1% in 2004, declined
larger portions of the firms’ profits. Since 2000, average executive pay levels have been between 300 and 500 times greater than pay received by average workers. Average CEO salaries have topped $10 million almost every year since 2000, while the most egregious outliers often received salaries twenty times that of the average CEO.33

However, it was not until the financial crisis that started in earnest in September 2008 that the pressure of shareholders, unions, the public, and the media elevated disputes about executive pay to national prominence. Executive salaries have been challenged not only for being excessive, but also for rewarding their recipients when those executives exposed their companies to a significant risk of large losses. Those losses threatened corporate viability and the viability of the economy as a whole.34 The argument that compensation brought about the crisis legitimized efforts to regulate executive pay and pressured federal and state governments to do something about executive pay.

Critics of the existing regime have pointed to pay-setting practices that consistently produce excessive executive pay packages and provide


34 “Compensation is among the most cited cause of the financial crisis because bonuses were often tied to short-term gains, even if those gains disappeared later on.” Louise Story, After Off Year, Wall Street Pay Is Bouncing Back, N.Y. TIMES, Apr. 26, 2009, at A1.
executives incentives to take on too much risk. The following section explains in more detail how executive pay is set and why it is the source of so much conflict.

B. Pay-Setting Practices

Although the shareholders technically own the corporation, they do not get to decide how much the people managing the corporation’s business will be paid. Instead, the board of directors, which the shareholders usually elect annually, hires and fires the CEO and sets his pay. Modern boards of directors commonly have a special committee, called the compensation or remuneration committee, whose duty is to evaluate performance of the executive team and to make recommendations relating to executive pay.

In theory, executive pay should result from an arm’s length negotiation between executives and directors, where executives bargain in their own self-interest while directors bargain in the interest of the shareholders and the company. In reality, however, executives have a fair amount of influence over the process. A majority of corporate directors themselves acknowledged that executive pay-setting practices are troubling. The compensation committee rarely initiates proposals on incentive packages or conducts market research on pay in peer companies. Instead, the firm’s human resources department, often working together with accountants and compensation consultants, usually makes the initial recommendation for pay levels and incentive plans. This recommendation is then sent to the top executives for review, and only after the CEO has given his stamp of

35 Election implies real competition. In reality, the vast majority of directors run unopposed. Furthermore, if the company has a staggered board, directors are usually up for re-election once every three years.

36 See Jensen et al., supra note 3, at 50. Because there are fewer than ten percent of female CEOs among Fortune 500 companies, this Article uses the male pronoun when referring to executives generally.


38 In a recent survey of U.S. corporate directors, “67% said that they believe boards are having difficulty controlling the size of CEO pay packages.” MAJORITY STAFF OF H.R. COMM. ON OVERSIGHT AND GOVERNMENT REFORM, 110TH CONG., REPORT ON EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS 3 (2007).

39 Jensen et al., supra note 3, at 50; Kevin J. Murphy, Executive Compensation, in HANDBOOK OF LABOR ECONOMICS 25 (Orley Ashenfelter & David Card eds., 1999), available at http://ssrn.com/abstract=163914. Note that the human resources department answers to the CEO.
approval is the recommendation delivered to the compensation committee for consideration.\textsuperscript{40} Although the CEO ordinarily participates in all committee deliberations, he graciously abstains when the committee discusses his pay.\textsuperscript{41} After the committee accepts the recommendation, the entire board votes on it. If approved, the contract binds the corporation and the executive without shareholder or any other additional input.\textsuperscript{42}

The compensation committee usually meets quarterly,\textsuperscript{43} and it is rarely sufficiently expert and informed to be involved in the details of setting performance goals and designing the optimal pay package.\textsuperscript{44} Empirical evidence indicates that when directors, who are CEOs of other firms, sit on the compensation committee they tend to pay the CEO similar to what they receive at their firm.\textsuperscript{45} Professor Murphy reports that judgment calls by the compensation committee consistently tend to be made in favor of the CEO. He adds that committees tend to err on the high side and over- rather than under-fund bonus pools, and argues that this tendency has contributed to the continuous rise of executive compensation.\textsuperscript{46} In addition, anecdotal evidence suggests that influential CEOs can pack the compensation committee with people who are likely to approve large pay packages.\textsuperscript{47} Soon after retiring, Jack Welch, the former CEO of General Electric, was asked at a boot camp for new CEOs whom to appoint as chairman of the compensation committee. He answered:

Put someone in charge who is nearing the end of their career, so they’re not jealous of you as a younger CEO, is immensely rich, much richer than you, and enjoys seeing other people get rich. . . . Never, ever make a distinguished academic your compensation committee chair because you’ll be a poor man by the end of it.\textsuperscript{48}

\textsuperscript{40} Id.
\textsuperscript{41} Id.
\textsuperscript{42} Even if a company allows shareholders a say-on-pay vote, their vote does not bind the board of directors.
\textsuperscript{43} See, e.g., Microsoft, Microsoft Corporation Compensation Committee Charter, http://www.microsoft.com/about/companyinformation/corporategovernance/committees/compensation.mspx/ (last visited May 1, 2009).
\textsuperscript{44} See Jensen et al., supra note 3, at 51; Murphy, supra note 39, at 25.
\textsuperscript{45} See Murphy, supra note 39, at 25.
\textsuperscript{46} See id.
\textsuperscript{47} See Bishop et al., supra note 22, at 796–97.
\textsuperscript{48} Id.
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When the firm hires a new executive from outside, the process is more complex and even more likely to lead to overpayment. When looking for a new CEO, corporate directors usually hire a search firm to identify the most promising candidates. Negotiations about pay generally do not begin until a single individual has been selected for the position. At this point, the board is usually anxious to secure the candidate’s services and is unlikely to bargain hard over pay. Furthermore, the candidate-executive, like a star athlete or actor, is usually represented by a professional negotiator (i.e., an agent), while the company rarely hires a professional to negotiate on its behalf.

Executive agents are able to bargain harder than any executive could on his own behalf; they are usually able to secure generous compensation packages for the executive, often including a significant signing bonus, guaranteed additional bonuses, option grants, retirement benefits, perquisites, and generous severance arrangements. This is particularly true when the board delegates salary negotiations to the general counsel or the head of human resources. These internal managers know that they will report to the incoming CEO when negotiations are complete. This provides strong incentives “to make their new boss pleased with his financial arrangements” and makes it very difficult for them to “play hardball,” knowing that any residual anger is unlikely to disappear when the deal is done.

As the above section demonstrates, executive pay is determined without much oversight and under significant pressures to increase pay, resulting in systemically overpaid executives. This raises questions about efficiency and about fairness, which affect not only the shareholders of the corporation, but also Americans more generally.

II. CURRENT RESOLUTION OF DISPUTES ABOUT EXECUTIVE PAY

Controversies over executive compensation are frequently reported and usually attract an inordinate amount of attention, but they are rarely resolved,

49 See Jensen et al., supra note 3, at 51.
50 Id. “This [search] procedure is a reasonable way to identify top candidates when ‘price’ is not an issue, but is clearly a recipe for systematically paying too much for managerial talent.” Id.
52 Jensen et al., supra note 3, at 52 (describing the elements of a standard contract that Joseph Bachelder negotiates on behalf of his clients).
53 Id.
formally or informally. Conflict about executive compensation—much of it latent—generates substantial costs.

The following sections explain in more detail what procedures are available for resolving disputes about executive compensation and why they are ineffective. This Part analyzes why so many of the disputes are never resolved and, finally, estimates the costs of conflict over executive compensation.

A. Challenging Executive Compensation Decisions

In contrast to employment discrimination and sexual harassment claims, a formal complaint is even more rarely brought in the case of an excessively-paid executive. Largely, this is because existing law makes it very difficult to bring a complaint.

Deciding how much to pay top executives is a corporate action made by the corporation’s highest body, the board of directors. Delaware, where sixty percent of America’s public companies are incorporated, entrusts the board of directors with management of the corporation in Section 141(a) of the Delaware General Corporation Law. Delaware courts interpreted this provision very broadly and subordinated other provisions of the Delaware Code, including provisions specifying shareholder rights, to Section 141(a). The provision gives the board of directors virtually unlimited freedom to

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54 Dispute resolution theory distinguishes between disputes that are formally brought (formal disputes) and those that are never brought, but nevertheless cause aggravation, anger, resentment, and eventually surface. In the employment context, latent conflicts often surface in the form of lower productivity, absenteeism, and ultimately, a full-blown strike (which, of course, is a formal dispute).

