S. HRG. 109–945

EXECUTIVE COMPENSATION: BACKDATING TO THE FUTURE

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

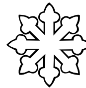
ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

OVERSIGHT OF CURRENT ISSUES REGARDING EXECUTIVE COMPENSATION, INCLUDING BACKDATING OF STOCK OPTIONS AND TAX TREATMENT OF EXECUTIVE COMPENSATION, RETIREMENT, AND BENEFITS

SEPTEMBER 6, 2006



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

36–595—PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
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EXECUTIVE COMPENSATION: BACKDATING TO THE FUTURE

WEDNESDAY, SEPTEMBER 6, 2006

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Hatch, Snowe, Thomas, Crapo, Baucus, Bingaman, and Wyden.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Welcome, everybody. Thanks to all of my colleagues who are in attendance.

We all know that the American work ethic is unrivaled anywhere in the world. We have always wanted a better life for our children and our grandchildren. It seems to be part of our heritage that brings us all together with one economic goal in mind.

Not only do we work harder than most societies around the world, but we also work smarter. The fact is, we even have to work smarter if we are going to keep up with international competition.

Entrepreneurship, innovation, and technological advancement have been hallmarks of our economy from the beginning of our history. We remember the spirit of invention of our founding fathers: Benjamin Franklin, Thomas Jefferson, and later on, Edison, Ford. Today, the pioneers are in Silicon Valley.

It is America's work ethic, coupled with our relentless search for innovation, that has led us to be the great economy that we are. The greatness of our economy and our society also rests on some very fundamental principles.

We are a capitalist society that believes strongly in the power of free markets to improve standard of living, not just here, but we believe that for other societies as well. We believe in the American dream, as I define it: the idea that we all have an opportunity to achieve as much and advance as far as our ability and our hard work will take us.

Underpinning that concept, we always have the idea that things ought to be done in a fair way, that an honest day's work will mean an honest day's pay. The factory worker who puts in his 8 hours—and maybe today a lot more than 8 hours—knows that he will be paid for those hours he works: no more, no less.

Similarly, a person in my profession of farming, who worked hard in the fields all season, takes his crop to market, gets paid the market price of that delivery date. He or she does not have the option to say, I want to sell my crops for the price 2 months earlier when the market was better. This is the concept of an honest day's work for an honest day's pay in our free market economy.

Our capitalist system creates winners and losers, but it is supposed to do so in a way that is fair to all and from which we all ultimately benefit. These are American values. We, as Americans, also believe in the supremacy of the rule of law as the ultimate enforcer of these American values.

When anyone threatens our fundamental principles, we must take it very seriously or we risk losing our greatness as a Nation. So today, at this hearing, we will hear about behavior at some of our largest corporations that is such a threat.

It is behavior that, to put it bluntly, is repulsive. It is a behavior that ignores the concept of an honest day's work for an honest day's pay and replaces it with a phrase that we hear all too often today: "I am going to get mine."

Even worse in this situation, most of the perpetrators had already gotten "theirs" in the form of six- or seven-figure compensation packages, of which most working Americans can never dream of receiving, or maybe dream about, but never receive.

But apparently that was not enough for some. Instead, shareholders and rank-and-file employees are ripped off by senior executives who rig stock option programs through a process called backdating which further enriches themselves.

And, as we have found far too often in corporate scandals in recent years, boards of directors were either asleep at the switch, or maybe in some cases willing accomplices.

We will hear today then from the Justice Department, the SEC, and the IRS about how they are responding to these unfolding scandals and what we, as a Congress, can do to aid their efforts.

We will also hear about executive compensation issues more generally, both from our panel of government witnesses and from the second panel of experts in this area.*

It is important that we defend the American principles of capitalism and free market innovation, but it is also important that we defend the equally important American principles of fairness and rule of law. These are not conflicting principles. I think they are the backbone of our Nation. Those who violate them need to answer for it.

The CHAIRMAN. Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

In the wilderness of Sinai where the children of Israel gathered manna from heaven, the book of Exodus reports, "He who gathered much did not have too much and he who gathered little did not have too little."

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*For additional information on this subject, *see also,* "Present Law and Background Information Relating to Executive Compensation," Joint Committee on Taxation staff report, September 5, 2006 (JCX–39–06).

Unfortunately, these days we cannot say the same about executive compensation. We regularly hear reports about executives who gathered much, and not infrequently hear reports of some executives who gathered much too much.

For example, in 2001 the CEO of Tyco received a compensation package of $36 million. The CEO was later indicted for grand larceny, enterprise corruption, falsifying records, and sales tax evasion.

In 2002, the CEO of Sun received $25 million. And we cannot forget Lee Raymond, who retired from Exxon-Mobil in January. It was in April we read that he received a retirement compensation package valued at about $400 million.

In 2004, the average compensation for top executives at the country's largest publicly held companies rose to $9.6 million. That is average. That is more than 300 times the wages of the average worker.

From 2003 to 2004, executive compensation increased by about 16 percent for that 1 year. At the same time, compensation to rank-and-file workers rose by about 2 percent. Last week's news reported that wages for working-age Americans actually declined in 2005.

As the Congressional Research Service found, these firms that announced layoffs tend to give their CEOs comparatively larger pay packages and a greater percentage of raises than do firms that did not announce layoffs.

How have companies been able to pay their executives such large compensation packages? That is what we are here to talk about today. Today we will address executive compensation and how the tax law treats it.

Now, I have nothing against people earning a good living. America is a land of opportunity. America is a place where people can invent that new idea, make the new product, and make a good deal of money doing it. God bless them.

We are also reading reports that some in corporate America are apparently backdating stock options to boost top executive compensation. We read that the authorities are investigating dozens of companies and executives for this latest corporate scandal. Today we will look into the backdating of stock options.

Today we will hear about the interplay between the tax rules and executive compensation. Yes, America is a land where people can make a great deal of money. That is one of the reasons that we have a progressive income tax. So today we will talk about whether America's tax system helps to promote fairness.

Fairness is important. No one wants to pay too much money to the Federal Government, or to anyone else, for that matter. Most folks simply want to pay their fair share, no more.

But some appear to be working to buck that system. Some appear to be spending their time searching for loopholes in the tax laws. These people appear to be working aggressively to avoid paying their fair share of taxes.

So I am glad that the committee is looking into the subject of executive compensation. It is high time that we discussed some of the abuses that have taken place, it is high time that we tried to close some of these loopholes, and it is high time that we focused on the

fairness of the tax code. A fair tax code should not be as rare as manna from heaven.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Now we go to our first panel. We have Deputy Attorney General Paul McNulty. We have Commissioner Mark Everson of the Internal Revenue Service, and I would take a moment just to thank him for the efforts he is making to follow Congressional intent on debt collection from people who do not pay taxes that we think are owed, and would express my gratitude to you because one of the firms you selected competitively was the CBE Group of Waterloo, IA.

Commissioner EVERSON. That was just by chance, Mr. Chairman. I do not want anybody to think that Iowa got a break here. [Laughter.]

The CHAIRMAN. I said "selected competitively." [Laughter.]

And, finally, we are going to hear from Linda Thomsen, Director of the Division of Enforcement of the Securities and Exchange Commission.

Mr. McNulty, then Mr. Everson, then Ms. Thomsen.

STATEMENT OF HON. PAUL J. McNULTY, DEPUTY ATTORNEY GENERAL, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, DC

Mr. MCNULTY. Thank you, Mr. Chairman and members of this committee. I appreciate the opportunity to be here to discuss the practice of backdating stock option grants to executives at publicly held corporations. Your interest in this issue and your initiative, as demonstrated by this hearing, will certainly help to discourage illegal conduct in this area.

Stock option grants are contractual rights to purchase a share of stock on a future date at a set price, known as the strike price. They are often granted to corporate employees as part of their compensation package.

Typically, the strike price is the market or trading price of the stock on the day the option was granted by the corporation's board of directors, commonly acting through its compensation committee.

The employee can buy the stock, usually at the end of a vesting period, at the strike price and realize a profit by selling it when the stock is trading at a higher price than the strike price.

Options are often granted to give employees incentive to work hard. Their hard work will theoretically result in more profit for the company and a corresponding increase in the market price of the stock.

Options with a strike price equal to the current trading price of the underlying stock are referred to as being "at-the-money," and options with a strike price below the current trading price of the stock are "in-the-money." The practice we are investigating and here to discuss today involves stock options that are backdated so that they are "in-the-money" at the time of the grant.

When options are backdated in this way, the strike price is fixed on an earlier date when the market price for the stock was significantly lower, even though the options were actually granted at a later date when the share price of the stock was higher. The practice of backdating allows corporate wrongdoers to fix a lower strike

price for the options, locking in an immediate gain to the option holder.

In order to avoid significant accounting, disclosure, and tax consequences resulting from option grants "in-the-money," some corporate executives have engaged in schemes to falsify corporate books and records, to mislead the corporation's board of directors and outside auditors, to file false reports and financial statements with the Securities and Exchange Commission, and to mislead shareholders, the investing public, and the financial media.

And, Mr. Chairman and members of the committee, that is how stock option backdating becomes a crime. A grant of "in-the-money" options is treated, under accounting principles, as compensation to the option holder, and therefore is an expense by the corporation and should be deducted from the reported revenue.

If a corporation backdates options and prices them "in-the-money" without properly disclosing this fact, the corporation is falsifying its books and records, fraudulently decreasing expenses, and falsely inflating profits.

Backdating of stock options also conceals the fact that employees are being given the right to purchase the underlying stock at a discount from the fair market value on the date the option was really granted, and that misrepresents the employee's compensation.

Corporations are required to accurately report compensation and other remuneration to officers, including the nature of the compensation. Corporations are also required to accurately describe the stock option plan for which they request shareholder approval.

When stock options are surreptitiously backdated, the corporation will file false and misleading reports and financial statements with the SEC and other regulatory authorities. By doing that, the corporation disseminates false and fraudulent information to the investing public.

Grants of backdated options, contrary to the terms of the shareholder-approved option and compensation plans, can also be considered an embezzlement of corporate assets because the defendants are misappropriating shares of the company at an unauthorized and discounted value.

Secretly backdating options to a date with a lower market price may also have tax consequences for the employee and the corporation, and I will defer to my colleague, Commissioner Everson, to explain this issue.

When this practice was first disclosed, the Department of Justice moved quickly to initiate appropriate investigations. Many companies have restated their earnings and made public filings to that effect.

At the same time, U.S. Attorney's Offices throughout the country, assisted by agents of the Federal Bureau of Investigation, initiated contact with the SEC and began to investigate.

In Silicon Valley, where much of this backdating occurred, an organized team approach to assess the criminal implications of backdating was needed. On July 13, 2006, the U.S. Attorney for the Northern District of California announced the formation of a Stock Options Backdating Task Force to investigate allegations that corporations and individuals in northern California had retroactively changed the grant dates of stock options with the intent to defraud.

The task force, consisting of personnel from the U.S. Attorney's Office and the FBI, is investigating companies in the Northern District of California to determine whether any of these companies or individuals engaged in fraudulent option backdating or related criminal conduct.

Fraudulent conduct involving backdating options can be investigated and prosecuted under traditional mail and wire fraud statutes and the prohibition against filing of false statements.

We can also use criminal statutes enacted as part of the Sarbanes-Oxley legislation, such as securities fraud, knowingly certifying false statements filed with the SEC, destroying, falsifying, or altering records in Federal investigations, and destroying corporate audit records.

Of course, some of this conduct may pre-date Sarbanes-Oxley, and, in those instances, that legislation cannot be used. These cases may also be amenable to prosecution under criminal statutes relating to obstruction of justice, perjury, and criminal tax violations. Thus, the Department of Justice can rely on a number of statutes in charging this conduct.

To date, there have been two criminal cases filed alleging backdating of options in violation of Federal securities laws and other criminal statutes. I have summarized the allegations in these two cases in my written testimony.

Our theories of prosecution are concerned with the accuracy and adequacy of disclosure of material information, and in that respect they are similar to many other DOJ prosecutions for corporate fraud.

The practice of stock option backdating to conceal information from corporate boards and regulatory authorities can only be seen as brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders.

Like other forms of corporate fraud, the Department of Justice takes stock option backdating seriously, and we will continue to use our best efforts to uncover criminal conduct where it occurs.

While we cannot say at this juncture how many cases will result in criminal charges or how many will be treated as civil matters, we are committed to using the resources of our experienced securities fraud prosecutors and investigative agencies throughout the country to ensure that each matter we open is thoroughly investigated.

Mr. Chairman, I chair the Corporate Fraud Task Force, and we took this issue up at our July 27th meeting and discussed ways in which we could work better as a group of agencies, coordinated in an effort against this emerging problem.

We owe a duty to the American people, whose hopes, dreams, and futures are tied more and more to the integrity of the stock markets. I thank you again for the opportunity to be here today, and I look forward to answering your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. McNulty appears in the appendix.]

The CHAIRMAN. Now, Mr. Everson?

STATEMENT OF HON. MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Commissioner EVERSON. Good morning, Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee. Thank you for inviting me to testify on the timely and important subject of corporate executive compensation and the backdating of stock options.

I would like to say, it is not in my written testimony, but listening to the numbers from Senator Baucus, I think we have had a couple of pretty good years, and I would like you to consider a salary increase for me. [Laughter.]

Senator BAUCUS. Is that performance based? [Laughter.]

Commissioner EVERSON. I think so. I think we can prove that at least as well as 162 would say. [Laughter.]

This is the first time that I have testified before the committee since passage of the Pension Protection Act. I want to thank the Chairman for his leadership, as well as the Ranking Member and the other members of the committee for supporting several vital provisions of that Act which strengthen tax administration, particularly those involving charities and the sharing of information with State charity officials.

Before I describe our activities in the areas of executive compensation, I want to repeat my request for you to support the President's fiscal year 2007 budget for the IRS. Over the past several years, the Service has increased its audits of both high-income individuals and large corporations, the taxpayer groups which we will discuss today.

I want to continue to increase our activities in this area, and a primary way to do this is by funding the President's request. The Senate budget bill calls for slightly more than the President's request, while the House of Representatives' bill falls short by over $100 million.

In each of the past 4 years, Congress has enacted less than what has been requested by the President for the IRS. I ask for your continuing support as the 2007 budget request moves towards resolution.

Turning to the subject of backdated stock options, I would like to make several points. I find this behavior abhorrent. These executives are already plenty rich and do not need to cheat on their options. The IRS is an active member of the President's Corporate Fraud Task Force, chaired by Deputy Attorney General McNulty.

The Service is also working directly with the SEC in our investigation of abuses in the area of backdated stock options. The IRS will follow up on every company and the relevant executives for each case where it is determined that abuses have occurred.

Where we determine that inappropriate deductions were taken by a company as a result of backdating, under section 162(m), we will take action. We will act with respect to corporate executives who violate new section 409(a), which will likely impact a smaller universe of cases where option exercises occurred beginning in 2005.

In working with the SEC, we have benefitted considerably from the quality and specificity of the information they have, and will

continue to provide us. As you know, the Service is prohibited from sharing taxpayer-specific information with the SEC.

As our collaborative efforts with the SEC unfold, I ask whether the time has come for Congress to consider authorization of targeted and protected sharing of information about public companies, and potentially their top executives, by the Service with the SEC and the Department of Justice.

While tax privacy laws continue to occupy a primary role in our tax administration system, the unquenchable appetite for exorbitant compensation on the part of executives and the sheep-like willingness of boards to feed it yet again raise the issue of whether modification to the standards of section 6103 is warranted.

Thank you.