55 See, e.g., In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005). The Disney case is one of the few that survived a corporation’s motion to dismiss at the Chancery level. Although the defendants prevailed on appeal to the Delaware Supreme Court, the case ultimately settled for an unspecified amount.

56 Del. Code Ann. tit. 8, §141(a) (2009) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”).

57 See CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232 n.7 (Del. 2008) (subordinating shareholder power to adopt, amend, or repeal bylaws under Section 109 to directors’ right to manage the affairs of the corporation under Section 141(a)). In AFSCME, the Delaware Supreme Court held that under Delaware law, shareholders cannot adopt a bylaw requiring the board to reimburse a stockholder’s “reasonable expenses” associated with a successful campaign to elect a shareholder-nominated director. Id. at 229.
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contract with executives regarding pay. Section 141(a) assumes that relying solely on the discretion of the board of directors will result in decisions that are better informed and less conflicted than decisions that would involve other parties in the negotiating process. Additionally, Section 141(a) assumes that the decision of the board of directors will be the most efficient for the corporation and its stakeholders, despite the fact that chief executives usually serve as chairmen of the board of directors in their company. As a result of these assumptions, Delaware law has created few methods to dispute the executives’ pay packages.

Delaware law provides shareholders, but not other stakeholders (e.g., employees and creditors), limited formal rights to challenge board decisions, including decisions regarding executive compensation. These shareholder rights include bringing binding and non-binding shareholder resolutions and litigation.

Until 1992, the SEC consistently disallowed non-binding shareholder resolutions regarding executive compensation, reasoning that such proposals relate “to the conduct of the ordinary business operations.”\(^{58}\) In 1992, the SEC began allowing non-binding shareholder proposals asking the board to establish a compensation committee. It reasoned that executive compensation has spurred “widespread public debate” and raised “significant policy issues.”\(^{59}\)

Since then, the plurality of shareholder proposals (between twenty-five and forty-five percent) addressed executive compensation.\(^{60}\) Few of these proposals won majority shareholder approval, but even those that did were rarely implemented. The board of directors can ignore expressed shareholder preferences if, in the board’s business judgment, the board’s decision is better for the corporation.

While shareholder proposals are precatory and do not formally bind the board of directors, bylaw amendments proposed by shareholders would bind the board of directors; however, they are frequently disallowed. The Delaware Supreme Court recently held that shareholders could not make proposals that would guide (or restrict) the board’s exercise of its business


\(^{59}\) Id.

judgment, even where there is evidence that the board is self-interested. As a result, shareholders cannot adopt bylaws that would restrict the board’s business judgment in setting executive compensation. Perhaps a charter amendment limiting board authority in setting executive pay would survive judicial scrutiny and could be submitted to a shareholder vote, but shareholders cannot unilaterally propose charter amendments. Under Delaware law, “shareholders may not vote on [a charter amendment] unless the board first elects to have such a vote.”

Delaware law also places almost insurmountable obstacles in front of shareholder lawsuits that challenge executive compensation. Professor Gordon identified three related obstacles to judicial oversight. First, in 1979 the Delaware Supreme Court relaxed the standard of review for stock option plans: it replaced “reasonableness” with “waste,” which is a very difficult standard for the shareholders to meet. Second, Delaware courts do not scrutinize compensation decisions any closer than they do other board decisions where conflicts of interest are not present. Third, Delaware courts developed significant procedural barriers to bringing shareholder suits challenging compensation practices. As a result, “few, if any cases involving large public firms were heard on the merits.” By imposing procedural barriers, however, Delaware courts “blinded themselves to the developing problems in that area, in particular the de facto constraints on board independence in compensation setting.”

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61 See AFSCME, 953 A.2d at 240.
62 I say “perhaps” because AFSCME suggests that even a charter amendment limiting board business judgment might not be permitted under Delaware law. Id.
66 Id. at 690–91 (In trying to avoid “the thicket of judicially determined compensation levels, the Delaware courts missed the separate question of adequacy of board process in light of management’s self-interest and influence in compensation setting.”).
67 Id. at 691.
68 Id.
69 Id.
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decided only six cases challenging the amount of executive compensation, and they decided another five challenging stock option awards. Of these eleven cases, the plaintiffs prevailed in only two.

Unable to sue or guide the decisionmaking of an existing board of directors, the only other “dispute resolution” mechanisms available to shareholders are exit, (selling their shares) or launching an expensive proxy fight to replace the current directors with their own director-nominees. Neither of these mechanisms is effective. Exit through the sale of stock is likely to send a weak signal because other economic news disguises the effect. In addition, unless investors move from stock to other assets, exit is not possible when most corporations similarly overpay their executives.

A proxy fight is difficult and expensive to conduct, and it is a very imperfect instrument to control executive compensation. It bundles together the decision about compensation with another important decision: to replace


72 In Cronin, the chairman, president, and CEO (all one person) had secured a salary equal to ten percent of the corporation’s market capitalization. Cronin, 2005 Del. Ch. LEXIS at *17. For the sake of comparison, even at current severely depressed prices, to satisfy the ten percent test, Citigroup’s CEO would have to receive $214 million in annual compensation (the lowest since August 1982) without court sanction. See NYSE Euronext, Listings Directory, http://www.nyse.com/about/listed/lc_all_overview.html (last visited Mar. 27, 2010).

73 In his groundbreaking book, Albert O. Hirschman explains how competition, under certain conditions, does not lead to socially optimal equilibria but, rather, suboptimal equilibria. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 21–43 (1970).

74 Bebchuk reports that between 1996 and 2002 there were on average only eleven proxy fights per year and only two in companies with market capitalization greater than $200 million. Lucian Arye Bebchuk, The Case for Shareholder Access to the Ballot, 59 BUS. LAW. 43, 45–46 (2003).

75 See Bebchuk, The Case for Increasing Shareholder Power, supra note 63, at 857.
incumbent directors with a rival team. Shareholders might be unhappy with the executive’s paycheck but quite satisfied with the board’s work overall. Even if they are somewhat dissatisfied with the incumbent board, they will often be reluctant to replace the devil they know with the devil they do not.

Because the chances of prevailing are tiny, very few formal disputes are ever brought. But, as the following sections will demonstrate, the absence of formal disputes does not mean that latent conflict about executive pay is insignificant, nor that it is costless.

B. Disputes About Executive Pay: Latent v. Formal

Executive pay engenders much conflict and consumes vast amounts of resources and time. In 2008, much of shareholder activism focused on executive pay, and the trend is not new. Except for one year between 2003 and 2007, the plurality of shareholder proposals (more than thirty-five percent of all proposals brought) targeted executive compensation. Shareholders asked corporations to abolish stock options, to change the option granting process, to limit executive retirement plans and golden parachutes, to recoup bonuses in case of a restatement, to cap compensation, and finally, to have a “say on pay.” These shareholder proposals achieved very little, mostly because none are binding on the board of directors.

Conflict over executive pay regularly enters congressional debate. Over the years, the House Committee on Oversight and Government Reform conducted hearings on excessive pay and heard calls for action. It conducted independent investigations and required CEOs of major U.S. corporations, including Citigroup, Merrill Lynch, and Countrywide, to testify before it. Despite its efforts, the Committee did not propose meaningful reforms but largely appeased the public demand for shaming executives.

Finally, many of the major newspapers have written extensively about executive pay at large publicly-traded corporations. Recently, the Wall

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76 Id.
78 Georgeson, supra note 60, at 30–32.
79 Id. at 30–32.
81 Smaller corporations, controlled corporations, LLCs, and partnerships are not the focus of this Article. Executive pay tends to be lower in smaller companies. In addition,
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Street Journal ran a six page special report about executive pay, and since 1971 Fortune Magazine has published a special section on executive pay. The Wall Street Journal also won the 2007 Pulitzer Prize for public service, the most prestigious of the Pulitzer Prizes, for reporting about backdated stock options. The New York Times Online has a special page devoted to executive pay that it features on its front page during proxy season.

Although there may be few formal disputes about executive pay, shareholder activism, congressional action, and media reporting suggest that substantial latent conflict about executive pay generates large costs.

C. The Costs of Executive Pay

The existing system for setting executive compensation generates substantial costs. These costs arise from compensation that is excessive and inefficient and from disputes that arise because of excessive and inefficient compensation. Excessive and inefficient compensation generates direct costs because executives are paid more than they would be willing to accept to do the same job. Excessive and inefficient compensation also generates indirect costs: costs of disputes over executive compensation, including shareholder resolutions (“say on pay”) and litigation, lowered employee morale, and negative publicity. Finally, the existing regime for setting executive pay generates substantial social costs by incentivizing executives to focus on short-term performance at the expense of long-term profitability.