The CHAIRMAN. Well, that was strong testimony. Thank you very much.

[The prepared statement of Commissioner Everson appears in the appendix.]

The CHAIRMAN. Now, Ms. Thomsen?

STATEMENT OF LINDA THOMSEN, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Ms. THOMSEN. Thank you. Good morning, Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee. Thank you very much for inviting me to testify today about options backdating.

I am very pleased to testify with Deputy Attorney General Paul McNulty and Internal Revenue Service Commissioner Mark Everson.

While each of us has different law enforcement responsibilities, options backdating can impact criminal and tax laws, as well as the Federal securities laws. Because of this, I want to assure the committee that the SEC's enforcement staff has been sharing information with the Department of Justice and the Internal Revenue Service, as warranted and appropriate.

Indeed, the Commission and the Department of Justice jointly announced the filing of two enforcement actions concerning backdating earlier this year.

Hardly a day has gone by this summer when this issue and the scandal it has raised have not been in the press. It is of intense public interest because it strikes at the heart of the relationship among a public company's management, its directors, and its shareholders.

My main objective today is to highlight, from an enforcement perspective, some of the incentives that Federal tax and accounting laws may have given companies and individuals to backdate, and the resulting Federal securities law implications.

The type of backdating I am referring to is the practice of misrepresenting the date of an option award to make it appear that the option was granted at an earlier date and at a lower price than when the award was actually made.

In a simple stock option grant, a company grants an employee the right to purchase a specified number of shares of the company's stock at a specific price, known as the exercise price. The exercise

price is usually set as the market price of the stock on the grant date, or “at-the-money”.

If an option is awarded at a lower market price, it is said to have been granted “in-the-money”. Typically, an employee cannot exercise the option and acquire the underlying stock until the passing of a specified period of time known as the vesting period.

Like all employee compensation, option grants can have significant Federal tax consequences, both for companies and for employees. Backdating option grants disguises “in-the-money” options.

Backdating allows the option recipients potentially to realize larger eventual gains, but still characterize the options as having been granted at-the-money for tax, financial and executive compensation reporting purposes.

The tax incentives for companies to grant stock options increased in 1993, when Congress capped the tax deductibility of certain top executive compensation at $1 million. The intention may have been to limit executive pay, but the reality is that compensation migrated to other forms, and particularly to performance-based compensation to which the cap did not apply, such as at-the-money stock option grants.

Until last year, companies had an accounting incentive to grant at-the-money options because they generally were not required to record an expense for options compensation unless the options were “in-the-money” when granted. And, of course, all other factors remaining constant, recording less expense results in reporting higher earnings.

Financial Accounting Standards Board statement 123R, which became effective last year, substantially eliminates the advantageous accounting treatment previously afforded to grants of at-the-money options because, unlike prior accounting guidance, statement 123R requires all option grants, including at-the-money options, to be expensed at their fair market value on the grant date.

For employees, stock options, and particularly at-the-money grants, can be more advantageous than other forms of no-risk compensation for two tax-related reasons. First, until options are exercised, there is no taxable event for an employee. Second, unlike salary, when incentive stock options are granted at-the-money and subsequently an employee exercises the option and holds the stock for the statutory holding period prior to sale, 1 year after exercise and 2 years after grant, the entire gain generally is taxed at the highly favorable capital gains tax rate.

For individuals in higher tax brackets, this can effectively reduce the tax liability of option-based compensation by up to 50 percent. This favorable tax treatment does not apply to in-the-money option grants.

Option backdating can result in companies reporting materially false and misleading financial and executive compensation information, and in executives making false disclosures concerning their individual stock option transactions.

Because option vesting periods can last for several years, the impact backdating can have on a company’s financials can last years. Even backdated options granted in the late 1990s can impact recently reported financial statements.

To date, the Enforcement Division has brought several actions against individuals and companies for backdating practices. We currently are investigating over 100 additional companies concerning possible fraudulent reporting of stock option grants. While we do not believe that all of the ongoing investigations will result in enforcement proceedings, I do expect there will be additional enforcement actions.

Our expectation is that most of the fraudulent practices found will have started in periods prior to 2003, before the Sarbanes-Oxley Act required officers and directors to publicly report option grants and exercises within 2 business days.

Backdating is much less advantageous within a 2-day window of opportunity. There simply is not as much time to cheat on the dates. Additionally, statement 123R greatly reduces companies' incentives to backdate options.

Mr. Chairman, that concludes my testimony. Thank you very much again for inviting me to appear before you today on this very important subject. I am happy to take any additional questions.

[The prepared statement of Ms. Thomsen appears in the appendix.]

The CHAIRMAN. Thank you.

We will have 5-minute rounds. The first four will be: Grassley, Baucus, Thomas, and Hatch.

For any of you on the panel, but I would ask you not to be repetitive of somebody else answering, I want to start with the fact that a significant number of cases that the Federal Government is reviewing are in response to companies coming forward after conducting their own internal reviews.

The fact that companies are trying to clean up now, even though it is after the lights have been turned on, is still very good news because it saves the taxpayers enforcement money. However, I want to make certain that the government is not waiting for the phone to ring.

So, three questions, and I will ask them all at one time. First, what percentage of backdating cases being worked on now are due to the government's own efforts, and what percentage are cases where the corporation turned itself in?

Second, what action is the government taking to identify and knock on the doors of corporations that it believes are engaged in backdating?

And, last, it would be my hope that the government would take a different view towards those corporations that failed to fess up. Is the government treating corporations differently who come clean as opposed to those who require the government to spend taxpayers' dollars to locate them and make the case? Whatever order you want to go in.

Mr. MCNULTY. Mr. Chairman, I will start first, just by saying that the general approach in this area is similar to a good bit of the corporate fraud enforcement work, in that the SEC is sort of a front line in its oversight and has a number of cases that it looks at and then refers to the Department of Justice cases where they believe that criminal conduct has occurred and it is appropriate for criminal charges.

So I think, in terms of what we see first, a lot of it comes up in the context of refilings by corporations as a result of information that they become aware of.

It is important to note that the conduct we are dealing with is very difficult to identify because it is an insider's game, where individuals have control of certain power and authority within a company and can manipulate records, reports, and other kinds of filings and deceive the compensation committee and create an appearance that the options were granted on a certain date and not backdated to a much better time. So, there has been some delay in discovering these things.

Once the problem came to light, more and more companies looked at their own books and found this and then made their refilings, so that has triggered a large number of cases.

I will defer to Linda on this, but I am not aware of any breakdown of percentage between those cases that we have seen which are discovered somehow on our own initiative versus those that have been reported to us. We would have to go back and check on that.

Ms. THOMSEN. Well, to follow up on that, I do not know of a percentage either. I would say that this issue is one that we have been pursuing at the SEC for some time and not waiting for the issue to be identified publicly or by companies.

Indeed, beginning in 2003, we brought our first case involving options. We brought one in 2004, and then some this year. We have also been working with academics to identify the potential for backdating, that is, suspicious optimal options grants, if you will.

Our own Office of Economic Analysis worked with the data so that we could identify likely sources of problems, and then we have been pursuing those and building on that record. As we have built on it, companies have indeed come forward, for which we are grateful.

We think it is the right thing for companies to do and we appreciate those efforts. We have had whistle blowers in this arena. We have followed leads in ongoing investigations. I think, cumulatively, we have developed a pretty decent record on pursuing this particular issue.

In part to answer your second question, as a result of the economic analysis we did, as well as the analysis we saw from academics, we did go knocking on doors to gather additional information, and continue to do so.

Finally, on the third question about how we treat people who fess up as opposed to those who do not, I think we and the Department of Justice have long been of the view that a company that acts responsibly when confronted with a problem will be treated better than those who do not.

Our policy is documented in an October 2001 document frequently referred to as the Seaboard Memorandum, although it is a report of the Commission. I know the Department of Justice Thompson Memorandum also addresses those issues.

The CHAIRMAN. My time is up. But do you have anything to add, Mr. Everson? I will not ask another question.

Commissioner EVERSON. The taxes do not drive this, sir. Most of the front end and the detection of this would come through the SEC, as my colleagues have indicated.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Turning to a related subject, and that is tax extenders and the failure of this Congress to extend those tax extenders.

A question to you, Mr. Everson. What is the cost going to be to the IRS if these are not extended soon? That is, it is my understanding that about mid-October, as sort of a drop-dead date, then the IRS is going to have to incur significant additional expenditures, whether it is with the contractors, its paperwork, its publications, website, forms, and so forth. Is that true?

Commissioner EVERSON. The longer the Congress waits to act in any year on tax matters, the tougher it makes it for us. If you look at last year with Hurricane Katrina and the legislation that did not come in until early December, we did not have all our forms ready until January or February. This is due to the fact that there are a lot of procedures and re-coding of the information system.

You are entirely correct. The longer you wait, the tougher it is. There are some costs, but the larger issue is the risk of mistakes and failures to do it correctly because of stress on the system. I urge you, if you are going to do anything more in the tax area, please do it quickly. [Laughter.]

Senator BAUCUS. Well, I am with you. Obviously, I am asking the question to get others to act more quickly.

Commissioner EVERSON. I am trying to be delicate in my response. [Laughter.]

Senator BAUCUS. Well, I am hoping that the Majority party hears what you just said, and what we are all saying. We have to, Mr. Chairman, get these extenders passed ASAP. If we do not, we are going to incur lots of additional costs in lots of different ways.

In fact, I think it is true, Commissioner, at least I have heard, that many companies now have to restate their financials because of the lack of extension of the R&D tax credit for this year. Is that correct or not?

Commissioner EVERSON. I have not heard directly of any particular numbers, sir, but I have heard that the issue has surfaced and this is a concern.

Senator BAUCUS. I think there is one in Iowa.

The CHAIRMAN. Yes.

Senator BAUCUS. One Iowa company, in fact, has written the Chairman to that effect. Word to the wise.

Commissioner EVERSON. My vote is with action.

Senator BAUCUS. All right.

I do not mean to be critical here. I am wondering, is there a problem here with the Justice Department and/or the SEC and IRS in uncovering this fraud? I say that because I understand that this was first brought to our attention by some statistical analysis, some firms looking at what is happening, and, lo and behold, discovered.

There is a lot of backdating, a lot of fraudulent backdating, a lot of in-the-money, if you will. It was only then that our agencies started to get cracking. Can somebody comment on that, please?

Ms. THOMSEN. I actually think that the increase in stock options, the use of stock options, is a phenomenon largely of the 1990s, particularly in the technology sector. I think that with Form 4s, for example, we have had better information after Sarbanes-Oxley.

Academics have gotten on top of this information, and I think we have followed the information as soon as we found it, and we were developing it before it surfaced dramatically, as it has recently. But as the Deputy Attorney General said, fraud is, almost by definition, collusive to a certain extent and hidden. So it is going to take some time after it starts to occur before we will detect it.

Senator BAUCUS. Right. But I understand that the problem came to light not because of IRS audits or SEC investigations, but because of statistical analysis by outside researchers. That is when this first came to light.

Ms. THOMSEN. It was a combination of academic research of data that we then followed up on. The data identified the potential for problems and then we, with our own Office of Economic Analysis, pursued that data and the companies highlighted to take those investigative leads to develop a case. What the data identified was the opportunity, if you will, the notion that there appeared to be fortuitous grants given.

Senator BAUCUS. This gets to another issue, as you well know, Mr. Everson, and that is the tax gap and resources to address the tax gap. As you well know, this committee—I, especially—has had ongoing discussion with the Treasury Department in order to come up with a plan to solve that tax gap, the $320, $330 billion, whatever it is, of income taxes legally owed but not collected every year that we have to begin collecting. It is only fair to U.S. taxpayers.

I am sure a lot of that depends on the resources that the IRS has, or maybe other agencies have, in order to determine the various components of that gap.

You mentioned in the beginning of your statement that you wanted us to support the President's budget, and in fact I will try to get additional resources to you. But to what degree are inadequate resources a problem in identifying and solving option backdating or excessive compensation or other issues here that are related to the tax gap question?

Commissioner EVERSON. Let me broaden the question just a little bit from the backdating of the options. In terms of the money that is at stake, it is not that great on the tax side compared to some of the many other components of the tax gap that we are familiar with.

What you are getting to is a very important point. It is about the harnessing of technology and the use of analytics to risk-assess and select what we look at.

As the committee knows, we mandated, at the end of 2004, the electronic filing of tax returns by large corporations and the largest not-for-profit entities. That is for the tax year 2005, the returns that are being filed now. This was resisted by corporations, who screamed like stuck pigs, but we are now getting this done. We are

reaching the real peak now, and we have had many of the largest returns filed.

For example, General Electric—I can say this publicly because they agreed to do this—has an extremely complex return, and that came in, and we have had other very complex returns come in. The final peak is just next week, and I am hopeful that will all go smoothly.

The ability to take that data, these thousands of pages of entries, and then to array that will give us the ability to make significant strides in our work. We will have the ability to be able to take a big company, that we might not be able to look at the whole return each year, but we will look at the areas where the ratios are out of line with other industry competitors and focus on that and get to issues like this.

So the question of the health of our systems, the infrastructure that we have, and the funding of all that is very pertinent to our ability to do that, sir.

Senator BAUCUS. But do you have the resources to do the analytic work, the algorithms? Google has all these algorithms to figure out how to get the right answer to your search request.

Commissioner EVERSON. No, we are not where we should be.

Senator BAUCUS. You need to develop algorithms so that you can get the right answers to your search request as to whether this person is or is not, potentially, properly filing or violating the law.

Commissioner EVERSON. You are absolutely right. We need to greatly enhance our analytical capabilities. Again, this does come back to the funding question, because the $1.8 billion that we spend each year on the combined base IT spending and modernization program, has not been fully funded each year by the Congress when we have requested it.

Senator BAUCUS. Well, maybe when we get this plan together of closing the tax gap, you can plug that in.

Commissioner EVERSON. That is certainly an element of any plan.

Senator BAUCUS. When you are talking to the Treasury Department and Secretary Paulson and the crew, because we have not closed on that yet, you can add a lot there.

Commissioner EVERSON. Since we have raised this, I would like to make a pitch. It would be helpful for us to have an Assistant Secretary for Tax Policy to finish up that plan. [Laughter.]

Senator BAUCUS. I think they are integrally related. You get the plan and you will get the Assistant Secretary.

The CHAIRMAN. Senator Thomas?

Senator THOMAS. This is an interesting issue. I am a little surprised by the implication that high executive pay and criminal behavior are inextricably linked. Now, I cannot imagine that this kind of behavior is the rule rather than the exception. You act like every high thing is illegal somehow. Would you comment on that?

Mr. MCNULTY. The issue of stock option grants has to be looked at——

Senator THOMAS. Well, stock option grants are not the only way people get paid, are they?

Mr. MCNULTY. No, certainly not. Maybe I did not understand your question.

Senator THOMAS. My question is, is high executive pay tied so closely to illegal things? That is the implication that you all have laid out here.

Mr. MCNULTY. That is not the implication that I certainly intend to communicate. As part of our corporate fraud effort we look at criminal wrongdoing, not something like the size of someone's pay, or whatever.

I mean, there may be tax issues that are involved in compensation questions, but as far as the question of enforcing Federal criminal laws, that is a very clear distinction of conduct that is not connected to just a dollar value, it is associated with a certain type of behavior, of deception and false filings of information, and those kinds of things. So, hopefully my testimony has laid out how we look at the criminal side of this particular subject of stock options.

Senator THOMAS. All right.

Does anyone else want to comment?

Commissioner EVERSON. I do not think high pay, in itself, will lead to illegality. I have said that I am very concerned about incentive compensation, particularly in the areas for the CFO, the general counsel, and the chairman of the corporation. This is because I believe that, in the area of corporate governance, the temptation to do the wrong thing is greatly increased if the stakes are as staggeringly high as they are.

I do think it is a risk factor that needs to be considered if individuals, particularly those who have a direct fiduciary responsibility, will personally benefit to the staggering degree that they have if the stock price goes up. The vast majority of compensation these days comes through the stock price, so, I think it is an issue.

I certainly do not mean, sir, to say that more money is necessarily going to cause a problem. I find this particular practice shocking, because these people are paid in the tens of millions of dollars, and the idea that they need to get a little bit more says that the controls within the companies and the attitudes within the companies certainly have gone out of kilter in those circumstances.

Senator THOMAS. So you are suggesting that the high pay is generally a result of stock options?

Commissioner EVERSON. I would defer to my colleague, but I think that the stock options certainly have been a major driver as to the component of the compensation.

Senator THOMAS. My time is going to run out. But let me just say, publicly traded companies are subject to a host of public disclosure statements, boards of directors, shareholders. I guess sometimes I wonder, is the system not there, if these are excessive kinds of things, you have a number of ways to react to it, do you not?

Ms. THOMSEN. Well, indeed, if I may step in. The recently enacted executive compensation rules by the SEC are geared entirely towards disclosure of compensation, and the Commission's approach is one that I think is neutral as to the amount of compensation, but quite clear that, whatever it is, it needs to be disclosed clearly and accurately.

Our focus from a law enforcement perspective is going to be on those situations where that is not going on, not so much geared towards the amount, but rather——

Senator THOMAS. I guess you have to think, when we are talking about this topic, certainly what you have said is true, but on the other hand, this is a free market system. This is a system where it is up to the people to disclose. We are not there to control the salaries that people are paid.

Commissioner EVERSON. I would not suggest that. If there is any inference of that, that the government should step in, sir, that is not where I am. I do find it disappointing that the boards of these companies have not done a better job of making sure we did not get to where we are.

Mr. MCNULTY. Mr. Chairman, may I make a real quick point? That is the issue, though, for us. You have identified these oversight structures that exist and are in the private sector and are very important, and we rely on them. The integrity of the marketplace depends upon truthfulness. What these cases are about is deception of those very systems that we count on for oversight and ensuring integrity.

Senator THOMAS. I understand that. I just hope we do not infer that most everybody is breaking the rules. Anyway, thank you.

The CHAIRMAN. Now the Senator from New Mexico.

Senator BINGAMAN. Thank you very much, Mr. Chairman. Thank you all for being here.

Let me ask Mr. Everson. My understanding is that, under the tax code, the general rule is, amounts paid in compensation to executives are deductible as long as they are reasonable. There is some reasonable test in there. Am I accurate about that?

Commissioner EVERSON. Section 162(m) has been in the law since 1993. I believe it pertains to the top five executives. I think it parallels what Linda and the SEC drive the disclosure on, the very most senior people.

There is a potential limit as to the deductibility of amounts over $1 million if it does not meet certain standards. Those standards, as I think you will hear from the follow-on panel, are relatively easy to meet.

Senator BINGAMAN. But, as a general matter, you are not aware of any requirement that, in order for an expense of the company to be deductible, it must be a reasonable expense and some kind of general requirement of reasonableness must apply.

Commissioner EVERSON. There are several standards about performance-based compensation, but some companies, in our experience, will even forego the deduction and continue to pay the high compensation.

Senator BINGAMAN. All right. So there is no effective limitation by virtue of a requirement of reasonableness on the ability of a company to compensate its executives.

Commissioner EVERSON. I would say at this stage, if there is a belief that the standards of 162(m) have changed practices in that regard, I do not think that that is correct.

Senator BINGAMAN. One of the witnesses on the next panel, Prof. Bebchuk from Harvard Law School, makes the point that "the massive use of deferred compensation plans has enabled getting around the limitations of non-performance pay established by section 162(m)."

He goes on to point out that "as long as the payment of the amount is deferred until the executive leaves, then the law does not in any way restrict the ultimate deductibility of that by the firm."

Would you agree that, if we are going to try to limit the deductibility of excessive executive compensation, we ought to close that loophole?

Commissioner EVERSON. I would not comment, sir, on any particular loophole. I would suggest to you that, by nature of the constituency that this affects, corporations work extremely hard to lawyer up and make sure that they are in compliance with standards that you would set in law.

So if you are going to review these areas, you want to step back and do it very carefully because they will find ways to find where those lines are and go right up to them.

Senator BINGAMAN. All right.

Let me ask, Ms. Thomsen, I gathered from your statement that you think this problem of backdating of options is largely a pre-Sarbanes-Oxley problem and that the law now under Sarbanes-Oxley, which requires the reporting of these option grants within 2 days, pretty much solves the major abuses that we are now aware of. Am I right about that or not?

Ms. THOMSEN. I think that—in combination with the change in the accounting rules—has done a lot to reduce the opportunity for abuse of options by backdating, yes.

Senator BINGAMAN. Is there anything more that you recommend that Congress do to try to solve this problem? Is there any change in statute that is required in order for us to be sure that this backdating problem is not there? I mean, anything in the reporting that people need to do to the IRS?

I was particularly struck by this response, Mr. Everson, that you gave to Senator Kerry earlier in August, where you said, "to my knowledge we were not aware of, nor had found in income tax returns, any indication of options backdating prior to the media reports that backdating had likely occurred." So is there anything that we should be doing to increase reporting requirements?

Commissioner EVERSON. I guess, sir, what I would say is, it does raise a question. The well-paid corporate executive fills out the same forms that the simple farmer does in Iowa. So the question is, if people want more reporting, more reporting could potentially surface some additional issues. This is not something we would see on the face of the tax return, though, or did see.

Senator BINGAMAN. Did you have any comment on this, Ms. Thomsen, if there is anything else that would be an appropriate action by Congress?

Ms. THOMSEN. I think at this point, given the new compensation rules that the SEC has just enacted, we are quite hopeful that that will also truly reduce the opportunity. We have not seen those in effect yet, so at this point I think it may be premature.

But I think the combination of the change in the accounting rules, the Sarbanes-Oxley reforms, as well as the new executive compensation disclosure rules, are going to go a long way in this arena to clear out some of these abuses.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Please do not use the word “simple” in front of a farmer. [Laughter.]

Commissioner EVERSON. My apologies, sir.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Everson, picking up on your last point, I do not think people want more dumb bureaucracy and more reporting.

Commissioner EVERSON. I agree.

Senator WYDEN. But I think they do want an end to the double standard. I think there is a sense now that the people at the top can manipulate the system, including stock options, and get a windfall, while the gal, say, in the secretary pool with a modest income does not get a fair share of the pie.

What I want to ask you about picks up on this question of what I think is a woefully inadequate law, what is called 162(m), with respect to the unfair, unwarranted compensation. But what are the options for strengthening that, in your view, so as to get at this double standard question?

Commissioner EVERSON. I think Senator, that you are raising a lot of policy questions that I would——

Senator WYDEN. I asked you for the options for strengthening 162(m). Not what you are even in favor of, but what are the options?

Commissioner EVERSON. I have not thought too much about what the options are. I will reflect on it with my colleagues from Treasury and we will get back to you. I would simply make the observation that, right now, as I indicated, because the standards are reasonably simple—as Senator Bingaman has already indicated—people will very closely study them and comply with them. I do not think it is having the impact that was anticipated. I would want to look at options before I would surface them for you.

Senator WYDEN. I would like you to do that, because I think some of these performance-based measures are really a joke. I mean, it is one thing to talk about something that really does reward a proven performance and track record that lifts all the boats, and another to set the bar so low with respect to performance-based goals as to make it, I think, pretty much a joke. That is what I think is troubling.

I would like to have you provide to the Chairman and to Senator Baucus, so we all can have it, your opinion with respect to the options on strengthening that.

Commissioner EVERSON. Yes. If I could go back to Senator Thomas's broader point, though, I think this is an area where the government ought to be careful in terms of writing things into the tax code here.

Senator WYDEN. Of course.

Commissioner EVERSON. These are decisions that are ultimately taken by the boards, and it would appear over these recent years, and certainly from what we see, if the boards want to pay somebody, they will pay them regardless of the tax consequences. I do not necessarily think you are going to fix this by changing the tax law, is what I would say, sir.

Senator WYDEN. I share your view and Senator Thomas's concern that we not have a caucus for price controls and the like.

Commissioner EVERSON. Yes.

Senator WYDEN. But I am interested particularly in ways to use disclosure, which I have thought was a pretty good disinfectant. Frankly I think, on Senator Thomas's point, there has been a lot of public backlash on this backdating kind of question. The companies' stocks go down in a hurry. So the bigger question is the executive compensation, in my view, dealing with the double standard.

Commissioner EVERSON. Well, as you know, sir, there is no disclosure in our area.

Senator WYDEN. Right.

Let me ask you a question that is specifically about disclosure, Ms. Thomsen. Another area that the public is very concerned about is "go-away" packages for executives. When they head out the door, it does not seem, for example, that some pretty deluxe health care benefits get disclosed.

Now, again, what a blue-collar person says coming to one of my town meetings, or Senator Thomas's town meetings, is they do not want some huge price control regime and the like, but they would like to know about that kind of information.

Do you think that these kinds of deluxe health care benefit packages for "go-away" executives ought to be disclosed?

Ms. THOMSEN. Under the new regime, the new rules, they will be. The new rule which was enacted by the Commission—again, this is an area where I really do need to defer to my colleagues in the Division of Corporation Finance, but I am sure they will correct me if I get it wrong.

Generally speaking, the new rule has a couple of components. One is a compensation discussion and analysis, where a company will discuss its compensation practices. There is also tabular disclosure of all forms of compensation to executives with a total number so that they are all comparable.

Included in that information will be health benefits, to the extent they are different than the rank and file, if you will. The deluxe benefits should be included in that and will be specifically broken out if they exceed certain levels or percentages.

Senator WYDEN. My time is up. I just know I saw something in the *Wall Street Journal* recently that raised some questions with respect to what actually is going to be disclosed. So could you get us a copy of that?

Ms. THOMSEN. I would be delighted to.

[The information appears in the appendix on p. 300.]

Senator WYDEN. I am going to get you this *Wall Street Journal* article that ran recently because it raised, in my view, some troubling questions about what will be disclosed.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

For the panel, we have been reading these stories about backdating and it always focuses upon the executive involved. It is hard to believe, though, that the executives did this all by themselves. To be honest, the idea that all executives at different companies came up with this idea at the same time stretches the imagination.

So, I go back to an experience that the Commissioner and I have had, that when we looked into tax shelters, we found a whole army

of enablers putting tax shelters together and, in fact, they were usually the ones coming up with the ideas.

Now, that certainly does not excuse the executives who were involved in those tax shelters, and today it would not excuse those involved in backdating. But what are you finding in regard to lawyers, accountants, and compensation consultants assisting, proposing, and signing off on the backdating of stock options?

Were there promoters? That is the basic question. If so, describe them, or if you know who some of them are, say who they are. To be blunt, what can we expect in terms of actions taken against those who aided and assisted in this effort, and sometimes in criminal activity?

Mr. MCNULTY. Mr. Chairman, in the two cases where we brought criminal charges, one of the two cases includes the general counsel of the company. My own sense is that the legal complexity here is not so great that inside counsel could very easily be able to work in collusion with the others to create the kind of false information necessary to deceive the compensation committee and to commit criminal acts.

In cases more broadly speaking, we would have no difficulty bringing cases against accountants and attorneys so long as we can meet the bar that is significantly high when it comes to criminal charges of the proper criminal intent. As I said, we have now charged general counsel, and we will always look at the actors in these schemes to know who meets that criminal intent standard.

The CHAIRMAN. I think you are saying that you do not see an outside industry then.

Mr. MCNULTY. Well, I think I see it as being less significant, at least in the cases we have charged, because of the small number of people who are involved in the particular fraud. Some of the other accounting scandals we have looked at in recent years are much different and much more complex and involve a lot of different players, outside and inside.

The CHAIRMAN. Do either of the other two of you have anything to add to that? [No response.] All right. Then I think I will just have one more question, then go to Senator Baucus.

Last November, the bipartisan Tax Reform Panel—in other words, Senators Mack and Breaux led this—recommended broad reforms to our Federal tax laws. Many of those reforms were aimed at expanding the tax base. One of the Tax Panel's recommendations was to cap the tax-free health insurance exclusion.

At the same time, there have been numerous press reports of lavish benefit packages and gold-plated health insurance coverage for senior executives that are not provided to rank-and-file employees. Most of these special benefits that are received by senior executives are not taxed under existing rules.

Ms. Thomsen, what do the SEC's new rules provide in terms of requiring disclosure of executive health and other benefits? Mr. Everson, I would like to have you comment on the Tax Reform Panel's recommendations and whether it would broaden the tax base and help level the tax playing field to some extent.

Ms. THOMSEN. Again, I hope I will be able to confirm this with my colleagues in the Division of Corporation Finance. The new rules generally provide that all forms of compensation be disclosed

so that, at the end of the day, top executives know the total package, however it is distributed to them through their corporation.

That means that, to the extent an executive is on a health plan, for example, on the same basis as every other employee, that is not disclosed. To the extent that there are special health benefits, they are part of the tabular disclosure. They will be disclosed.

And to the extent that, truly, the value is high enough, they will be specifically disclosed and that value would be keyed off either amounts or percentages of a like kind of benefit.

The CHAIRMAN. All right.

Mr. Everson?

Commissioner EVERSON. Sir, I would say that, this is a smaller issue in terms of dollar amount compared to the other compensation piece we are talking about today.

Backing up to the general premise, there are very few areas where the executives are really treated any differently than anybody else. Under the code, this is one of them. Obviously, from a principal's point of view, that would bring them more in conformity with them treatment of everybody else.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Commissioner Everson, on March 14th of this year you were speaking before the National Press Club. There you suggested that corporate executives receive "generous, but fixed, compensation for a specific contract period rather than compensation packages that include stock options."

In a sense, it sounds like you were suggesting a fixed compensation package at a certain level, say $5 million, but then that is it. If the company wants to pay more than that it certainly can, but it would not be a deductible expense.

Commissioner EVERSON. What I got to is not quite that, but it was a limitation on that. It is interesting you raised this, because I thought this was going to draw a lot of attention.

Senator BAUCUS. It is drawing a little.

Commissioner EVERSON. With the remarks on transparency and the (m)(3) and everything, that kind of overshadowed this.

Senator BAUCUS. Right.

Commissioner EVERSON. As we started to say to Senator Thomas, I am very worried about the impact on behaviors, on people—the CFOs, the general counsel, and the chair of the board—of all of the incentive compensation, because who is minding the cookie jar? Those are the people in the companies who I think are supposed to play it totally straight. And I am not suggesting that Congress step in here.

I think that as a matter of board policy, if you pay the CFO $5 million more than the CEO, and that is more than the CEO would typically get as a matter of straight compensation, and that is for a fixed term, then that guy is not going to fudge backdating stock options. His reputation is going to go down the tubes if he does that. He has no reason to do it.

I like the British system, where there are more non-executive chairs of companies because they take an independent look. I am

not suggesting that Congress step in on this. That was more of a general remark.

I think there is a difference, and we have lost track of this to some degree, between the work—I was trained as an accountant—the accountants do or the lawyers do and the work that the operators or the people who are trying to develop the product do.