Although this Article focuses on disputes about compensation, the collateral effects of compensation practices that create excessive and inefficient pay packages ought to be evaluated as part of the existing regime.
for setting executive pay. This Article assumes that a more effective regime for resolving disputes about executive compensation would likely affect not only the process for determining what executives ought to be paid, but also the outcomes.

Direct costs of excessive executive compensation are astonishing. Bebchuk and Fried estimate that the top five executives at American public corporations received a total of $351 billion between 1993 and 2003, or close to ten percent of the companies’ aggregate net earnings.\(^{87}\) This figure reflects only the base salary, bonuses, and stock option or restricted stock awards, as disclosed by the firms in their annual proxy statements. The figure does not include many other types of compensation, including executive pension plans, deferred compensation arrangements, post-retirement perks, golden parachutes, and signing bonuses. There is evidence that these non-disclosed payments are also significant: one study estimates the actuarial value of CEO pensions at one-third of the total compensation (equity and non-equity) the CEOs received during their entire service as CEOs.\(^{88}\)

In addition, the existing regime also produces compensation packages that provide weak or perverse incentives for executives. First, there is substantial empirical evidence that executives’ annual pay—salaries, bonuses, and stock options—is only very loosely related to performance. Executives are paid well whether or not their companies do well and often when their companies have done poorly.\(^{89}\) Second, golden parachutes and retirement packages are unrelated to performance but often make it more valuable for the CEO to retire than to continue working. Third, stock option awards, even when they are not being reloaded,\(^{90}\) spring-loaded,\(^{91}\) or backdated,\(^{92}\) provide executives with incentives that diverge from those of...

\(^{87}\) Bebchuk & Fried, supra note 37, at 10.


\(^{89}\) See, e.g., Kathy Kristof, How CEOs Steal From Your 401(k), MSN MONEY, Mar. 2, 2009, http://www.law.harvard.edu/programs/olin_center/corporate_governance/MediaMentions/03-02-09_MSBnMoney.pdf (reporting that although KB Home lost $929 million in 2007, the board of directors awarded the CEO a discretionary bonus of $6 million and a total compensation package of $16.4 million).

\(^{90}\) Stock options are canceled and then reissued at a lower exercise price after a large stock price decline. See Murphy, supra note 38, at 16.

\(^{91}\) Spring-loaded options are stock options issued just before announcement of good news.

\(^{92}\) Back-dated options are stock options dated prior to the date that the company actually granted the option, at the lowest exercise price.

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the shareholders. Stock option values increase with stock-price volatility.\footnote{93} As a result, executives with options are encouraged to take bigger risks,\footnote{94} even though as managers they are supposed to manage against volatility.\footnote{95} Options provide “perverse incentives to focus on short-term results to the detriment of long-term performance.”\footnote{96}

Large and inefficient compensation packages also have negative effects on the performance of non-executive employees. The rapidly increasing ratio between what executives are paid and what rank-and-file employees receive (from approximately 42:1 in 1980 to above 300:1 in 2008)\footnote{97} resulted in important and significant indirect social costs.\footnote{98} The tremendous pay gap creates perceptions of injustice and inequality on the part of workers.\footnote{99} Perceptions of injustice, in turn, affect employee morale, disrupt teamwork, reduce productivity, and increase absenteeism.\footnote{100} Lowered morale, in addition, reduces loyalty among workers and makes it harder for companies to retain employees, resulting in increased costs for training and replacement.\footnote{101}

The perception of injustice also increases monitoring costs for employers.\footnote{102} Employees who believe they are not being treated fairly are more likely to shirk when they are not being watched. Preventing employee

\footnote{93} Stock options are valuable only when they are “in the money.” For example, a call stock option—i.e., the right to buy stock for a set price—is worthless unless the market price for the stock is higher than the exercise price. The longer the time during which the option can be exercised and the greater the volatility of the stock price, the more likely it is that at some point during the validity of the option the exercise price will be lower than the market price, and the more valuable the option. It is worth noting that volatility generally reduces asset prices (except for options). The more volatile the value, the more risky the asset and the lower the price.

\footnote{94} Murphy, supra note 39, at 18.

\footnote{95} See Bishop et al., supra note 22, at 800.

\footnote{96} Bebchuk, supra note 14.


\footnote{99} See id.

\footnote{100} Id. at 147; COSTANTINO & MERCHANT, supra note 17, at 6 (identifying lack of productivity, low morale, and withholding knowledge as some of the ways in which conflict manifests itself in organizations).

\footnote{101} Stabile, supra note 98, at 148.

\footnote{102} Id.
waste requires increased monitoring, which is not only costly but also breeds a “destructive atmosphere of distrust.”

Although formal disputes over executive compensation are rare, they nevertheless generate substantial costs. Every year, shareholders spend $35 million bringing non-binding shareholder proposals about executive pay.\(^\text{104}\)

In addition, litigation expenses, although difficult to estimate, are likely to amount to tens of millions of dollars per year. Congressional hearings, too, are costly, as is media research.\(^\text{105}\)

Conflict over executive pay also generates substantial opportunity costs: it costs congressional time, executives’ time, and shareholders’ time—time they could use more productively. A corporate law practitioner estimates that executives spend about a third of their working time on “governance-type issues,” including discussing their compensation packages, instead of minding the corporation’s business.\(^\text{106}\)

Less visible costs, including distorted incentives that brought down venerable Wall Street banks, wiped out twenty years of profits, lowered employee morale, resulted in poorer product quality,\(^\text{107}\) and are much harder to measure.\(^\text{108}\)


\(^\text{105}\) Jerry Useem, senior writer for *Fortune Magazine*, lamented about how difficult it was to calculate aggregate values of executive compensation packages:

> I budgeted about a week to... go through the numbers. Well, really it took me about three weeks, even using outside number crunchers to even come to a credible number. There’s so many troughs, as it were, that CEOs can feed from so getting a credible number, a total number, is very difficult to do.

Bishop et al., *supra* note 22, at 801.

\(^\text{106}\) Theodore N. Mirvis, Some Inconvenient Questions (Nov. 27, 2008) (on file with author).


\(^\text{108}\) “As regulators and shareholders sift through the rubble of the financial crisis, questions are being asked about what role lavish bonuses played in the debacle. . . . [Merrill Lynch’s] losses . . . all the profits that the firm earned over the previous 20
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In addition to real costs to firms, excessive pay packages also generate reputational costs, including negative publicity and outrage. News reports result in significant reputation and credibility costs for overpaid executives, as well as for the companies that overpaid them. Reputation and credibility costs include “lost business opportunities, withdrawal of job offers, flight of capital, collapse of company stock, the derision of peers, removal from other boards, and expulsion from social clubs and professional organizations.”

Some of these costs are borne by culpable executives and directors who awarded the pay package. Many costs, however, are borne by innocent parties: the shareholders whose stock portfolios decline in value; employees, who may lose job satisfaction because of the perceived unfairness in compensation; and replacement executives who may find the workforce unmotivated, disloyal, and unwilling to negotiate salary or benefits adjustments, and the business community less willing to invest in the company.

Several recent examples come to mind. The Home Depot received much media notoriety because of a severance package it paid its outgoing CEO Robert Nardelli. When he was instituted as the Home Depot’s CEO in 2000, the Wall Street Journal published six articles. The same newspaper published more than fifty articles about Nardelli’s $200 million severance package when Home Depot fired him six years later. Although Nardelli has been gone since January 2007, Home Depot’s reputation still suffers from association with Nardelli and the excessive severance package he received.

At AIG, $165 million in retention bonuses promised and paid to its financial products division generated much more outrage (and death threats to individual employees) than the credit default swaps that bankrupted the company and forced the federal government to provide $182.5 billion in guarantees to prevent AIG’s demise. The public outrage and defense of


111 See, e.g., Paul Ingrassia, The Auto Makers Are Already Bankrupt, WALL ST. J., Nov. 21, 2008, at A23 (“Before that [Nardelli] was at Home Depot, where he took a $210 million departure package when the board wanted him out.”).

112 The opportunity cost of media attention is hard to estimate. If, for example, stories about executive compensation displace coverage of conflict in the Middle East, the costs are likely to be small since the marginal value of each story is small.
bonuses created a toxic environment within the firm, forcing many of its employees to leave, jeopardizing the firm’s future success.

Last, but not least, there is some indication that executive compensation packages contributed to the current financial crisis because executives “were paid too much for doing the wrong things.”\(^{113}\) Business leaders were paid to take on excessive risk in order to increase next quarter’s profits, without regard to long-term viability.\(^{114}\) Instead of focusing on producing quality goods and services, executives “[became] consumed with earnings management, ‘financial engineering,’ and moving risks off their balance sheets.”\(^{115}\)

Evidence suggests that the costs of the existing regime for setting executive pay are significant, and include costs arising from inefficient compensation packages themselves as well as costs of conflict that arise because compensation packages are inefficient. Much of that conflict is latent, though no less costly nor significant than disputes that make it to court.

But even more significant than direct costs are opportunity costs of time that executives, directors, and Congress spend dealing with actual and latent conflict about executive pay; reputation and credibility costs incurred both by parties directly involved in pay negotiations (executives and directors) and innocent parties (shareholders, employees, etc.); and, finally, opportunity costs of the media and the general public spent fuming about executive pay instead of focusing on issues that matter more.\(^{116}\)

### III. A SYSTEM READY FOR A CHANGE

The process for setting executive compensation is ready for a change. This Part describes the two possible directions for change: regulation and negotiation. This Article suggests that the latter will produce better results.

\(^{113}\) Samuelson & Stout, supra note 11 (arguing that executive pay packages are the “over-arching cause” of the financial crisis).

\(^{114}\) Id.

\(^{115}\) Id.

\(^{116}\) Cf. Susan Dominus, $80,000 for a year Off? She’ll Take it!, N.Y. TIMES, Apr. 12, 2009, at A1; Reader’s Comments, Posting of Wage Slave, http://community.nytimes.com/article/comments/2009/04/13/nyregion/13bigcity.html?s=3 (Apr. 13, 2009, 7:39 EST) (“[W]e have grown weary of NYT stories that treat the recession as an existentialist adventure that allows upper middle [class] people to explore interesting options during their involuntary free time . . . [w]hile a lot of people are actually fighting to preserve a decent way of life, one that won’t consign them and their kids to permanent wage-slave status.”).
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than the former. Then, this Part analyzes the barriers to negotiations: why, if a negotiated process is superior to regulation, it has not been adopted already. Finally, this Part proposes the necessary steps to implement a negotiated process for setting executive compensation.

A. Options for Change

It is rare for economists, lawyers, boards of directors, policymakers, and the public to agree that imminent action is needed to solve a problem. Executive compensation is one such problem. Economists noted that boards of directors have consistently negotiated compensation packages that give executives too much money to do the wrong things. Lawyers lamented that arm’s length negotiations between corporate boards and executives are a myth, and that deferring to the board of directors is not likely to produce outcomes that are in the best interest of the shareholders or the economy as a whole. Corporate directors themselves have observed that they “are having trouble controlling the size of CEO compensation.” Policymakers called pay packages “shameful,” and the public is of the opinion that bonuses “for showing up at work” are “absurd, particularly at a time when so many jobs are disappearing.”

When so many different groups coalesce around an issue, some change is inevitable. But the fact that there is impetus for improving the process for setting executive compensation does not imply that the new process will be better than the system already in place.

There are two general directions for reform that are possible and likely: a top-down adoption of mandatory rules modifying the pay-setting regime, subjecting pay packages to governmental oversight and substantive restrictions, or a bottom-up voluntary adoption of improved pay-setting practices.

117 See, e.g., Jensen et al., supra note 3.
118 See, e.g., Bebchuk & Fried, supra note 9.
119 PriceWaterhouseCoopers, supra note 12, at 8.
121 Dash & Glater, supra note 4 (referring to retention bonuses that AIG paid to executives in its financial products division that lost more than 100 billion dollars on credit default swaps).
1. Regulating Executive Pay

There exists a lot of momentum for top-down reform of executive compensation practices by way of government regulation. Several senators and representatives are considering bills that would require taxation of stock options in the year they are awarded and deny tax deductibility for compensation “that exceeds 25 times the lowest paid worker’s wage in the company.”

But such reform is unlikely to satisfy anyone or resolve the problem for a number of reasons. First, since politicians are not experts on executive compensation, even the best considered proposals are bound to disappoint. No matter how well thought out, any regulatory reform bill is likely to be both under- and over-inclusive and create incentives for companies to comply in form, but not in substance.

Second, there is reason to believe that federal legislation is unlikely to exit the congressional process “unscathed.” After a bill is introduced in Congress, its proponents lose control over it. Because any bill that passes Congress is subject to severe lobbying, its proponents might find that the final version of reform has been significantly watered down. This is particularly likely for executive compensation reform, where executives are well-organized, well-funded, and well-represented by the Business Roundtable, while only 7.2% of private sector employees are still unionized, and there does not exist an effective shareholder association.

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122 David R. Francis, Should CEO Pay Restrictions Spread to All Corporations?, CHRISTIAN SCIENCE MONITOR, Mar. 9, 2009.

123 Recent negotiations over the health care bill provide an excellent example.

124 Business Roundtable, About Us, http://www.businessroundtable.org/about/ (last visited May 1, 2009) (“Business Roundtable is an association of chief executive officers of leading U.S. companies. . . . Business Roundtable unites these top CEOs, amplifying their diverse business perspectives and voices on solutions to some of the world’s most difficult challenges.”).


126 Carl Icahn has tried for years to organize and mobilize shareholders. He established an organization called the United Shareholders of America with the hope of attracting a sufficient number of supporters to “create change in Washington.” The Icahn Report, http://www.icahnreport.com/ (last visited May 1, 2009). Despite his efforts, the organization has not been very successful, particularly when compared with the Business Roundtable that represents executives. There also exist organizations with a narrower purpose. See, e.g., Investment Company Institute, Key Issues,
Organized groups like the Business Roundtable regularly lobby Congress and state governments behind the scenes and are very effective.

And finally, poorly considered rules may have been added to the bill. Once a rule is adopted, it becomes difficult to amend because the impetus for regulation largely disappears after a bill has passed.

The most recent attempt, the American Recovery and Reinvestment Act of 2009 [ARR Act], demonstrates some of the pitfalls of government intervention. The ARR Act includes a limitation on executive bonuses in banks receiving federal assistance: as long as the banks retain federal assistance provided under the TARP, they cannot pay golden parachutes, must limit incentive compensation of its twenty highest paid executives to one-third of total pay, and must subject executive compensation to a nonbinding shareholder vote. This provision was not included in the original bill introduced by President Obama. The original bill proposed that the top five executives’ base salary be capped at $500,000 but did not cap the bonuses, addressing the concern of lawyers and economists that executives were receiving lavish compensation packages regardless of how well their companies did. The provision Congress passed, however, was added later by Senator Chris Dodd and Representative Barney Frank. Commentators criticized the limitation because, first, it does not fix the problems with executive compensation, it caps performance-based compensation instead of requiring that compensation be linked to performance. Second, because the law is so punitive, it causes capital-starved banks to turn down federal assistance, or at best, return the money sooner than is healthy for the banks and the financial system. Banks repaid federal funds as soon as they were able to, not because they were financially healthy, but because they wanted to avoid limits on executive compensation. Citigroup, for example, attempted to escape government regulation of compensation just before the end of 2009 by repaying the bailout funds, presumably so that it could pay high year-end


128 See Bebchuk, Congress Gets Punitive on Executive Pay, supra note 14 (“In a last-minute addition to the stimulus bill passed Friday, Congress imposed tight restrictions on pay arrangements in all financial firms that . . . will receive funds from the federal government[,] . . . constraining incentive compensation, limiting it to one-third of total pay.”).

129 American Recovery and Reinvestment Act § 7000 et al..

130 See Story, supra note 34.
In order to pay the government back, the bank turned to public markets to raise the money it needed. However, Citigroup was unable to raise enough money and will remain government-controlled for at least another six months. The bank’s failure suggests that executives would rather risk the company than accept a lower salary.

In addition, the cap on bonuses has forced at least some executives to leave federally supported banks and other publicly traded corporations altogether. The bill has failed to satisfy the shareholders, who are still paying executives for attendance, not performance; the executives, who want to avoid punitive restrictions; and the public, who suffer because underfunded banks are unable to provide enough credit to the economy.

For all these reasons, legislative reform is unlikely to satisfy: even when well-meaning, it is drafted by insufficiently informed politicians, subject to severe lobbying during the process, and usually passes substantially amended and watered down.