I was, perhaps, trying to provoke a little bit of a discussion on that. It was before backdating, but I think the backdating sort of fuels this issue again.

Senator BAUCUS. But generally you tend to think that that is an idea that is worth pursuing, that is, a limit, a reasonable limit, high limit, maybe indexed, but nothing beyond that. Everything beyond that would not be deductible.

Commissioner EVERSON. It was not a deductibility question. I was not asking the government to step in. I was suggesting that maybe boards would be better served by knowing that the CFO has a 5-year contract and absolutely no incentive to pull his or her punches on questions like what we are talking about today. That is what I was getting at, not undeductibility, sir.

Senator BAUCUS. I understand. But, so how do we get there, if that is an admirable goal? If Congress does not——

Commissioner EVERSON. I am not sure. I keyed up the issue and nobody bit on it until now. So, we will see. [Laughter.]

Senator BAUCUS. But you are asking us not to bite. So who is going to bite?

Commissioner EVERSON. Ultimately, I think that these issues that the committee is getting at today will not be reformed by the Congress. They are going to have to be reformed by American business through a variety of solutions.

Senator BAUCUS. We all admire American business. We have done a great job in America over the years. But I think we are honest with ourselves. We also think that a lot of executives are going to kind of pad their pockets a little bit here and do something that they do not want fully known to the public, or to their shareholders, or to their employees.

It is a little bit of a club. A lot of them tend to talk to each other. They are in the same associations, the same clubs they belong to, and so on, and so forth. They say, well, Joe is getting this, so I should get it, too. There is a little of that going on.

It gets a little bit embarrassing, I think, even to some of them, but they do not want to disclose it all because it would be even more embarrassing. So I do not know for sure that all this is going to be self-policed. I just do not think that is going to happen.

And you yourself said, or as maybe Mr. McNulty said, often the intricacies are devised in a way that are hidden from the compensation committee so the compensation committee is not fully aware of what is going on here. So what are we going to do here?

Is this a problem that should not be addressed because it is not that big? That is a deeper public policy question. My personal view is, it is becoming a big problem. The gap is becoming too large. It is starting to undermine employee morale.

As backdating shows, the value of a lot of these companies' stock has fallen after the backdating, the in-the-money, has been ex-

posed. They are not doing the right thing for their companies or stockholders. They are not helping their employees.

If we are going to compete in the world effectively, and for our kids and grandkids, so they can have the same standard of living that we enjoy, it seems to me—and I do not want to overstate this point—that we are going to have to have a little more working together in America, employees as well as the executives.

Commissioner EVERSON. Let me be clear here, Senator, because I think it is an important issue. I think Sarbanes-Oxley and the things we have done on taxes, and a few of the other factors, the Corporate Fraud Task Force, all these have contributed to better controls and better actions on the part of companies.

I do think that this incredible compensation continues to require people sometimes to display heroic virtue rather than normal virtue in doing some of these jobs that they do, because the money is so much at stake in what they are looking at in terms of some of these decisions.

Senator BAUCUS. I think a lot of CEOs, frankly, are going to perform, because if they do not, they get booted out, irrespective of the compensation. That often happens, too, by the board of directors. I could name lots of examples recently where the board says, hey, it is not so much a compensation issue, it is that you are not performing for the company, so you are out of here.

So, compensation is helpful, but I do not know that performance-based compensation and all the loopholes that have evolved around it really helps the company do any better. I think it is kind of irrelevant, in my view.

The CHAIRMAN. Senator Bingaman?

Senator BINGAMAN. Let me just follow up on a line of questions that I raised a little bit earlier with Mr. Everson. Section 162(a) of the code says, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including, (1) a reasonable allowance for salaries and other compensation for personal services actually rendered."

Has the IRS ever considered challenging the deductibility of executive compensation, any executive's compensation, on the ground that it was not a reasonable allowance?

Commissioner EVERSON. I would want to go back and get an answer for you, Senator. I know that we have made some adjustments over recent years in the hundreds of millions of dollars on 162(m).

Senator BINGAMAN. But 162(m) is separate.

Commissioner EVERSON. I do not know whether that has been implied by the 162(a) section that you are referencing. I do not know the answer to that question, so I will go back and inquire about it. You are saying we have a choice as to what we can pursue. I do not know if we pursued that element of it.

Senator BINGAMAN. Yes. It strikes me that you have discretion under this statute, and perhaps you have more than discretion, you have direction under this statute, to ensure that if compensation is to be taken as a deduction, that it be reasonable.

Commissioner EVERSON. I guess I share a lot of the views of my colleague at the table here. I think it would be pretty tough to put,

as a general rule, our auditors in the shoes of making that decision in all but the most outrageous situations.

I mean, I think we would have a lot of litigation on just what that meant, so I am not terribly surprised if that standard is there, or if it has not been used as much as a lot of the sort of bright line tests that are out there.

Senator BINGAMAN. I agree. But I think there are some pretty extreme situations that we read about in the papers about compensation levels. I think the IRS would have a pretty strong case that some of these compensation levels are not reasonable and, therefore, if the company wants to compensate at that level they can certainly do so, but they will not be able to claim a deduction for it.

Commissioner EVERSON. Well, you have brought something to my attention that I was unaware of. I think this committee knows I am pretty pro-enforcement, so we will take a look at it.

Senator BINGAMAN. Very good. I would appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. Do you have more questions, Senator Baucus?

Senator BAUCUS. No, thank you.

The CHAIRMAN. All right. We thank the panel very much for your expert testimony.

We now hear from Prof. Lucian Bebchuk, professor of law, economics, and finance, and director of the Program on Corporate Governance at Harvard Law; Prof. Charles Elson, director of the Weinberg Center of Corporate Governance, University of Delaware; and Prof. Steven Balsam, professor of accounting, Fox School of Business and Management at Temple University. We thank each of you for being here.

I left out somebody, our first witness. I left out Ms. Nell Minow, editor and co-founder of The Corporate Library. I am sorry.

We will start with you, then the way you folks are seated is the way we will take you. Your entire testimony will be put in the record, as we have asked you to summarize. Thank you.

STATEMENT OF NELL MINOW, EDITOR, THE CORPORATE LIBRARY, PORTLAND, ME

Ms. MINOW. Thank you very much, Mr. Chairman and members of this committee. It is a great honor to be here. I am very, very pleased that the committee is looking into this vital area of concern.

Backdating and springloading of options are only the latest in a series of abuses and dodges that have escalated CEO pay to levels that Marie Antoinette would be embarrassed by.

If I may just mention an issue that was brought up by the questions before, I think one of the most distressing aspects of this backdating problem is how widespread it is. We have documented a lot of abuses of CEO pay over the years at The Corporate Library, and many of them fall into patterns where companies have consistent problems in a number of areas, accounting, et cetera, and problems with pay.

But this backdating thing, what is so distressing about it, is it has occurred in such a widespread fashion at many companies that

have had otherwise exemplary records, so we really have to ask ourselves what the systemic problem is.

I am particularly outraged by those who suggest, like the *Wall Street Journal* editorial page, that there is nothing wrong with this manipulation. Everything is wrong with it.

We believe in pay for performance; nobody is a more passionate capitalist than I am. But what this is, is pay for pulse. We are paying people for the fact that they are still breathing, and we do not even check to make sure that is the case.

I look at CEO pay like any other allocation of corporation resources. What is the return on investment of the money that is being paid out? As Senator Baucus had raised earlier, we have had a number of recent cases of extraordinary abuses of departure packages for CEOs who have performed very badly, et cetera, that really undermine the credibility of the capitalist system.

The entire justification for options is to align the interests of management with those of the shareholders. That is the great challenge of capitalism, exactly this issue. How do you keep the managers as committed to creating shareholder value as those who are providing the capital?

Well, options seem like a good answer, and that was the theory behind 162(m), but as you know, that well-intentioned provision has had unanticipated perverse consequences.

Options only work when executives make money based on how the company does, not on how the overall market does, and when the number of options is not so excessive that you get a mountain of payout for a molehill of performance, and all information relating to the options is promptly, clearly, accessibly, and comprehensively disclosed.

Backdating is just one of a series of abuses, like, for example, springloading, when you issue options knowing that you are about to make an announcement that is going to raise the price of the stock. So there is a tremendous amount of manipulation, not all of which is currently illegal.

I am appalled by the people who, as I said, suggest there is nothing wrong here. If it is not illegal, it is only because it is such an obvious outrage no one thought outlawing it was necessary.

One *Wall Street Journal* piece said that "it was a clever way to grant executives more compensation in the pre-expensing days without having to take a hit to the income statement."

Well, if that is true, why hide it? If it is a clever way, do we not want to all know about it? If the company is clever, does that not want to make us invest in it? Why would we want to give executives more compensation if it was not tied to performance? Executive compensation is an important element, not just in motivating executives, but also in informing investors about what the company's priorities are and how effective they are.

I documented, in the very first report issued by The Corporate Library in January of 2000, a problem with a company that was doing essentially the same thing as backdating, except that they were public about it.

They gave the CEO 2 million options at $10 a share below market. I said, gee, I think maybe the CEO thinks the stock is going to tank. People laughed at me, because it was the fastest-rising

stock in the history of the New York Stock Exchange, and became the fourth-largest bankruptcy in U.S. history, and that was Global Crossing.

I was happy that some of the earlier questions referred to the board of directors. I think obviously they are involved, whether they are knowledgeable or not. They should be knowledgeable about abuses like backdating, and if backdating occurs, they should be held responsible.

Other than that, I am happy to answer your questions. Thank you again for inviting me to appear.

The CHAIRMAN. Thank you, Ms. Minow.

[The prepared statement of Ms. Minow appears in the appendix.]

The CHAIRMAN. Prof. Bebchuk?

STATEMENT OF LUCIAN A. BEBCHUK, WILLIAM J. FRIEDMAN AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, ECONOMICS, AND FINANCE; AND DIRECTOR, PROGRAM ON CORPORATE GOVERNANCE, HARVARD LAW SCHOOL, CAMBRIDGE, MA

Prof. BEBCHUK. Chairman Grassley, Senator Baucus, and distinguished members of the committee, thank you very much for inviting me to be here today to testify.

I was asked by the staff to discuss executive retirement plans. As my written statement explains, these plans have provided top executives over the years with very large amounts of non-performance compensation that both fell below investors' radar screens and got legally around the limitations of section 162(m).

So, first, a few words about executive pensions. In a recent empirical study, Robert Jackson and I documented the large significance of executive pensions in the executive compensation landscape.

We looked at the pension plans of S&P 500 CEOs and we found, first, that the pension plans of the CEOs had a median value of $15 million per CEO. Second, the median plan was worth twice as much as the aggregate salary payments received during the CEO's whole service as CEO. Third, the value of the median pension plan comprised 34 percent of the total compensation, and that includes both equity and non-equity compensation that was paid during the service of the CEO.

When you look at pensions, at first glance the massive use of defined benefit pensions for executives might appear puzzling. That is because firms have been moving away from defined benefit plans for non-executive employees, and defined benefit structures actually look more valuable to non-executive employees who are less able, relative to top executives, to bear the investment risks that are associated with defined contribution plans.

So what explains the executive pension plans? One possible explanation is that non-performance compensation that was provided via pension plans, however large, has not been subject to the limits of 162(m). Our study showed that the amount of non-performance pay that escapes 162(m) in this way was quite large. Lack of disclosure was obviously another reason.

Let me now turn to say a few words about deferred compensation. The great majority—some surveys say 90 percent—of public

firms offer their top executives deferred compensation plans that are outside the framework of 401(k) accounts.

With those plans, the executive defers the receipt of compensation until retirement, and in the meantime enjoys tax-free investment returns. These tax savings come at the expense of the company, the taxpayers, and sometimes both of them.

Again, the question is, why do firms commonly offer non-qualified deferred compensation arrangements to executives, but rarely do so for non-executive employees? One reason is that those plans provide another legal way of getting around 162(m).

Any amount of non-performance compensation that is granted in a given year, no matter how large it is, escapes 162(m) if it is placed in a deferred compensation plan. On top of the original amount that was deferred, the gains to the executive from the tax-free accumulation of returns also escape 162(m).

I would like to note that past disclosure requirements allowed firms to provide very, very little information about deferred compensation plans. Indeed, the lack of disclosure has made it impossible for outsiders to form even ballpark estimates of the compensation that had been provided via deferred compensation plans.

In the next proxy season, the SEC's disclosure reform will force companies to disclose for the first time the amounts that are credited to executives in such plans, and public officials should be paying close attention to the figures that come out.

I would like to conclude by stressing the importance of strengthening shareholder rights. The motivation for the SEC's recent disclosure reform and for the adoption earlier of 162(m) came partly from recognizing that, without some push from the outside, both cannot be expected to make pay sufficiently tied to performance.

However, as long as shareholder rights are not strengthened as well, neither disclosure requirements nor tax penalties can, by themselves, address the problem. What needs to be done? Shareholders' power to remove directors must be turned from a fiction into a reality, and there are a number of ways that we can do that.

Furthermore, shareholders should have more power to influence the setting of company's governance arrangements. In the past, the role of shareholders has been limited to passing advisory resolutions that boards often elect not to follow.

In the end, executive pay arrangements reflect the quality of the government processes that produced them, and strengthening the rights of shareholders is essential for making boards more accountable and attentive to shareholders, and in this way enhancing shareholder value.

Thank you.

The CHAIRMAN. Thank you very much, Prof. Bebchuk.

[The prepared statement of Prof. Bebchuk appears in the appendix.]

The CHAIRMAN. Prof. Elson?

STATEMENT OF CHARLES M. ELSON, EDGAR S. WOOLARD, JR. CHAIR, JOHN L. WEINBERG CENTER FOR CORPORATE GOVERNANCE, LERNER COLLEGE OF BUSINESS AND ECONOMICS, UNIVERSITY OF DELAWARE, NEWARK, DE

Prof. ELSON. Thank you, Chairman Grassley, Senator Baucus, and distinguished members of the committee. I am delighted to be here to speak to you today to testify both as an academic and a public company director.

The problem with backdating is pretty obvious. Number one, it is sort of like betting on a horse race after the race is over with; it offends our sense of fairness. But number two, it defeats the whole point of the option and is, I think, devastating to the notion of option-based compensation.

Frankly, as an issue, it is over. Due to the Sarbanes-Oxley director/officer option reporting requirement, it is no longer going to happen. But, more importantly, the cause of the problem remains and I think has led to other current problems in the compensation area affecting the health of the corporation, shareholder value, and shareholder confidence in our public companies.

There is an overt compensation problem in corporate America. It is caused by, number one, over-reaching executives, and number two, compliant management-dominated boards who fail either to negotiate or exercise appropriate oversight over executive compensation and the compensation process.

So what is the solution? It is actually pretty straightforward. You have to encourage better and greater board negotiation and oversight over management through change in board composition, period.

Well, what will that be? Number one, independence on the part of the outside directors, financial and quasi-financial independence from management to promote objectivity, and number two, equity ownership, stock ownership in the company by the directors. That aligns the boards' and shareholders' interests and incents the board to exercise the objectivity that the independence brings. I think those two facts are critical.

There is some good empirical evidence out there on the link between equity ownership by directors and a reasoned pay package. I think we see, frankly, much the same problems coming up vis-à-vis ineffective board composition in the nonprofit sector as well. I know it is something that this committee has some interest in.

But I think changes are in the works to encourage board independence and stock ownership. Sarbanes-Oxley, the New York Stock Exchange, the NASDAQ listing requirements, investor pressure, and State law actions, particularly on the part of the Delaware judiciary, have led to greater independence on the part of boards and greater ownership.