2. Negotiating Executive Pay

Instead of relying on top-down reform, this Article proposes that all involved parties would be made better off by voluntarily adopting a bottom-up process: a process that includes, informs, and consults important corporate stakeholders in designing compensation and internal governance policies.

To design the process, the parties can employ the theory of dispute systems design (DSD), a relatively new field of alternative dispute resolution. Unlike traditional ADR processes, DSD helps parties to think more broadly, beyond the scope of their current dispute. DSD helps parties consider the organizational mission, include all affected groups of stakeholders in the dispute resolution and prevention process, deal systematically with the stream of conflict, and increase efficiency and the quality of the produced outcomes.

By employing DSD theory, parties can design a process to fit the particular circumstances of the company and reduce the negative consequences of a one-size-fits-all regulatory solution. Voluntary adoption of a workable process by more than a small minority of corporations will, at the least, postpone and inform subsequent federal intervention and possibly

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132 See id.

133 See, e.g., Jake DeSantis, Dear A.I.G., I Quit!, N.Y. TIMES, Mar. 25, 2009, at A29 (letter of resignation by DeSantis, Executive VP of AIG financial products unit).
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preempt it altogether. This will serve the interests of all stakeholders, executives in particular.

In addition to avoiding federal intervention, executives who initiate negotiations with interested parties will be rewarded by positive media coverage, increased investment, and more leeway to pursue long-term business goals. A participatory pay-setting process, particularly if coupled with initiatives to improve governance and performance of employees, could also work very well.

Bottom-up reform is also likely to increase the involvement of investors, thereby reducing the need for shareholder action, increasing trust in the corporate management, and reducing the perceived risk of the company’s securities, thereby increasing their value. A fairer process is likely to have a positive effect on the workforce, increasing productivity, improving employee relations, reducing employee turnover, and lowering training and replacement costs. Finally, an inclusive bottom-up process will improve corporate reputation and increase the corporation’s ability to win future contracts and realize new investment opportunities.

A well-designed negotiated process is likely to bring to the surface much of the latent conflict over executive compensation. Initially, the process might consume more time than the existing regime, though that is hard to believe given that executives currently spend a third of their time on governance-related matters. But it will pay dividends in the following years by reducing the costs associated with conflict over executive compensation: reputational harm from negative media reports, costs associated with defending against shareholder actions, suboptimal worker productivity, and higher risk premiums on a corporation’s securities.

In addition to reducing latent conflict associated with executive compensation, a bottom-up process is likely to change the balance of power in pay negotiations. As a result, a bottom-up process is more likely to produce compensation packages that are in line with the expectations of

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136 See id. at 5–6.
shareholders, the board of directors, and employees. Even if the ultimate payout to the executives does not change, performance criteria might, as well as the ability of parties to dispute executive salaries.

B. Barriers to Agreement and Ways to Overcome Them

Because the existing regime for setting executive pay is controversial and costly, regulation ineffective, and the benefits of a participatory negotiated process numerous, it is perhaps surprising that voluntary negotiations between executives, the shareholders, and other potential stakeholders about executive pay are not more common.

If compromise on executive pay were easy, stakeholders would already have hammered-out mutually satisfactory agreements in all firms. However, interest-based negotiation over executive pay is almost never used, except in response to a shaming campaign combined with a serious stock price decline. The vast majority of disputes are unresolved year after year.

Lax and Sebenius suggest that even when the situation is ripe for a change, compromise will not be forthcoming unless it offers “enough value to all sides,” and unless

the right parties have been involved, in the right sequence, to deal with the right issues that engage the right set of interests, at the right table or tables, at the right time, under the right expectations, and facing the right consequences to walking away if there is not deal.

137 After Pfizer was discredited for having paid its underperforming CEO a $213 million severance package in December 2006, its board decided to turn itself around. In June 2007, the board announced that it would meet with representatives from some of its largest institutional shareholders owning approximately thirty-five percent of Pfizer stock. The meetings were intended to initiate an “[o]pen and candid dialogue” with the shareholders and the stakeholders. The board chairman and CEO of Pfizer acknowledged that the meetings are “very valuable and will help [Pfizer] become a better company.” Press Release, Pfizer, Inc., Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company’s Institutional Investors on Corporate Governance Policies and Practices (June 28, 2007), available at http://www.pfizer.be/Media/Press+bulletins/Financial/PFIZER+BOARD+OF+DIRECTORS+TO+INITIATE+FACE-TO-FACE+MEETINGS+-+WITH+COMPANY%E2%80%99S+INSTITUTIONAL+INVESTORS+O.htm.)

Pfizer instituted regular meetings with its shareholders and put in place other mechanisms to foster communication, such as e-mail communications and investor conferences. Id.


139 Id. at 12.
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The prerequisites for compromise that Lax and Sebenius list are usually called barriers to agreement. They include setup barriers, design barriers, and tactical barriers. The following Sections analyze each type of barriers in turn, as applied to conflict about executive compensation. Design barriers and tactical barriers largely depend on particular circumstances, relationships, and personalities, and are difficult to analyze in the abstract. Therefore, this Article only provides guidelines and steps that a planner ought to take into account to determine actual design and tactical barriers in each firm. Setup barriers, although also subject to particular circumstances, relationships, and personalities, can be analyzed in the abstract.

1. Setup Barriers

Setup barriers are possibly the most significant impediments to compromise. As Lax and Sebenius explain, compromise may be difficult, if not impossible, unless the scope of the negotiations, the sequence of negotiations, and basic process choices favor compromise.\(^{140}\) Scope usually means that the right parties must be involved in the negotiations with good information about their interests and about their fallback, or no-deal, options. Sequence means that the parties must be approached in the right order. Process choices include choosing the right tools to organize the negotiation and maximize the odds of success.\(^{141}\) The right tools might include mediation, bringing in a neutral expert, sequencing negotiation, or engaging in a consensus building exercise. The following three Sections analyze separately two elements of scope, the parties and their interests, and their no-deal options, followed by an analysis of sequencing barriers and process choices.

a. Scope: Real Parties and Their Interests

Lax and Sebenius point out that compromise is unlikely unless “the right parties have been involved . . . to deal with the right issues that engage the right set of interests.”\(^{142}\) A voluntary process that does not involve, at the least, shareholder representatives, will fail. A process that does not include employees in a corporation with large employee ownership, usually through an employee stock ownership plan [ESOP], is also likely to fail. Because negotiations over executive compensation occur between real individuals, not

\(^{140}\) Id. at 24.
\(^{141}\) Id.
\(^{142}\) Id. at 12.
between abstract executives and boards of directors, the determination of what parties are necessary to reach a lasting compromise will depend on the particular circumstances of the corporation. Although no two corporations are alike, some generalizations about party roles in the executive compensation compromise are plausible.\footnote{See infra Tbl. 1.}

In addition, whether or not a party should be included in the negotiation will depend on whether she has a stake in the outcome of the negotiation. Including too few parties can undermine the legitimacy of the compromise and reduce the positive effects that compromise promises; including too many parties can unnecessarily complicate the negotiation and, likewise, reduce its legitimacy.\footnote{See LAX & SEBENIUS, supra note 138, at 66–67.}

Understanding interests, one’s own and those of other negotiating parties, is crucial for a successful negotiation.\footnote{See id. at 70–71.} Negotiators often fail to sort out their own interests: the “‘must-have’ from the ‘important’ and from the ‘desirable but not critical.’”\footnote{Id. at 70.} The best negotiators are clear on their ultimate interests, know their trade-offs among lesser interests, and are very flexible and creative in advancing their ultimate interests.\footnote{Id. at 71.}

For example, perhaps an executive’s ultimate interest is to be able to run a business well, and he might be willing to trade off a severance package in exchange for more freedom to manage the business with long-term goals in sight. Without a process that allows for trade-offs, the outcome is likely to be suboptimal. The existing rules, for example, disable the executive from asking the shareholders for leeway to manage the business without incessant demands for short-term returns, in exchange for a smaller severance package. The executive thus ends up with a million dollar golden parachute, which he does not need and has to live with shareholder demands for short-term profits, which he does not want. In the end, no one is satisfied: the shareholders might have to pay a large severance package to the executive, who lost much of the company’s value pursuing short-term boosts in profitability that the shareholders “demanded.”

Further complicating the negotiations is the fact that shareholder turnover is very high. The manager might reach a binding settlement with one group of shareholders that is completely replaced within a year. But corporate law already gives managers a substantial amount of leeway with regard to their performance of their duties. In addition, most corporate law
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rules are default and can be changed if so provided in the corporate charter. The only real concern for the manager is a takeover, but the concern is small. Not only can managers effectively reduce the likelihood to close to zero by adopting takeover defense measures, they can also codify their agreement with pre-existing shareholders in the charter, thus delaying a successful acquirer’s ability to unilaterally undo the agreement and improve their own bargaining position.

Although the ranking of interests for individual parties will be different in each corporation, a typical party’s interests can be generalized, to some extent. Individually, some executives might be more interested in being paid at least as well as their industry peers, others might prefer lower but stable compensation with generous retirement benefits, and still others may be willing to forego stock options in exchange for being able to use the company jet on private business. The table below cannot identify individual interest priority lists; it provides a roadmap that corporations can employ to ferret out the interests that are most important, identify those that are less important in the given case, and thereby find room for agreement.
Table 1. Parties and Their Interests

<table>
<thead>
<tr>
<th>PARTY</th>
<th>ROLE</th>
<th>INTERESTS</th>
</tr>
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</table>
| Executives      | • run the company, make decisions that affect the business  
|                 | • negotiate compensation on their own behalf (or represented by an agent) | • high pay for hard work and contribution to business enterprise  
|                 |                           | • ability to run a business effectively (productive employees, access to capital, innovation, etc.)  
|                 |                           | • ability to pursue long-term goals instead of constantly worrying about quarterly results  
|                 |                           | • pay that signals prestige and high status compared to peers  
|                 |                           | • downside protection in bad economic times  
|                 |                           | • increasing trust among investors  
|                 |                           | • good reputation  
|                 |                           | • prevent individual shareholders from interfering with day-to-day operations  
| HR Department   | • design pay package on behalf of executives | • do what executives want to avoid conflict and keep their own jobs  
| Compensation Committee | • negotiate compensation with executives on behalf of the board of directors | • negotiate a pay package that will please executives, who will hire the consultant again |
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| Board of Directors | • approve compensation package (by vote) | • negotiate a pay package that best furthers the interests of the shareholders  
| | | • being reelected  
| | | • furthering organizational mission  
| | | • preserve own reputation and the company’s reputation  
| | | • avoid conflict  
| Shareholders\(^{148}\) | • owners of corporation  
| | | • no direct role in pay negotiations  
| | | • long-term returns (pensions funds, family investors)  
| | | • short-term returns (hedge funds, mutual funds, day traders)  
| | | • shared interest: not overpay executives, but provide the right incentives  
| | | • shared interest: more information and more say about what corporations do with investors’ money  
| Employees | • no direct role in pay negotiations  
| | | • often own stock in the company  
| | | • fair compensation for themselves and executives  
| | | • being recognized as part of the team  
| | | • job security (avoid layoffs or bankruptcy)  
| | | • pride in the company and the job  

\(^{148}\) There is an image that U.S. public companies are owned by millions of lay shareholders, who are unable to make informed decisions about what is best for the company. But this image is incorrect: as professor Black explains, “the model of public companies as owned by thousands of anonymous shareholders simply is not true. There are a limited number of large shareholders, and they know each other.” Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 574 (1990).
<table>
<thead>
<tr>
<th>Compensation Consultants</th>
<th>• advise compensation committee on executive pay</th>
<th>• being hired by company to provide advice on executive compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Government</td>
<td>• regulates commerce</td>
<td>• a system of compensation that is efficient and fair: provides the incentives for executives to take reasonable risk without externalizing the cost</td>
</tr>
<tr>
<td></td>
<td>• levies taxes</td>
<td>• avoid passing judgment on individual pay packages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• economic growth</td>
</tr>
<tr>
<td>State Governments</td>
<td>• regulate corporations</td>
<td>• Delaware: do nothing that would cause corporations to flee the jurisdiction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• New York: strict enforcement of state securities laws against (mostly non-NY) corporation</td>
</tr>
<tr>
<td>Other Stakeholders</td>
<td>• no direct role</td>
<td>• varied interests</td>
</tr>
<tr>
<td>(creditors, suppliers,</td>
<td></td>
<td>• shared interest: avoid bankruptcy and provide executives incentives to grow a productive business</td>
</tr>
<tr>
<td>customers)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media</td>
<td>• no direct role, but potentially influential</td>
<td>• publicity and increased advertising revenues: negative stories about executive compensation do not sell ads, but may sell more copies</td>
</tr>
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</table>

As of December 2008, only 36.9% of all equity in U.S. corporations was held by individuals; 62.6% was held by institutional investors (11.2% foreign and 51.4% domestic).\(^{149}\) It is true that there exist many different types of institutional investors—the Federal Reserve identifies eleven—that have different interests: pension funds are interested in stable long-term returns to

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satisfy their long-term obligations, while mutual funds may be more interested in shorter-term returns. Within groupings, different funds may have different goals. But there may only be a couple different institutional investors of any significance in each firm. Wal-Mart, the world’s largest company, for example, is owned by the Walton family and corporate insiders (forty-four percent) and by 1353 different institutional investors (thirty-nine percent). However, only two institutions own more than two percent of Wal-Mart, and only seven own more than one percent. The ownership structure of institutional holders is similar for other large corporations, like Chevron and Exxon, and smaller corporations tend to have even more concentrated ownership. If singling out institutional investors by size is insufficient, firms could select a representative institution from each largest group. For example, if mutual funds own a large stake, the largest mutual funds could be asked to participate.

Finally, even individual shareholders are not all likely to be uninformed laypersons or disinterested, diversified shareholders. Contrary to popular belief, many large U.S. public companies have significant individual or family owners. According to a recent study, in thirty-seven percent of Fortune 500 companies, an individual or a family owns at least five percent, and in twelve percent the family is the largest shareholder and owns at least twenty percent of the firm’s stock. For example, firms with significant insiders include Microsoft (Bill Gates), Hewlett-Packard (Bill Hewlett and David Packard), Time Warner (Ted Turner), New York Times (Ochs-Sulzberger family), Washington Post (Graham family), and Berkshire Hathaway (Warren Buffet and his wife).

The above table makes possible three preliminary conclusions. First, many parties may be interested in the outcome of the executive compensation negotiation, but not all should be involved in the negotiation. Although compensation consultants benefit from the current setup, they have no

151 Id. The eighth largest institution owns 0.68%. Id.
153 The Fortune 500 list includes the 500 largest U.S. corporations measured by their gross revenue.
credible interest in a particular compensation decision; rather, they are interested in being paid to provide expert advice on compensation. Human resources departments, too, provide advice only and are not affected by the outcome of the negotiation.

Second, the table identifies parties with similar interests that are likely to form coalitions in a negotiation: shareholders, employees, and the federal government are a plausible coalition, interested in keeping executive compensation in check; Delaware and boards of directors, on the other hand, are interested in giving the directors freedom to approve whatever compensation package they believe will best further the business interests of the company.

Third, the table demonstrates that each party can have a number of conflicting interests that are not all going to be equally important in each case. A board of directors in a corporation with a single large shareholder is likely to be very responsive to the interests of that shareholder. Without the large shareholder’s support, directors are unlikely to be re-elected. In addition, directors with good reputations to protect are likely to want to avoid visible conflict with an important shareholder: it may generate bad publicity and make life in a boardroom unpleasant.155 A board of directors in a corporation with dispersed ownership, on the other hand, will be more interested in satisfying the executives, who control the director nomination process.

b. Scope: No-Deal Options

The deal/no-deal balance under current law is stacked heavily in favor of the executives. They are able to extort virtually unlimited pay packages and, if dissatisfied, are able to walk away with millions in severance payments. But the current financial crisis and the role that executive compensation arguably played in it have dramatically changed the no-deal options of the parties involved.

Considerable evidence suggests that a party is more likely to agree to a proposal, and on less attractive terms, the worse his no-deal option—that is, refusing to negotiate—appears.156 Conversely, the better the perceived no-

155 Considering how concerned boards of directors are about being placed on CalPERS’s Focus List of underperforming companies, coming under the fire of a large and important shareholder is unlikely to be a place where board members would like to be.
deal option, the less likely a party is to begin and continue negotiations. Therefore, what matters is not the actual alternative to a deal, but the perceived alternative, and perceptions often do not match reality. Overoptimism about one’s own alternatives, and perception that the other side’s alternatives are worse than they are can derail negotiations where a deal could be struck.