But what about disclosure as a solution, the current SEC proposals? Well, on the Federal level, the recent SEC changes in executive compensation disclosure requirements, I think, are helpful—very helpful—but ultimately they are not the solution to the problem because it was board composition that created the problem, not lack of disclosure.

What about taxation? I know you were talking about this today. Taxation-based changes are not the solution, in my view, at all. In

fact, I wrote an article about it in 1993 when this first came up, 162(m), and I submitted it for the record.

The problem is, 162(m) has just not been effective. It can either be lawyered around by a compliant board, or the company, frankly, simply chooses just to not take the deduction at all. The problem is, the shareholders lose on both accounts, whether it is over-compensation or, in fact, whether they choose not to take the deduction.

The key here is incentivizing the directors to negotiate with management as owners and not simply the ancillaries of corporate management. But this actually is a matter of State law and the marketplace, unfortunately, rather than a Federal issue.

But is there anything that can be done on the Federal level here? I think there are a couple of things. Number one, heightened disclosure in two big areas. One, director independence, particularly quasi-financial linkages between the directors and management of the company, such as charitable donations by the company directed by management to director charities.

Second, the issue of compensation consultants who play a critical role in designing these compensation plans. Compensation consultants have independence issues. I think it has to be disclosed in the proxy, any work that the compensation consultant does, not simply for the board, but other work for the company itself, because I think that does affect the advice that they are giving the board itself. That has not been disclosed. It was proposed. There were some good comment letters to the SEC, but they did not go forward with it, and I think that needs to be worked on.

Finally, I think State and Federal rule changes that encourage director stock ownership and independence are quite helpful. I also think that State and Federal rule changes that encourage greater shareholder involvement in the director selection process, such as a proposed expense reimbursement scheme for short-slate director contests, I think, are quite helpful as well.

But in the end, it is going to be the marketplace that is going to encourage the change in director composition, and ultimately, frankly, it is the director itself that has to fix the problem in this controversy and, frankly, restore shareholder confidence in our system of compensation.

Thank you.

The CHAIRMAN. Thank you, Prof. Elson.

[The prepared statement of Prof. Elson appears in the appendix.]

Prof. Balsam?

STATEMENT OF STEVEN BALSAM, PROFESSOR OF ACCOUNTING, THE FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA

Prof. BALSAM. Mr. Chairman, I would like to thank you for inviting me to appear before your committee today. It is a pleasure to have this opportunity to discuss with you the effectiveness of section 162(m).

Based on my own research, the research of others, and anecdotal reports, section 162(m) has, at best, been only marginally effective in reducing executive pay and/or tying pay to performance. It is

clear that executive compensation has gone up dramatically since the passage of 162(m).

Why has the tax code failed to restrain the growth in executive pay? Section 162(m) capped the deduction for executive compensation at $1 million per executive, providing an exception for performance-based compensation. This gave the corporation three choices.

The first choice was to limit executive pay to the $1 million cap. There is limited evidence that this has occurred. From my own research I found that, in 2005, more than 250 corporations paid their CEOs or other executives at least $1 million in salary, *i.e.,* non-performance-based compensation.

A second choice is for corporations to restructure their compensation packages to fit the criteria of section 162(m) and the performance-based exception. In fact, we have observed companies doing that.

David Ryan, one of my colleagues at Temple University, and I have done research and have shown that stock options have increased since 162(m) and have increased in those firms and executives that are affected by 162(m). So, 162(m) has had an effect of encouraging stock option compensation.

However, one of the problems is that economic theory suggests that, when you add risk to the executive compensation package, you also increase the reservation price of the executive. In fact, research has shown that compensation has gone up since 162(m).

The shift to performance-based compensation also accentuates the incentives for executives to manage earnings, as missing targets adversely affects both bonus plan pay-outs and stock options, which are tied to share prices.

The third choice is to forfeit deductions. In research conducted after the passage of 162(m), David Ryan and I noted that many firms that qualified their performance plans to meet the performance-based exception explicitly reserved the right to pay non-deductible compensation if they determined it was in the best interests of the corporation.

In research conducted using data from the mid-1990s, Jennifer Yin and I found that at least 40 percent of corporations admitted to forfeiting deductions because of section 162(m).

My prediction is that that percentage is much higher today, especially as firms switch from stock option compensation, which is deductible, to restricted stock, now that Statement of Financial Accounting Standards no. 123R requires the expensing of stock options.

I should note that the choice to forfeit deductions is not limited to section 162(m). Many corporations are willing to not only forgo deductions for excess parachute payments, as defined under section 280(g), but are also grossing up the executives' compensation to pay the excise taxes levied on the executive.

My recommendations to strengthen and fine-tune section 162(m):

First of all, provide increased disclosure of details in plans submitted to shareholders. To qualify as performance-based under section 162(m), corporations have to obtain shareholder approval of their bonus plans.

While ostensibly the plans presented to shareholders disclose their material terms, in reality they do not. That is, they lack details about actual plan parameters, targets, thresholds, et cetera.

Disclosure of these details would allow shareholders to evaluate if indeed the thresholds, targets, et cetera were adequate, in other words, if the bar is not being set too low.

A second proposal or recommendation is that we require stock options be market adjusted so that the executive will only benefit if the firm's share price out-performs the market index.

Under section 162(m), stock options were, de facto, assumed to be performance-based as long as they were not in-the-money at the time of grant and a plan was approved by shareholders. In reality, stock options are pay for performance with a threshold of zero.

That is, any increase in a firm's stock price increases the value of an executive's stock options, even if the firm under-performs the market, its industry index, or even risk-free investment such as treasury securities.

My final recommendation is to require numerical disclosures of actual deductions forfeited and additional taxes paid. Currently, many firms discuss forfeiture of deductions in their proxy statements, but are exceedingly vague.

For example, Wal-Mart's most recent proxy statement said "a significant portion of the company's executive compensation satisfies the requirements for deductibility under Internal Revenue code section 162(m)."

Other companies, for example, Exxon-Mobil and General Motors, while paying their top executives' salary far in excess of $1 million, give no indication of whether they forfeit deductions or not.

Disclosure of details would allow shareholders to evaluate if amounts are material and put the onus on directors to justify those forfeitures, which I believe would make them less likely to do so.

In closing, I would like to thank the committee for the opportunity to testify today, and look forward to answering any questions you may have.

[The prepared statement of Prof. Balsam appears in the appendix.]

The CHAIRMAN. Yes. My first question deals a little bit with what you just spoke about, Prof. Balsam, but I want other panelists to address it. So let me state it as I was going to state it for everybody.

There seems to me to be wide agreement that 162(m) has failed to achieve its policy goals in regard to high corporate salaries. So the question is, now what do we do? I am going to suggest four options, but if you have other options, I would be willing to consider them.

These options vary with reality. We could repeal it, but that is very CBO-expensive. We could tighten up the performance goals, but you know how the English language is. That is tough to do and get done what you want done, or this policy would be working in the first place.

Three, we could just eliminate the performance goals altogether and just state that pay and benefits over $1 million are not deductible. There are many examples in the tax code, like home mortgage deductions, where that is done. But then you get into the policy of

Congress setting corporate executive pay, and that is not very wise policy, or you get the inconsistency of some movie that is bombing and not hitting the movie stars the same way, or the baseball players that are batting 200 and still getting a good salary.

So to the rest of you, or even Prof. Balsam if he wants to go further, those are four ideas I see. I just want your reaction to them, or anything else you have to suggest.

Ms. Minow?

Ms. MINOW. Thank you, Mr. Chairman. I am glad you mentioned movie stars and baseball players, because of the people in the stratosphere of pay, that is basically it. We have athletes, movie stars, rock stars, investment bankers, and CEOs. The other four are the ultimate pay for performance. Believe me, Tom Cruise's pay package has just gone down significantly because of his poor performance, and it will go back up; look at John Travolta over the years.

So the reason is, as Prof. Elson has said, that CEOs are the only people who get to decide who picks their pay. They get to decide who is on their board. Nobody understands better than you gentlemen what the term "election" means, but corporate America does not really seem to understand the definition of the term, because management nominates the candidates and counts the votes, and no one runs against them. So, it is a very closed system.

So if it were up to me, let me just make "my wish come true" proposal first, then I will make a more realistic one. My "make my wish come true" proposal would be to say that no executive compensation would be deductible unless the company has adopted a majority vote provision, so that if shareholders do not like what they see, they can change the board of directors. That will make the board of directors more responsive to shareholders.

I realize that, under principles of federalism, corporate governance has been left to the States since 1789, and you are not likely to change that in this committee.

So, therefore, my more realistic proposal would be something like, that stock option plans would only be deductible to the extent that they are tied to specific company performance and not the overall market as a whole. Therefore, we would only capture plans that are indexed to the market or to the competitors, or premium-priced options. I think that would really make pay for performance.

The CHAIRMAN. Prof. Bebchuk?

Prof. BEBCHUK. There are two considerations that should guide whatever the committee comes out with on this. One is that it would be important to have a level playing field among different forms of compensation so that companies do not make distorted choices. That has been a big problem in the past.

Second is that the very problems that led originally to the adoption of 162(m)—and the very problems being, one, we do not have arm's length contracting, and two, that pay is only weakly linked to performance—are still very much there. So one thing we cannot do is declare victory in this draw.

The CHAIRMAN. Prof. Elson?

Prof. ELSON. Actually, I kind of like option one, which was just getting out of 162(m) altogether, getting out of the sort of tax regulation, if you will, of executive compensation, because I think it

does not get at the problem. In the end, the losers here are the shareholders. They are the ones we are really concerned about in this issue.

The whole point of it was to force reasoned compensation packages vis-à-vis shareholder wealth. It did not happen. I think using tax policy in this area is not very helpful and, in the end, is quite harmful, I think, to the investors.

So I think we go ahead and think about repealing it, sunsetting it, and then think about other means to strengthen negotiating on the part of the board so that in the end you create real shareholder value and, more importantly, greater corporate profitability, which in the end brings greater tax revenues, much more so than this deduction.

The CHAIRMAN. And Prof. Balsam, you probably do not have anything to add. You had a long list.

Prof. BALSAM. Well, I always have things to add. [Laughter.] I would just like to follow up on what Prof. Elson said, that depending on the points that you pursued, the shareholders could be the real losers.

For example, limiting deductibility over $1 million and forgetting about a performance-based exception. Companies are going to pay those amounts and the shareholders are going to pay. So that is one thing to be careful about.

What is your goal? Is it to reduce executive compensation? Limiting deductions will not do it. Is it to make compensation more performance-based? Limiting deductions will not do that, either. So the best potential solution there is your second solution, which was to tighten performance goals, combined with more disclosure of those goals. Thank you.

The CHAIRMAN. Thank you.

Senator Baucus?

Senator BAUCUS. Yes. Let me play Devil's Advocate here and ask any of you, why in the world should Congress care about what companies pay their executives? Why should it matter? Anybody? Why should Congress get involved in this issue, as long as the compensation is fully disclosed?

Ms. MINOW. Congress already is involved. The question is whether they should continue to be involved, or how they should continue to be involved.

Senator BAUCUS. Why not repeal this provision, the 162(m), for example?

Ms. MINOW. Congress will continue to be involved. I think it was Senator Bingaman who quoted the overall tax provision about the reasonableness of salary expenses. In other words, Congress is involved in this in many, many ways. You could unplug this one provision and Congress would still be involved, it would just be changing their involvement.

Senator BAUCUS. Why should Congress care? Anybody?

Prof. ELSON. You should care. You should care. The problem is, it really has undermined, in my view, shareholder confidence in the system. If shareholders are not confident, they are not going to invest, and then we really do have a larger problem. So, yes, you should be concerned about it.

The question is, what do you do about it? I think 162(m) was well-intentioned at the time, but I do not think it has carried out its results. I think you have to go in a different direction.

Senator BAUCUS. All right. Say that is repealed, as you suggest. What do we do, if anything?

Prof. ELSON. I think that you create rules that encourage better disclosure, full disclosure of compensation, and particularly director conflicts of interest that really have not been brought out in the proxies as they should.

The SEC has made some good inroads in that area, but I think we need to go further. I think that conflicts of interest vis-à-vis the compensation consultants is an easy fix, and I think we should move in that direction.

I think the key, though, is going to be in State law, liberalizing a bit how directors are elected. The majority voting provision was a good idea, I think, some sort of scheme where you reimburse director candidates for elections. It is like we have in campaign financing in this country—to aid more vibrant shareholder elections to create greater accountability.

Prof. BEBCHUK. If I may add, I think we should care a great deal about this, because it is an important economic issue. It is not just symbolic. It has an impact on shareholders in two ways.

First of all, the numbers are quite large. In a study I did, we found that aggregate top five compensation over a 10-year period added up to about $350 billion, and that is before you include gains from pensions and deferred compensation arrangements.

Second, the cost to shareholders from flawed compensation arrangements is not just excess pay, it is the poor incentives that are provided by such arrangements. So, you have to add to that.

Last, executive compensation is not something that we can just say, let us leave it to the system to work things out, because some of the impediments right now that prevent the systems from working are as a result of legal rules.

So shareholders right now are impeded by Federal proxy rules from putting candidates on the corporate ballot, and sometimes for putting buy-out amendments on the corporate ballot.

Senator BAUCUS. So are you saying that the SEC should relax those? More disclosure, for example? The corporate bylaws. Is that State law or is that something the SEC can address?

Prof. BEBCHUK. There are important things here that are a result of Federal law, so the SEC could allow shareholders to put candidates on the ballot, which is something the SEC considered 2 years ago, but they withdrew the proposed ruling.

Senator BAUCUS. So what is the proper role of the Finance Committee in this area? One of you suggested repeal of the most relevant statute. Does the Finance Committee have a role? Should the tax code be used to address excessive executive compensation or should that be left, again, to States, to the SEC, and so forth?

Ms. MINOW. I think it is generally not a tax issue. I think that the failure of the very well-intentioned 162(m) shows how treacherous that territory is. It is always, always, always, as you know, tempting to bring the tax power in to address a number of policy issues, but I think it has not been effective here and is unlikely to be effective in the future.

Senator BAUCUS. All right.

Do any of the other three of you disagree with that statement? Go ahead.

Prof. ELSON. I agree with Nell.

Senator BAUCUS. One agrees. The other two?

Prof. BALSAM. I basically agree. I mean, as was pointed out, there is, without section 162(m), the reasonableness criteria, that really outrageous cases could be taken up by the IRS.

Traditionally, at least the way I was taught and have taught it, the IRS does not challenge compensation in widely held companies, and it is a provision that is just used for closely held companies.

Senator BAUCUS. And that is for tax purposes? Because they are usually trying to get around another provision in the code in closely held companies.

Prof. BALSAM. Correct.

Senator BAUCUS. All right.

Prof. ELSON. But in the end, if they disallow the deduction, the losers are the shareholders, and they were the whole group you were supposed to protect with this provision. That is the problem. It is the problem of using other people's money. When boards play with other people's money, not their own, that is the issue. That is, I think, what we are seeing.

Senator BAUCUS. Doctor?

Prof. BEBCHUK. I think that we use tax incentives for many things. The problem that we had in the past was the difficulty of defining when you have pay sufficiently sensitive to performance, and that is a very tricky exercise.

But there is another way of providing incentives, and I talked about it: providing incentives to governance structures. That is something that is more amenable to a clear definition in which taxpayer subsidies can be provided.

Senator BAUCUS. Well, this has all been very interesting, and hopefully helpful. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. All right. I had a couple of other questions I wanted to ask.

The first question would be for anybody on the panel who would like to tackle it. In recent years we have heard through numerous press reports and court cases of lavish benefit packages for senior executives that are not provided to rank-and-file employees, even when we have these non-discrimination rules that were supposed to prevent the inequitable treatment.

Most of these special benefits that are received by executives are not taxed. Moreover, it is hard for shareholders and investors to find out exactly what kind of executive-only benefits are being paid. What should we be thinking about in terms of possible changes to disclosure requirements or tax rules governing these types of benefits?

Ms. MINOW. Mr. Chairman, I am really delighted that you raised this as an issue, because it is a particular problem for me. I know that this committee has already made some progress on this, but I particularly am concerned about the use of corporate jets for personal travel.

That is a good example, where executives are allowed to reimburse for the lowest commercial fare and they do not declare the difference as income. I think that is terrible.

So, obviously, what I would like to see is that any benefit that the executive gets should be considered income and that any disclosure that he must make about income for the purposes of his tax payments should be required also for the purposes of the SEC filing so that we get a full picture of what the pay includes.

Prof. BEBCHUK. As I explained in my written statement and a little bit here earlier today, executives can make very substantial gains from tax savings which often come at the company's expense when they have deferred compensation plans.

We do not have, and we should have, information about both the benefits to the executives from those tax gains, as well as the cost to the company. Those are figures that would be very important to have disclosed in a clear way.

Senator BAUCUS. I am sorry. You mean, the SEC has to ask for that information? Who would ask for that information?

Prof. BEBCHUK. The SEC could ask for this. In the recent reform, which I very much applaud, at some point they were considering adding increases in deferred compensation balances in the aggregate compensation tables, but in the end they did not do that.

So they just are going to have information about the balances out there, but it is not going to get into, kind of, the salient total compensation figures. It would be helpful if companies were required to put a dollar figure on their own tax costs from subsidizing the taxpayer returns and on the executives' gains from this taxpayer accumulation.

Senator BAUCUS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Anybody else?

Prof. ELSON. I concur with Nell. I mean, I think greater transparency is critical disclosure of these benefits. I particularly agree on the corporate aircraft. I mean, the idea of an executive using a corporate aircraft for personal purposes is sort of like taking the company car to Disney World: you do not do it. A board that would permit it, I think, is problematic.

Senator BAUCUS. It happens a lot.

Ms. MINOW. All the time.

Prof. ELSON. It does. It is wrong. It is a misuse of shareholder funds, shareholder assets. The asset was not bought for personal use of the executive. The executive gets paid enough. Let them charter a plane if they really want it. They get paid plenty. But to use it on the company's time, shareholders' time, I think is inappropriate. A taxation change to change how, in fact, the benefit is calculated, I think, is helpful. Again, disclosure. It goes back to the board of directors. A board that would permit it is the problem.

Prof. BALSAM. I would like to actually address two issues here. One is disclosure, or the current lack of disclosure. Corporate aircraft, souped up health plans, they all fall under the category of prerequisites.

Currently, they are disclosed if the total is greater than $50,000 or as an "other" compensation. Individual items have to be disclosed if they are more than 25 percent of that total. Unfortunately, a lot of the little items fall under that radar.

So if the executive is getting extra medical benefits, extra life insurance, it usually does not catch up to that 25-percent threshold and is not disclosed separately, so we actually have very little data on what is being done. So, improved disclosure would be nice.

The other issue is the tax code. Mr. Chairman, you did mention in your opening question that, under the tax code, most provisions need to be non-discriminatory in order to qualify for favorable treatment. Yet, many of these executive benefits are both discriminatory, yet treated favorably for tax purposes.

Again, to refer to the executive health plans, they are deductible by the corporation and they may be excluded by the executive from taxable income, even though they are not offered to other employees. That is a loophole in the tax code that I believe your committee could address.

The CHAIRMAN. On another question, for any of you—and maybe everything that corporations can think of to pay people in ways that are not taxed has been known—but if there are any new things out there in executive compensation that should give us pause or should be considered by Congress, do you want to mention any of those, if you know about them?

Ms. MINOW. Oh, boy. Yes. Absolutely. Thank you, Mr. Chairman. I would really like to mention the fact that I pay my taxes, you pay your taxes. I do not think that CEOs should have the shareholders paying their taxes. That is a very, very popular provision these days. We call it the Leona Helmsley provision. I think that is an outrage.

The CHAIRMAN. All right. Anybody else?

[No response.]

The CHAIRMAN. Everything has been mentioned then that can be mentioned? All right.

We have a vote. I have one other question that I am going to submit to you for answer in writing. Besides thanking you today, I would like to kind of sum up with these thoughts that I have.

First of all, I think we have had a very informative hearing. This is oversight of the tax code, and we need to do more of that. I think it is clear that we have learned that 162(m) is broken.

The 1993 law—by the way, part of a bill that I did not support or vote for—was meant by its advocates to deny deductions when there was a great deviation between what executives got paid and what people further down the ladder got paid.

I do not have any doubt it was well-intentioned, but it really has not worked. Companies have found ways to get around it. Quite frankly, it has more holes in it than Swiss cheese has in it. Of course, we want to know what went wrong. We want to consider whether it makes sense to make changes. This panel has discussed that very well.

Eliminating the deduction for performance-based pay entirely, or at least tightening up the eligibility for it, are possibilities that I think members of the Finance Committee will want to consider, based on the comments that I have heard at this hearing. Today's hearing has been helpful in sorting through the pros and cons of that issue.

It is challenging for Congress to stay one step ahead of some of the companies that try to exploit tax loopholes faster than we can

close them. I think we have done a good job lately of closing some of them, but we still have a long ways to go.

I will be reviewing today's record, submitted materials, and questions for the record on what to consider as our next step, and I will be working with Senator Baucus on that.

If we are going to keep this code section, I think a question that needs to be answered is whether it is equitable to treat high-salary top executives at publicly-traded companies differently from high-salaried other individuals.

On another note, I wonder if, sometimes in legislating, we set ourselves up for disappointment. Sometimes, it is clear what we are driving at. Sometimes, we are reacting. When we are reacting, it may not be clear where we're heading. I think that may be the case with section 162(m).

Back in 1993, when section 162(m) was being processed by this committee, Senator John Chafee raised concerns about the provision's design. Cetainly, Senator Chafee was no defender of high-paid CEOs or other corporate titans. He did raise the question about what we're trying to get at with a limit on deductible compensation.

Senator Chafee raised the example of athletes. Senator Chafee cited examples of Boston area athletes who were paid under high-end guaranteed contracts and then didn't perform.

Senator Chafee cited Glenn David, a baseball player, and Robert Parish, a Boston Celtic. Both athletes were highly paid, but not subject to the rule. By the way, back in 1993, Senator Chafee referred to Michael Jordan, as a performance pay example. I guess that example was proven right over time.

We have also heard today troubling testimony about a wide disparity of treatment between regular workers and top executives when it comes to deferred compensation. The President's Panel on Tax Reform touched on some of these same issues.

I think that that panel, hopefully with the President making some recommendations, will get some attention next year. Workers who make their living paycheck to paycheck have a right to expect fair tax treatment; you folks have made that very clear.

Finally, I fear that we have a new set of problems behind this backdating: all the individuals who support the illegal activity. This includes board members, attorneys, accountants, and outside consultants.

In response to this hearing, I intend to write to several major corporations that have been involved in backdating of stock options.

I want these corporations to provide me with board minutes regarding the decision to backdate, as well as any and all materials from advisors, including attorneys, accountants, and compensation consultants who assisted in this effort. We need to understand and bring enforcement action against all the actors.

Thank you all very much for your participation. Very good testimony.

[Whereupon, at 12:09 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of Steven Balsam
Professor of Accounting, Temple University, Fox School of Business

Effectiveness of Section 162(m) in controlling executive pay

Mr. Chairman I would like to thank you for inviting me to appear before your Committee today. It is a pleasure to have this opportunity to discuss the effectiveness of Section 162(m). Before I begin I would like to point out that my discussion today revolves around fine tuning section 162(m) to make it more effective, and not illegal activities such as option backdating and deductions that may have been inappropriately taken under section 162(m).

I'd also like to state up front that, based upon my own research, the research of others, and anecdotal reports, that section 162(m) has been at best, only marginally effective in limiting executive pay or in making it more responsive to performance. It is clear that executive compensation has gone up dramatically since the passage of Section 162(m). [Please refer to Table 1 on page 4 at the end of the text] However this increase has not been limited to executives of publicly held corporations, but applies to other highly sought after individuals. For example a fellow by the name of Howard Stern was reported by Forbes magazine to have earned $302 million in 2005.

Why has the tax code failed to restrain the growth in executive compensation?

In an attempt to limit executive compensation, Section 162(m), as well as Section 280(g) which defines excess parachute payments, cap the amount of payments that are deductible, leaving a corporation with three choices.

The first choice would be to cap payments at the threshold set by the code provision. There is very limited evidence that this has occurred. For example in 2005 my research indicates that at least 250 corporations paid one or more executives salary, i.e., non performance-based compensation, in excess of $1 million, 988 paid one or more executives total cash compensation in excess of $1 million, and 1,335 paid one or more executives total compensation in excess of $1 million.

The second choice would be to structure payments to maximize deductions. Corporations may do this by shifting compensation from non performance-based salary to performance-based bonuses and stock options and/or defer compensation to periods in which the deductions would be allowed. In our research, David Ryan and I have found evidence that firms have increased stock option grants in response to section 162(m). Economic theory, as well

as well as extant research, suggests this increase in riskiness of compensation will be accompanied by an increase in expected compensation – counter to the intent of the provision. The shift to more performance-based compensation also accentuates the incentives for executives to manage earnings as missing targets adversely affects bonus compensation and the value of stock options.

The third choice is to forfeit deductions. In research conducted after the passage of section 162(m), David Ryan and I noted that many firms that "qualified" their bonus plans to meet the performance based exception, added verbiage in their proxy statements saying they reserved the right to pay non deductible compensation if they determined it was in the best interest of the firm. In research conducted using data from the mid-1990's, Jennifer Yin and I found that nearly 40 percent of corporations admitted to forfeiting deductions because of section 162(m). My prediction is that this percentage is much higher today. Especially as corporations shift from stock options to restricted stock in the wake of Statement of Financial Accounting Standards 123R which required the expensing of stock options.

I should note that the choice to forfeit deductions is not limited to section 162(m). From my reading of executive compensation contracts and disclosures, I have found many corporations are willing to not only forgo deductions for excess parachute payments as defined under section 280(g), but are also grossing up the executive's compensation to pay for the excise taxes levied on the executive.

Recommendations

1. Provide increased disclosure of details in plans submitted for shareholder approval

To qualify as performance based under Section 162(m), corporations have to obtain shareholder approval of their bonus plans. While ostensibly the plans presented to shareholders have to disclose their material terms, in reality they do not. That is, they lack specificity with regard to actual plan parameters, targets, thresholds, etc. (Please see excerpt from Tyco International 2004 Stock and Incentive Plan on page 5). Disclosure of these details would allow shareholders to evaluate if thresholds for performance are adequate. In other words, allow them to determine if pay was not for performance, but for adequate performance. I believe requiring this disclosure will increase the link between pay and performance as directors and executives would be less likely to set low standards. And shareholders, now in possession of the material facts, would be less likely to approve those plans with low performance standards.

2. Require that options be market adjusted, so that the executive only benefits if the firm's share price outperforms the market index.

Under Section 162(m) stock options were de facto assumed to be performance-based, as long as they were not in the money at the time of grant, and a plan was approved by shareholders. In reality stock options are pay for performance with a threshold of 0! That is, any increase in a firm's stock price increases the value of an executive's stock options even if the firm underperforms the market, its industry index, or even risk free investments such as treasury securities. (See example on page 6). Even something as seemingly innocuous as frequent grants ensure that executives benefit from the fluctuating share prices without shareholders seeing any increase in long term value. And this is without even manipulating the system via things like backdating and spring-loading.

3. Require numerical disclosure of actual deductions forfeited and additional taxes paid.

Currently firms discuss forfeiture of deductions in their proxy statements but are exceedingly vague. For example, Wal Mart's most recent proxy statement states "***A significant portion*** of the Company's executive compensation satisfies the requirements for deductibility under Internal Revenue Code Section 162(m)." Other companies, for example Exxon-Mobil and General Motors, while paying their top executive(s) salary far in excess of $1 million dollars, give no indication of whether they forfeit deductions or not.

Disclosure of details would allow shareholders to evaluate if amounts are material and put the onus on directors to justify – which I believe would make them less likely to forfeit deductions.

In closing I would like to thank the committee for the opportunity to testify today and look forward to answering any questions you may have.

Table 1
Average CEO Compensation 1994-2005

Year	Salary	Cash Compensation	Total Compensation including present value of option grants	Total Compensation including profits from option exercise
1994	$516,420	$961,610	$2,165,710	$1,644,190
1995	$528,130	$1,019,400	$2,255,160	$1,948,280
1996	$545,860	$1,126,740	$3,085,240	$2,608,580
1997	$558,570	$1,167,820	$3,739,950	$3,421,990
1998	$578,710	$1,181,060	$3,886,910	$4,139,530
1999	$581,250	$1,263,090	$5,433,460	$4,425,240
2000	$604,360	$1,353,080	$6,798,500	$5,634,030
2001	$640,640	$1,308,120	$6,363,230	$5,042,440
2002	$657,880	$1,357,360	$4,958,510	$3,794,220
2003	$685,180	$1,557,670	$4,625,960	$4,412,310
2004	$707,810	$1,749,060	$5,159,520	$5,911,390
2005	$745,960	$1,946,380	$5,578,290	$7,127,200

Table 2
Use of Restricted Stock 1994-2005

Year	Number of Corporations Granting Restricted Stock	Percentage of Executive Compensation	Dollar amount of restricted Stock Granted
1994	436	4%	$648,972,450
1995	499	5%	$754,126,950
1996	534	5%	$1,052,007,170
1997	557	5%	$1,430,845,500
1998	592	7%	$1,672,348,910
1999	584	6%	$2,945,467,230
2000	574	6%	$2,269,551,410
2001	576	6%	$2,040,594,590
2002	615	11%	$2,320,166,890
2003	721	9%	$2,877,404,900
2004	854	12%	$3,570,085,930
2005	839	14%	$3,698,090,670

Example 1: Lack of disclosure of performance measures - Tyco 2004 stock and Incentive plan (Appendix B to proxy statement filed with Securities and Exchange Commission 1/28/2004)

(i) Within 90 days after the commencement of a Performance Cycle, the Committee will fix and establish in writing (A) the Performance Measures that will apply to that Performance Cycle; (B) with respect to Performance Units, the Target Amount payable to each Participant; (C) with respect to Restricted Units and Restricted Stock, the Target Vesting Percentage for each Participant; and (D) subject to subsection (d) below, the criteria for computing the amount that will be paid or will vest with respect to each level of attained performance. The Committee will also set forth the minimum level of performance, based on objective factors, that must be attained during the Performance Cycle before any Long Term Performance Award will be paid or vest, and the percentage of Performance Units that will become payable and the percentage of performance-based Restricted Units or Shares of Restricted Stock that will vest upon attainment of various levels of performance that equal or exceed the minimum required level

(ii) The Committee may, in its discretion, select Performance Measures that measure the performance of the Company or one or more business units, divisions or Subsidiaries of the Company. The Committee may select Performance Measures that are absolute or relative to the performance of one or more comparable companies or an index of comparable companies.