No-deal options or best alternatives to a negotiated agreement (BATNAs) are often perceived and described as fixed walk-away prices. But, as Lax and Sebenius demonstrate, calculating the deal/no-deal balance in an ongoing process, no-deal options, and perceptions of no-deal options in particular, are likely to “evolve and shift,”157 and they are not limited to prices, but may include other valuable interests. No-deal options are particularly likely to change as the process continues in a multiparty negotiation, where early agreement among some parties may worsen the no-deal option of the other parties.158

In an executive compensation decision, the perception of one’s own and, in particular, other parties’ deal/no-deal options will depend largely on available information of what the other party is actually willing to do. Will the executive, if displeased with the negotiation, walk away unless he receives a guaranteed $20 million? Or will he accept a lower salary, but with a higher potential pay-out if the company achieves target goals? Will the shareholders ask the state Attorney General to prosecute the chief executive and the board of directors if they approve a disfavored pay package? Or will they let the decision stand?

The table below generalizes the initial deal/no-deal options for different parties before and after the financial crisis. After a negotiation starts, however, the no-deal options are likely to change.

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157 LAX & SEBENIUS, supra note 138, at 28.
158 Sebenius, supra note 156, at 333.
Table 2. No-Deal Options and Bad-Deal Consequences Before the Financial Crisis and After

<table>
<thead>
<tr>
<th>PARTY</th>
<th>BEFORE CRISIS</th>
<th>AFTER CRISIS</th>
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<tr>
<td>Executives</td>
<td>• If no deal with board of directors: good. If pay negotiations are not successful, executive can retire from the company, usually leaving with millions in severance.</td>
<td>• May still walk away with severance, but “unreasonable” compensation may be taxed at 90%, tarnish the executive’s reputation and limit his exit options.</td>
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<tr>
<td></td>
<td>• If no deal with the shareholders: good. No reason to negotiate unless corporation’s reputation has been tarnished (Pfizer).&lt;sup&gt;159&lt;/sup&gt;</td>
<td>• State Attorney General might criminally prosecute executive.</td>
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<tr>
<td></td>
<td>• Able to negotiate almost any salary up to 10% of corporations’ market capitalization.</td>
<td>• Congress might cap pay, require detailed disclosure, and make life difficult for executives &amp; few good job alternatives.</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>• If no deal with executives: poor. Few boards have succession plans in place and are willing to risk the media attack for letting a competent executive leave over money.</td>
<td>• “Unreasonable” compensation likely to be publicly exposed → reputation costs &amp; increased risk of litigation.</td>
</tr>
<tr>
<td></td>
<td>• If no deal with the shareholders: good. No reason to negotiate with shareholders, except in firms with large shareholders or groups of shareholders due to concern about reelection.</td>
<td>• Congress might regulate pay, making it more difficult to hire competent executives.</td>
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<sup>159</sup> See Press Release, Pfizer, Inc., supra note 137 (discussing how Pfizer felt compelled to meet with its shareholders and discuss possible improvements to the firm’s governance after some heavily-publicized corporate governance failures).
<table>
<thead>
<tr>
<th>Stakeholders</th>
<th>Action</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>• Usually do not get to negotiate.</td>
<td>• (Threaten to) lobby Congress for regulation.</td>
</tr>
<tr>
<td></td>
<td>• File a lawsuit with a tiny chance of success</td>
<td>• Lobby state Attorney General to prosecute executives.</td>
</tr>
<tr>
<td></td>
<td>• Bring a shareholder proposal with a tiny chance of success.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Vote against directors, which may be effective threat if large shareholder.</td>
<td></td>
</tr>
<tr>
<td>Employees</td>
<td>• Do not get to negotiate.</td>
<td>• Strike unlikely in current economic times, unless business is insolvent and there is nothing to lose.</td>
</tr>
<tr>
<td></td>
<td>• Threaten to strike, of which effectiveness and likelihood depends on the industry (neither very high).</td>
<td>• Lobby prosecutors to bring criminal charges.</td>
</tr>
<tr>
<td></td>
<td>• If shareholders, same as above under shareholders.</td>
<td></td>
</tr>
<tr>
<td>Federal Government</td>
<td>• Regulate, but face severe opposition by shareholders and executives alike if attempted.</td>
<td>• Regulation more acceptable, but would still face severe lobbying.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Important political constituencies have different views on regulation; no law will satisfy everyone: “damned if you do and damned if you don’t.”</td>
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The effectiveness of the shareholders’ no-deal option—threatening with federal regulation—depends also on the behavior of other corporations. This Article assumes the more corporations that adopt effective voluntary processes to set executive compensation, the less likely is federal regulation (and the less restrictive it will be if passed). If only a few corporations are willing to amend voluntarily their pay-setting practices, federal regulation is more likely. But if federal regulation is likely, then few executives will be willing to negotiate with the shareholders, the employees, etc., because there may be no benefit to negotiating, assuming that regulation will supersede any negotiated agreement. Imperfect information about likely actions of other corporations creates a situation called the “collective action problem”: rational choice leads corporations to defect, i.e., refuse to adopt a voluntary
process, even though each corporation’s and party’s individual reward would be greater if everyone played cooperatively.

Because real executives can continue to communicate with other companies and with the federal government, the prisoner’s dilemma is unlikely to affect severely their decision of whether to initiate voluntary negotiations. As they try to figure out whether and how to structure their process, they will likely have information about what other companies are doing.

c. Sequence and Process Choices

Current law places relatively few process barriers in the way of the executives, the board of directors, or the shareholders interested in negotiating executive pay. A company that wants to include the stakeholders in the process for setting executive pay is allowed, under Delaware law, to include as many parties as necessary in the process for setting executive compensation, so long as the board of directors does not divest itself of its authority to decide what an executive should be paid. The business judgment rule, as adopted in Delaware, does not prohibit the board of directors from considering opinions of interested parties, or compensation consultants for that matter, in making its decision.160

Barriers associated with sequence and process choices are more difficult to identify in the abstract than parties, their interests, and their no-deal options. The party interested in reaching a negotiated solution will look to put in place the best sequence by which to involve different potential parties in order to increase the likelihood of success.161

In corporations subject to existing federal restrictions on executive pay (e.g., TARP recipients and banks in general), the most difficult party to negotiate with is likely to be the federal government itself. Other parties will need to consider whether to approach the federal government right away, to ascertain what actions might be exempt from the reach of the regulation, or whether internal consensus should precede negotiations with the federal government. The sequence will vary from corporation to corporation. Sometimes, the shareholders may want to begin negotiations directly with the party with opposing interests, the executive, and then proceed with their natural allies. At other times, different groups of shareholders may start the

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160 The business judgment rule requires and allows directors to consider the effect of their decision on the corporate enterprise, which includes “‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally).” Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

161 See LAX & SEBENIUS, supra note 138, at 29.
process by forming coalitions amongst themselves, then negotiating with the board of directors who, in turn, will negotiate with the executives.

The process to determine the right sequence might be complicated and involved, Lax and Sebenius warn. Parties need to search broadly among “internal, external, actual and potential parties” to the negotiation; they need to figure out the relationships between these individuals and groups, “especially who defers to whom, and who influences whom, positively or negatively.”162 This will be particularly important among different shareholders who, as identified above in Table 1, may have very different interests. Then the planner must focus on the most-difficult-to-persuade party and figure out who must say “yes” before that party will agree and then continue backward from the most difficult to the least difficult party.163 Finally, the planner must decide whether to negotiate with parties together or separately, privately or publicly, and carefully manage the information flow.164

2. Design Barriers and Tactical Barriers

“An inadequate deal design can impede, or even preclude, progress.”165 Parties are more likely to begin negotiations if they believe they will be made better off by negotiating than not. Zero-sum negotiations are likely to break down quickly, particularly in the executive compensation realm, where the parties could believe that their no-deal options are either very good for them or very bad for the other side. Executives might believe that their no-deal option is a rich golden parachute, while the shareholders might believe that their no-deal option is to lobby the federal government to confiscate the payment by imposing a high tax on it. To make compromise more likely, the planner will need to show the parties how the value of a compromise exceeds the value of the alternatives. He can do that by following these design principles:

1. Probe behind what are apparently incompatible bargaining positions to understand the full set of interests at stake for all parties.166

2. Encourage parties to probe for different interests that are easy for them to concede in exchange for interests that they consider more valuable.167

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162 Id. at 107.
163 Id. at 107–08.
164 Id. at 108.
165 Id. at 30.
166 LAX & SEBENIUS, supra note 138, at 135.
Differences include, predictions about the future (how likely is a particular project to succeed and create value for the shareholders); in attitudes toward risk (Is the executive willing to take a $1 salary in exchange for a bonus contingent on meeting revenue and profitability goals? Is he willing to forego a bonus for a higher guaranteed pay-out? Is he willing to accept a claw-back requirement in exchange for a restricted stock award?); attitudes toward time (receive lower compensation today instead of higher compensation in ten years?); and other possible differences including taxability, liquidity, investment expertise, relationships, and precedents. A board of directors may be willing to allow shareholder representatives to observe board meetings if that lowers the odds of negative publicity. An executive may be willing to meet with shareholder representatives a few times a year to hear their ideas, respond to governance concerns, create good publicity, and avoid time-consuming and costly legal altercations. In addition, all parties involved can choose to publicize some parts of their compromise, for example, that the executive is taking a one dollar salary and meets with important shareholders once every quarter, reaping the benefits of positive publicity, and avoiding publicity for other parts of the agreement that are likely to attract criticism, like the fact that the executive received pension benefits.