(iii) The Committee, in its discretion, may, on a case-by-case basis, reduce, but not increase, the amount of Long Term Performance Awards payable to any Key Employee with respect to any given Performance Cycle, provided, however, that no reduction will result in an increase in the dollar amount or number of Shares payable under any Long Term Performance Award of another Key Employee.

Example 2: How stock options might not be pay for performance

In its proxy statement filed with the Securities and Exchange Commission on March 12, 2001, Apple Computer reported that it had granted its Chief Executive Officer Steven Jobs, 20 million options in January of the previous year, and that if its share price rose at a rate of 5 percent per year, at the end of the options term, those options would be worth $548,317,503. Of course, if its share price increased by five percent per year, Apple stockholders might have preferred purchasing thirty year U.S. Treasury Bonds which offered a 6.34 percent yield risk-free at that point in time.

Questions for the Record for:

Steven Balsam
Professor and Merves Research Fellow
Fox School of Business
Temple University
Philadelphia, PA

September 19, 2006

From Chairman Grassley:

1. For the record, I'd like to get the panel's views on these three questions. How would you rate the results of efforts to deal with what are viewed as high corporate salaries through the tax code such as section 162(m)?

The second question, do you believe that improved transparency as recently proposed by the SEC is more effective than the tax code in dealing with high corporate salaries?

And finally, how important is it that we have improved governance and independence of board members, that several of you have cited in your testimony, if the SEC's new transparency rules are going to have a strong impact on addressing high corporate salaries?

Response

Mr. Chairman, I welcome the opportunity to elaborate upon my testimony given to the committee. My answer to your first question is straightforward and direct. Section 162(m) has not been effective at reducing executive pay, and may have in fact had the effect of increasing executive pay and payouts by encouraging the use of stock options.

With respect to your second question, I believe that transparency and the tax code are not mutually exclusive ways to deal with high executive pay. Rather they can work together to restrain executive pay and increase its relation to firm performance. For example, if firms needed to disclose the numerical terms of the plans, they would be more likely to ensure that only outstanding performance was rewarded. And if they had to disclose tax deductions they forfeited, they would be less likely to do so.

To answer your third question, we don't know how transparency will play out. There are many who assert that increased transparency will lead to a race to the top. Alternatively, having to clearly disclose executive pay and summing up to one number may make the board more willing to restrain pay.

2. I would ask the panel two questions: First, Ms. Minow, you did a good job of highlighting in your testimony what are some of the current practices in executive compensation, and I was wondering if you could expand on those, particularly those with a tax play?

I also would ask the rest of the panel for their comments on what they believe are the new things out there in executive compensation that give you pause or concern and that should be considered by Congress.

Second, I would ask the panel do you believe it is possible to estimate the amount of known performance pay that escapes taxation under section 162(m), and if so, what is that amount? You can round up to the nearest billion.

Response

Mr. Chairman, in response to your question asking for an estimate on the amount of performance pay that escapes taxation under section 162(m), I would like to reiterate my call for more and clearer corporate disclosure on this issue. While I can tell you the amount of pay in excess of $1 million per covered officer, I cannot tell you, with any precision, how much was deducted by the corporation, and how much represents deductions forfeited because of section 162(m). For example, I can tell you that in 2005, for corporations comprising the S&P 1500, approximately $20 billion in compensation was paid in excess of $1 million per executive. I can also tell you that over $11 billion of this total represented the gains from stock option exercise, and hence was likely to qualify under section 162(m). Of the remaining $9 billion, I cannot say one way or the other if it escaped taxation by qualifying under section 162(m).

3. We have talked about high compensation with publicly traded companies quite a bit but we have all read many headlines about excessive compensation in the nonprofit sector. It seems that similar problems of board failure exist in dealing with excessive executive salaries in the nonprofit sector.

But I'd like to get the panel's views on this, I know that you, Professor Elson, have in particular thought about this so I would appreciate your thoughts and views and anyone else on the panel as well.

Response

Mr. Chairman in answering this question I would like to emphasize the nonprofit sector fills an important role in our society in diverse areas from education to the environment to healthcare. I would also like to emphasize that in fulfilling its role, it competes for the services of talented individuals who have alternative opportunities in the for profit sector. The question is how can a nonprofit organization compete in the managerial labor market when (1) by its nature it is unable to offer certain types of compensation, for example stock options, and (2) its constituency will object if it attempts to pay the "going rate" in the managerial labor market. Examples of the latter range from the 1992 uproar that resulted from the disclosure that United Way of America President William Aramony had received an annual compensation package worth $463,000, to the 2003 revolt that

resulted from the disclosure that New York Stock Exchange Chairman Richard Grasso had earned a retirement package of almost $140 million. In both cases the offending executive was forced to resign. But is this good? Or, will it drive talented executives away from the nonprofit arena?

The issue is particularly important in the healthcare industry. Nonprofit hospitals and medical centers compete with publicly traded companies such as UnitedHealth. In 2005 William McGuire, Chairman and CEO of UnitedHealth received salary and bonus totaling $8 million, long term performance awards of $2 million, and stock options potentially worth $125 million if the share price appreciated at a rate of 10 percent per year for the next ten years. In contrast, the President of Johns Hopkins Health System, Ronald Peterson, earned not quite $1.5 million in 2003, the last year for which information was available.

Perhaps even more disconcerting, while directors at publicly traded companies earn significant amounts of money (e.g., $30,000 cash retainer at UnitedHealth plus $1,000 for each meeting attended plus 8,000 stock options per quarter), non employee trustees at most nonprofit organizations do not receive any remuneration! Probably for this reason boards in the non profit sector have less ability and incentive to monitor management.

From Senator Bunning:

1. Mr. Balsam, several witnesses have commented on the increase in executive compensation since the passage of Section 162 (m).

Can you speculate on how you think the landscape of executive compensation would be different if that provision had never been enacted?

Response

Senator Bunning, in my opinion, which is based upon my own research, the research of others and anecdotal reports, executive compensation is not much different than what we would have observed had section 162(m) not been enacted; as I do not believe section 162(m) has been effective. The major difference we have observed (see attachment A) is an increase in stock option grants to executives who are "affected" by section 162(m). To reiterate a point made in my oral testimony, I do not believe fixed at the money stock option grants require sufficient performance from executives to be classified as performance based.

2. The first panel today talked quite a bit about concerns of manipulation of stock options. Do you believe that repealing the Section 162 (m) limitation would reduce the motivation for corporations to engage in manipulations like this?

Response

Senator Bunning, in my opinion the manipulation of stock options is a disclosure issue. That is, while discount options are legal, firms do not want to disclose them as it sends a negative impression to the market. The fact that discount options would not qualify as performance based under section 162(m) is irrelevant, as corporations have demonstrated a willingness to forfeit deductions (see attachment B).

3. Could you comment on what impact you think the new FASB rules on stock option expensing may have on the structure of executive compensation?

Response

Senator Bunning, it is clear that companies are concerned with their reported accounting numbers and as such will take more care in issuing stock options. In fact, we have seen some reduction in stock option grants over the past few years, in part because of the anticipation of the new rules, but also because the market peaked in March of 2000 and has at best, been flat since then. In a survey conducted by the Controllers' Leadership Roundtable this past June (see attachment C), we found that almost 40 percent of companies responded that they reduced stock option grants in response to the new rules.

From Senator Kerry:

1) Should backdating be illegal?

Response

Senator Kerry, I would like to qualify my response by stating that discount options, or options issued at less than the market price on the date of grant are legal. Restricted share grants which have become more popular in recent years are the extreme example of a discount option as they are equivalent to an option granted with an exercise price of zero. However, granting an option at a discount, and claiming it was issued on an earlier date at the then market price is, and should be, illegal. Assuming the company and executive treat the option as having been granted at the market price, both will be filing false tax returns, which is illegal. In addition the company and executive will be violating securities laws by filing false statements with the Securities and Exchange Commission. However, as was pointed out during oral testimony, the Sarbanes-Oxley requirement that option grants be reported to the SEC within two days, limits the ability to backdate, essentially making the issue moot going forward.

2) Are there any legitimate instances in which backdating should be allowed?

Response

Senator Kerry, if you are asking that misrepresenting the terms of an option grant to your shareholders, the IRS, and the SEC could ever be justified, the answer is an unambiguous no.

3) What can be done to prevent spring-loading?

Response

Senator Kerry, I believe there are limits as to our ability to regulate behavior – this would be one of them.

4) What are your recommendations for making boards more accountable?

Response

Senator Kerry, the simple answer would be free and fair elections. Currently our system of electing directors provides shareholders with the choice of ratifying management's choices

5) Are they any legislative changes that you would recommend in the area of executive compensation, including disclosure?

Response

Senator Kerry, the changes I would recommend would be to increase disclosure and tie deductibility to that disclosure. As I discussed in my oral testimony, to qualify for the performance based exception under section 162(m), ostensibly corporations are required to disclose the material details of compensation plans presented to shareholders for approval; in practice, the disclosures are so vague that they are meaningless. Shareholders are asked, and usually do, approve performance plans without knowing thresholds, targets and parameters to be used in the calculation. Personally, I would never sign a contract that omitted such important details – why should shareholders be asked to approve them in such a state? I would also, as a shareholder and researcher, like more quantitative disclosure on the effect of section 162(m) on the corporation, in particular the value of deductions lost because of failure to comply with section 162(m) and the additional taxes paid as a result.

6) Do you think changes need to be made to Code Section 162(m)? Do you think it is appropriate to limit the amount of compensation that a company is able to deduct? If so, what is an appropriate limit?

Response

Senator Kerry, the changes I believe need to be made are those specified immediately above with respect to disclosure. To me the public policy question is not whether it is appropriate to limit the amount of compensation that a company is able to deduct, but rather how can we utilize the tools available to us, be it the Internal Revenue Code or the Securities and Exchange Commission, to ensure that corporations are managed for the benefit of their shareholders.

The Effect of Internal Revenue Code Section 162(m) on the Issuance of Stock Options

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The Effect of Internal Revenue Code Section 162(m) on the Issuance of Stock Options

Abstract

IRC section 162(m) limits tax deductibility of executive compensation to $1 million per covered executive, with an exception for performance based compensation. Consequently, firms that wish to pay an executive more than $1 million either have to forfeit deductions or structure the compensation package so that the excess over $1 million qualifies under the performance based exception. While a variety of compensation forms can qualify as performance based, they vary in the difficulty of qualification and the degree of risk that qualification imposes on the executive. Amounts paid under a bonus plan, for example, qualify as performance based, if the payout does not exceed that determined based upon objective plan parameters set at the beginning of the year. In contrast, almost any stock option grant qualifies as performance based. While there clearly is risk associated with both stock option and annual bonus compensation, the requirements of section 162(m) changed the risk associated with annual bonus compensation relative to what it was prior. Consequently, section 162(m) encouraged the use of stock options vis-à-vis other forms of compensation.

The results of this study show that the propensity to issue stock options has increased for affected executives as a percentage of total compensation. Additional analysis provides evidence that this increase in stock option compensation is substituting for lower increases in salary for affected executives. But, there is no evidence of stock option compensation substituting for annual cash bonuses. In summary, the results indicate that firms and their executives are acting in a way consistent with the incentives provided by section 162(m).

Keywords: IRC section 162(m), executive compensation, tax deductibility, costs and benefits

The Effect of Internal Revenue Code Section 162(m) on the Issuance of Stock Options

INTRODUCTION

The Revenue Reconciliation Act of 1993 added section 162(m), limiting the corporate tax deduction for executive compensation to $1 million per individual for the top five executives of a corporation, providing an exception for compensation in excess of $1 million if it qualifies as "performance-based." This paper extends the prior research on the effect of section 162(m) on executive compensation by focusing on whether 162(m) is achieving its intended effect of increasing the use of such performance based compensation as stock options in executive compensation. Using the population of firms available on Standard & Poor's ExecuComp database, the results show that the propensity to issue stock options has increased for affected executives, not only in absolute terms, but also as a percentage of total compensation. Additional analysis shows that the increase in stock option compensation may be substituting for lower increases in salary for affected executives. But, there is no evidence that stock option compensation is substituting for annual cash bonuses.

The Congressional intent of section 162(m) was to reduce excessive, non-performance based executive compensation (U.S. Congress, House 1993). The results indicate that firms and their executives are acting in a way consistent with the incentives provided by section 162(m). Under section 162(m), firms that wish to pay an executive more than $1 million either have to forfeit deductions or structure the compensation package so that the excess over $1 million qualifies under the performance based exception. While a variety of compensation forms can qualify as performance based, they vary in the difficulty of qualification, the risk qualification imposes on the executive, etc. For example, for amounts paid under a bonus plan to qualify as performance based, the payout must not exceed that determined using objective plan parameters set at the beginning of the year. In contrast, stock option plans are relatively easy to qualify under section 162(m) and as long as the exercise price is set at or above the market price on the date of grant, are assumed to be performance based.

This study continues in section 2 with a discussion of section 162(m), and a review of the relevant literature in section 3. Section 4 develops our research question and model, while section 5 discusses our sample selection. Section 6 presents the empirical results. The findings of the study are summarized in section 7.

SECTION 162(m)

Section 162(m) was a response to the concern about the perceived link between the international competitiveness of United States industry and the substantial salaries paid to United States executives (Brownstein and Panner 1992). Corporate governance critics (e.g., Crystal 1992; McCarroll 1993) argued that executive compensation was excessive, both in comparison to that paid lower level employees and that paid overseas executives; and that executives were setting their own pay with no shareholder input.

Section 162(m), which became effective for compensation that is otherwise deductible for tax years beginning on or after January 1, 1994, places a $1 million cap on the annual deduction for non-performance based compensation to the top five executives (the chief executive officer

(hereafter CEO) and the next four highest compensated officers). Executive compensation generally consists of salary, fringe benefits, annual cash incentives, and long-term cash or stock-based incentives. The section 162(m) limit does not apply to (1) commissions, (2) non-taxable fringes and qualified retirement plan contributions, and (3) performance-based compensation.

Prior to the imposition of section 162(m), most firms claimed to tie compensation to performance. However, compensation committees had substantial discretion in awarding executive bonuses. Specific goals and performance criteria were rarely set in advance and even more rarely made public. Under section 162(m), to qualify bonus plans for the performance-based exception, firms are required to adopt a performance-based plan that is based on the executive's attainment of one or more performance goals that were established *ex-ante* by a compensation committee composed solely of independent directors. The performance goals must be based on objective formulae and the material terms of the plan must be disclosed to and approved by shareholders. The compensation committee, which has the discretion to award less, but not more than the objectively determined amount, must certify that the performance goals have been met before payment is made. Any compensation awarded by the committee based on discretionary assessments of performance that is in excess of the objectively determined amounts does not qualify for deduction.

By definition, salary will not qualify as performance-based since it is not contingent on the attainment of any criteria. Thus, any salary amounts earned in excess of $1 million are not deductible unless payment is deferred until after the executive's retirement or unless paid under a contract executed prior to February 17, 1993. Annual bonuses will qualify under the performance-based exception as long as the firm adopts a bonus plan consistent with the section 162(m) requirements discussed above. On the other hand, employee stock options easily qualify. The regulations specifically state that employee stock options qualify as performance-based under section 162(m) if the grant or award is made by the compensation committee, the plan states the maximum number of shares that can be granted during a specified period, and the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

LITERATURE REVIEW

There is a growing body of research that shows section 162(m) has had some impact on firms' compensation practices, albeit perhaps not the intended impact. For example, Balsam and Ryan (1996) examined the propensity of firms to qualify their short-term bonus plans to meet the requirements of section 162(m), finding that many firms were sensitive to the potential tax and political costs of not qualifying. However, they showed that firms more likely to make the requisite modifications were those where compensation was most related to performance – a formalization of existing policy. Further, approximately half of the firms in their sample chose not to modify, and many of those that did, expressly reserved their right to pay nondeductible compensation. Reitenga, et al. (2002) also observed that many firms elected not to qualify their compensation plans on the grounds that executive performance could not be evaluated using a fixed formula and that reserving the use of discretion in determining executive pay was in the best interest of the firm.