3. Maximize the total net pie: by looking imaginatively and very broadly at the interests of the parties, they will be able to find higher value compromises. For example, few executives understand that their pay package is not just their business. A poorly-designed executive compensation package affects employee productivity and increases the odds that good people will leave. Taking into account broader interests will affect the structure of the executives’ pay package but might also result in compromise with employees about aspects of their own compensation.

Tactical and interpersonal barriers are most familiar to seasoned negotiators. They include difficult at-the-table tactics: “hardball moves, put-

167 See id. at 123.
168 See id. at 136–38.
169 See id. at 138–41.
170 See id. at 142–43.
171 See id. at 143–44.
172 See LAX & SEBENIUS, supra note 138, at 125.
173 See id. at 125–28.
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downs, last-minute demands, pressure tactics, hiding information, walk-away threats.”174 In addition, tactical barriers include communication problems stemming from poor presentation, poor framing and poor listening, lack of trust between parties, different styles and personalities, and, in international corporations, cross-cultural issues.175 These barriers are likely in intra-company negotiations, but they depend almost entirely on the personality of the parties. As a result, abstract analysis would be pointless. Carl Icahn, a shareholder activist, and Michael Eisner, former CEO of Disney, are both likely to be difficult negotiators, but generalizing the behavior of either to a class of parties, shareholders or executives, would be counterproductive. Warren Buffet, on the other hand, has a reputation for being reasonable negotiators who do not enjoy playing games and strategic behavior. Nevertheless, when it comes to their own compensation, all executives are likely to be quite sensitive and less willing to negotiate than otherwise.176

C. Designing a New Process

In order to succeed, the DSD process needs to be informed and principled. Fader identifies six steps that an entity interested in reforming its dispute resolution process needs to take before implementing a modified process.177 Although Fader writes about state courts, design steps are equally applicable to a corporation looking to reform its process for settling and disputing executive compensation awards.

1. Self-Assessment: the design process begins by identifying the interested parties. It needs to begin with an honest and thorough investigation of the company, its history, its goals and corporate mission, and its challenges. The company will need to determine whether the problems of the current situation could be ameliorated through a modified process.178

174 Id. at 32.
175 Id. at 34.
176 Recently, Robert Diamond, the president of Barclays Capital, a large U.K. bank, was asked: “If you really love working for Barclays, why do you need that huge incentive to do the job you are paid to do anyway?” He could not provide a good answer. Landon Thomas Jr., Executive at Barclays Defends Pay, N.Y. TIMES, Dec. 19, 2009, at B1, available at http://www.nytimes.com/2009/12/19/business/global/19barclays.html?scp=2&sq=barclays&st=cse/.
177 Fader organizes the steps differently and therefore identifies seven steps, not six. See Hallie Fader, Designing the Forum to Fit the Fuss: Dispute System Design for the State Trial Courts, 13 HARV. NEG. L. REV. 481, 485–88 (2008).
178 See id. at 487.
2. Getting Leadership on Board: in order for a process design effort to succeed, parties must view the new process as a benefit to themselves. Barriers to agreement that are discussed above—setup barriers and no-deal options in particular—may make it difficult to convince corporate boards and management of the benefits of a more inclusive negotiated process. Costantino and Sickles Merchant suggest that participants be offered incentives and rewards for taking part in the system. For example, the board of directors might be willing to trade off shareholder participation for reduced pressure to cut the R&D budget. In addition, the party interested in modifying the process would be well-advised to propose changes that are incremental and produce large benefits at a low cost. For example, the executive could offer shareholders the right to vote on executive compensation. It is a low cost concession for the executive but yields far-reaching benefits, including improved publicity and a means for the shareholders to voice concerns at least once per year.

3. Design process: whatever process the company adopts will depend on who are interested parties, their interests and no-deal options, and other barriers to agreement. In addition, the company will consider whether and what matters in addition to executive compensation should be included in the negotiation. For example, it could be cost-effective for a company to combine negotiations about pay with a discussion about dividend policy and long-term business plans.

4. Training and implementation: parties must understand the purpose of the new process and its likely effects. Unrealistic expectations will undermine even the best reform effort. The collective action problem—no corporation wants to implement a new process if the federal government will regulate compensation anyway, but if many corporations implemented new and improved processes, federal regulation could be avoided—might reduce the willingness of corporate boards to initiate change. A pilot program implemented in a company whose reputation had recently been tarnished by poor compensation practices, for example AIG, would serve as a model and lower the perceived risks of a new and untested process.

179 See COSTANTINO & MERCHANT, supra note 17, at 92–95.
180 See id. at 189–98.
181 See Samuelson & Stout, supra note 11 (noting that many firms have cut their R&D budgets in response to shareholder pressure to produce short-term profits).
182 See Fader, supra note 177, at 487.
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5. Evaluation: the criteria for evaluation should be built into the process to continuously collect data and make changes as appropriate: clarify goals, determine the methodology, establish a baseline, chart progress, modify the system, and re-clarify goals.183

6. Diffusion: if the process is deemed effective and efficient, a pilot program can be expanded, taking into account the limits of the program’s effectiveness.184

It is important for the company to go through all the steps. A botched negotiated process is unlikely to produce the benefits identified above—preempt federal regulation, lower the costs of conflict, reduce the risks of harm to reputation, lower costs of capital, improve employee productivity, and lower training and retention costs, etc.—and will likely produce substantial costs.

A process that is perceived as perfunctory will further harm the reputation of the company. Whether well-designed or not, a negotiation that includes a number of parties will be logistically difficult and costly. The company might have to hire a consultant to assist with the design of the negotiation process. In addition, by creating additional opportunities to provide input on executive pay decisions, an inclusive process is likely to increase the costs of formal disputes. Finally, the negotiation will likely take a substantial amount of time. Without any of the benefits, these costs do not justify the process design effort.

CONCLUSION

Rahm Emanuel, President Obama’s Chief of Staff, recently said: “Never let a serious crisis go to waste. . . . [I]t’s an opportunity to do things you couldn’t do before.”185

The existing system for setting executive compensation is in crisis. It occupies the President, Congress, and the media. Time is ripe for a change. Instead of focusing on regulatory solutions, the Article proposes intra-firm negotiation as a possible solution to the problem of executive compensation.

This Article expands the scope for dispute systems design and suggests that its theoretical teachings could be used to improve the process for setting executive compensation. The Article describes how the existing process for

183 Id.
184 Id. at 488.
setting executive compensation consistently leads to overpayment, which usually creates friction within the corporation. Existing legal rules result in much latent conflict that is not managed at all, or, at best, is managed very poorly, generating substantial costs. The costs include costs directly associated with overpayment and costs of conflict that overpayment generates: lower morale, harm to reputation, increased cost of capital, and excessive focus on short-term results.

Because conflict about executive pay is prevalent, and the costs of conflict significant, one would expect that corporate executives, shareholders, directors, and other parties would have already voluntarily reached agreement about improving executive pay practices. The fact that corporations have not come up with better solutions is sometimes used as evidence that the existing regime must be efficient. This Article argues that this is not the case. It observes that barriers to compromise will prevent corporations from initiating value-increasing negotiations and describes those barriers in more detail as they apply to disputes about executive pay. Finally, the Article proposes steps that a company interested in rethinking its process for negotiating executives’ salaries should take to reduce the overall costs of disputes about executive compensation, increase participation, and thereby improve the system for setting executive pay.