Prior research (see e.g., Balsam, 2002; Perry and Zenner, 2001) found that all components of the compensation package increased after 1993, with the largest increase coming in the form of stock option grants. This finding that compensation increased post section 162(m) is consistent with the theoretical predictions of Halperin, et al. (2001). However, while prior research shows the increase post section 162(m), it does not show that the increase in stock options is

disproportionate to affected executives and firms. There is also research showing that section 162(m) affected 'unaffected firms'. Harris and Livingstone (2002) examined firms whose CEOs earned less than $1 million and found it had the perverse effect of raising the compensation of those CEOs.

While research shows that section 162(m) has not led to a reduction in executive compensation, there is some limited (and mixed) evidence that compensation has become more responsive to firm performance. Examining the sensitivity of pay to performance, Johnson et al. (2001), Perry and Zenner (2001), and Balsam and Ryan (2006) all found some evidence of an increased sensitivity of compensation to performance after 1993. While Johnson et al. (2001) did not attribute this increased sensitivity to section 162(m), Perry and Zenner (2001) did, "especially for firms with million-dollar pay packages." Similarly, Rose and Wolfram (2000, p. 201) provided some evidence that the 162(m) limit "has led firms near the $1 million cap to restrain their salary increases and perhaps to increase the performance components of their pay packages." However, in a later paper, Rose and Wolfram (2002, S138) concluded "There is little evidence that the policy significantly increased the performance sensitivity of chief executive officer (CEO) pay at affected firms. We conclude that corporate pay decisions have been relatively insulated from this policy intervention."

A more recent trend is for researchers to examine the details of firms' responses to section 162(m). Balsam and Yin (2005) examine the actual tax status of executive compensation, finding that almost 40 percent of their sample firms forfeit some tax deductions because of section 162(m). Interestingly, they found that in 90 percent of the firm years in which a forfeiture occurred, the firm had at least one plan that met the requirements of section 162(m) and consistent with our research expectations, they had a qualified stock option plan in the vast majority of cases.

RESEARCH QUESTION

In firms where the CEO or other top officers are earning in excess of $1 million in annual compensation, the after-tax cost of performance based compensation such as bonuses and stock option grants is reduced relative to other forms of compensation. As discussed above, the firm must take a number of steps and put compensation at risk for an annual cash bonus to qualify for the performance based exception under section 162(m). In contrast, stock option plans can be easily qualified with no change in compensation risk. Option grants are performance-based compensation if the options have exercise prices equal to or greater than the market price at the time the award is made and the plan states the maximum number of shares that can be granted during a specified period. Most firms already met these requirements when section 162(m) was imposed.[1] Thus, unlike annual cash bonus plans, section 162(m) required minimal modifications to compensatory option plans. That being said, depending upon the firm, options may still be riskier than annual cash bonuses. However, as illustrated by Reitenga, et al. (2002), qualifying a bonus plan makes it riskier than it was before. In contrast, qualifying a compensatory option plan has little effect on its risk. Hence, section 162(m) increased the risk of annual cash bonuses relative to options. Consistent with Congressional intent to decrease non-performance based compensation, the firm may find it desirable and easier to shift compensation into options if the executive is subject to 162(m) and earns more than $1 million a year.

Model (1): Increased Use of Stock Options Compensation

The following pooled, cross-sectional Tobit regression model tests the hypothesis that section 162(m) has lead to the increased use of stock options in the compensation packages of affected individuals. Tobit is used in the analysis because the dependent variable in the primary analysis, the ratio of stock option to total compensation, is bounded by zero and one. The formal model is:

$$PERCENTOPT_{it} = \alpha_0 + \alpha_1 DUM1_{it} + \alpha_2 DUM2_{it} + \alpha_{3\text{-}6} RANK_{it} + \alpha_7 VALUE_{it-1} + \alpha_8 DIVYIELD_{it} + \alpha_9 SIZE_{it} + \alpha_{10} TRS_{it} + \alpha_{11} ROA_{it} + \alpha_{12} VARROA_{it} + \alpha_{13} RISK_{it} + \alpha_{14} CONSTRAINT_{it} + \alpha_{15} FCF_{it} + \alpha_{16} BKM_{it} + \alpha \sum YEAR + \alpha \sum IND + \varepsilon_{it} \quad (1)$$

where the dependent variable is:

$PERCENTOPT_{it}$ = the Black-Scholes value of options grants to executive i in year t divided by executive i's total compensation, where both the Black-Scholes value and total compensation are provided by ExecuComp;[2]

and the independent variables are:

- $DUM1_{it}$ = an indicator variable taking the value of 1 if cash compensation of executive i is greater than $900,000 in year t, 0 otherwise;[3]
- $DUM2_{it}$ = an indicator variable taking the value of 1 if cash compensation of executive i is greater than $900,000 in year t and year t is 1994 (1995 if non December fiscal year end) or later, 0 otherwise;
- $RANK_{it}$ = a series of indicator variables for executive rank, where rank is based on the level of salary plus bonuses;[4]
- $VALUE_{it-1}$ = value of executive i's shares held plus the intrinsic value of exercisable and unexercisable options deflated by total direct compensation, all measured at the end of year t-1;
- $DIVYIELD_{it}$ = the dividend yield of executive i's firm in year t;
- $SIZE_{it}$ = the log of assets of executive i's firm in year t;
- TRS_{it} = the return to shareholders of executive i's firm in year t;
- ROA_{it} = net income before extraordinary items and discontinued operations deflated by total assets for executive i's firm for year t;[5]
- $VARROA_{it}$ = variance of net income before extraordinary items and discontinued operations, deflated by total assets for executive i's firm for year t ;
- $RISK_{it}$ = the volatility measure (60 month) used by ExecuComp to calculate the Black-Scholes values for executive i's firm in year t ;
- $CONSTRAINT_{it}$ = indicator variable taking the value of 1 when retained earnings plus the value of cash dividends and stock repurchases in the current year divided by cash dividends and stock repurchases is less than two and 0 otherwise;
- FCF_{it} = ratio of free cash flow to total assets measured as common and preferred dividends less cash flow from operating and investing activities deflated by total assets for executive i's firm in year t;
- BKM_{it} = the ratio of book value to market value for executive i's firm in year t ;
- YEAR = a series of indicator variables for years, 1 in year t, 0 otherwise for years 1993 – 2002.[6]

IND = a series of indicator variables for two digit SIC codes.

The test variable is DUM2. The coefficient on DUM2 represents the incremental effect of section 162(m) on the percentage of stock options in the compensation package of individuals who are affected by the requirements of section162(m). A positive coefficient on this variable would be consistent with section 162(m) leading to an increase in stock option compensation for this group.

Control Variables

The previous literature shows that executive compensation is related to both executive and firm related factors. Consequently, the following control variables are included in the model:

Executive related controls

DUM1 is included because, independent of section 162(m), the composition of the compensation package may be more heavily weighted towards options for more highly paid individuals. Consequently, a positive coefficient is expected for this variable. A series of indicator variables for executive rank, RANK, is included because the composition of an executive's compensation package has been shown to vary with rank (Balsam, 2002, table 2.11). VALUE is included as a proxy for the preexisting holdings of managers because there is an optimal level of equity holdings and compensation can be used to adjust for deviation from that optimum (Core and Guay, 1999). VALUE is measured as the value of the shares held plus the intrinsic value of both un-exercisable and exercisable options deflated by total compensation. A negative coefficient is expected for this variable.

Firm related controls

DIVYIELD is included because the value of a firm's stock options is less, all else equal, the higher the dividend yield. Thus, managers in firms with high dividend yields are less likely to prefer stock option compensation (Lambert et al. 1989). A negative coefficient is expected for this variable. SIZE, measured as the log of assets, is included because prior research has shown that the portion of options in an executive compensation package increases with firm size (Balsam, 2002, table 2.6). Thus, there should be a positive coefficient on SIZE.

TRS and ROA are included because performance may affect the composition of the compensation package. However, the direction of the effect is not clear. While Murphy (1985) finds a negative association between stock option compensation and firm performance, Liang and Weisbenner (2001) find a positive association between stock option compensation and stock price. Consequently, there is no prediction for the direction of the association between stock option compensation and firm performance.

Variables to proxy for the relative risk of compensation tied to market and accounting measures are included also. RISK, measured as the 60 month volatility measure used by ExecuComp in calculating the Black-Scholes values, controls for market related risk. Its effect on the compensation package is ambiguous. That is, while RISK increases the value of an option under the Black-Scholes model, implying a positive coefficient, it also may make the option less desirable to an under-diversified executive. For example, Meulbroek (2001) estimates that for Internet firms, the estimated value of stock options to undiversified managers is only 53% of their cost to the firm. However, a recent paper (Hodges et al., 2005) shows that managers overvalue options relative to the Black-Scholes model. Which effect predominates is an

empirical question. VARROA, the variance of ROA, proxies for the risk associated with accounting measures of performance. VARROA is expected to be positively related to the dependent variable because the greater the volatility of a firm's income, the greater the risk of compensation tied to accounting measures of performance[7].

Prior research (Yermack, 1995; Dechow et al., 1996; Core and Guay; 1999; Carter et al., 2004) shows that firms with less free cash flow are more likely to use equity instead of cash compensation since equity compensation requires no cash payment. Following Core and Guay (1999) and Carter et al. (2004), free cash flow, FCF, is included as a control variable, constructed such that a larger value represents less free cash flow. Consequently, a positive coefficient is expected on this variable. A proxy for a firm's investment opportunity set, BKM is also included because firms with greater investment opportunities may be more likely to conserve cash and use stock option compensation instead. (Core and Guay, 1999; Carter et al., 2004) This is measured as the ratio of firm book value to the market value of its equity. A negative coefficient is expected because a greater value indicates a lesser opportunity set.

Core and Guay (1999, 160) also argue that "firms that are constrained with respect to earnings will grant more stock options" because cash compensation is expensed while stock option compensation has, until now, only been required to be disclosed in footnotes to the financial statements. Consequently, consistent with Core and Guay, the control variable, CONSTRAINT is included. There should be a positive coefficient on this variable.

To account for any macro-economic year-to-year or industry wide effects, indicator variables for each year and industry (2 digit SIC codes) in the sample are included. Tables 1 & 2 provide the sample distribution by year and industry.

TABLE 1
Industry Distribution

	Two-digit SIC Code	*Number of Observations*	*Percentage of Obs*
Agriculture production-crops	1	188	0.30
Agricultural services	7	18	0.00
Metal mining	10	442	0.70
Coal Mining	12	15	0.00
Oil and Gas Extraction	13	2,000	3.40
Crude petroleum & Natural gas	14	140	0.20
Mining, Quarry nonmetal minerals	15	365	0.60
Heavy Construction	16	215	0.40
Construction-Special Trade Contract	17	74	0.10
Food and Kindred Products	20	1,609	2.70
Tobacco Manufacturers	21	85	0.10
Textile Mill Products	22	516	0.90
Apparel and other Textile Products	23	586	1.00
Lumber and Wood Products	24	470	0.80
Furniture and Fixtures	25	399	0.70
Paper and Allied Products	26	1,174	2.00
Printing and Publishing	27	1,268	2.10

Chemicals and Allied Products	28	4,633	7.80
Petroleum and Coal Products	29	624	1.00
Rubber and Misc. Plastics Products	30	613	1.00
Leather and Leather Product	31	199	0.30
Stone, Clay, Glass, & Concrete Products	32	396	0.70
Primary Metal Industries	33	1,509	2.50
Fabricated Metal Products	34	959	1.60
Industrial and Related Products	35	3,775	6.30
Electronic & Other Electric Equipment	36	4,289	7.20
Transportation Equipment	37	1,931	3.20
Instruments and Related Products	38	2,707	4.50
Miscellaneous Manufacturing Products	39	450	0.80
Railroads, line-haul operating	40	283	0.50
Transit & passenger trains	41	29	0.00
Trucking and Warehousing	42	425	0.70
Water Transportation	44	241	0.40
Transportation by Air	45	579	1.00
Transportation Services	47	191	0.30
Communications	48	1,397	2.30
Electric, Gas, and Sanitary Services	49	4,608	7.70
Wholesale Trade-Durable Goods	50	1,241	2.10
Wholesale Trade-Nondurable Goods	51	733	1.20
General Merchandise Stores	52	289	0.50
Food Stores	53	856	1.40
Auto. Dealers & Gas. Service Stations	54	493	0.80
Apparel and Accessory Stores	55	256	0.40
Furniture and Home Furnishing Stores	56	960	1.60
Eating and Drinking Places	57	472	0.80
Miscellaneous Retail	58	1,075	1.80
Depository Institutions	59	1,171	2.00
Nondepository credit Institution	60	58	0.10
Security and Commodity Brokers	61	557	0.90
Insurance Carriers	62	882	1.50
Insurance Agents, Brokers & Services	63	2,501	4.20
General Merchandise Stores	64	386	0.60
Holding and Other Investment Offices	67	433	0.70
Hotels and motels	70	202	0.30
Personnel Services	72	308	0.50
Business Services	73	4,643	7.80
Auto Repair, Services, and Parking	75	119	0.20
Motion Pictures	78	188	0.30
Amusement & Recreational Services	79	447	0.70
Health Services	80	973	1.60
Educational Services	82	155	0.30
Social Services	83	14	0.00
Engineering & Management Services	87	612	1.00
Nonclassifiable Establishments	99	272	0.50

TABLE 2
Year Distribution

Fiscal Year Ending	*Number of Observations*	*Percentage of Observations*
1993	4,526	7.60
1994 (Pre December)	2,280	3.82
1994 (December)	3,966	6.64
1995	6,253	10.50
1996	6,339	10.60
1997	6,562	11.00
1998	6,170	10.30
1999	6,301	10.60
2000	6,090	10.20
2001	5,763	9.70
2002	5,448	9.10
	59,698	

Model (2): Substitution Effect

Model (1) tests whether affected executives are receiving a greater portion of their compensation in the form of stock options in the post section 162(m) period. Increased stock option compensation post-section 162(m) may have occurred for two reasons. The first possibility is that stock options increased because section 162(m) gave it additional imprimatur and consequently, compensation committees simply added more options to compensation packages without any offsetting reduction elsewhere in the package. In fact, this theory is consistent with the pattern observed by Balsam (2002, table 2.7), whereby stock option grants increased over time, but so did the other components of the compensation package. The other alternative is that the increase in stock options was offset by reductions, or if not reductions, lesser increases in the other components of the compensation package than would have been observed in the absence of section 162(m). In effect, did firms substitute stock option compensation for other forms of compensation in the pay packages of affected executives?

Risk and taxes provide opposing incentives to substitute options for bonuses. If the annual bonus plan is non-qualified, then there is no change in the risk of the bonus. Hence, there is no reason from a risk perspective to shift from bonuses to options. However, the firm may shift compensation from bonuses to options to preserve deductions. Alternatively if the annual bonus plan is qualified, then the risk of the bonus has increased relative to the risk of the options (which may still be riskier). Consequently, for risk reasons, there may be a shift from bonuses to options. However, since both are deductible, there is no tax reason to expect a shift. The following modified version of model (1), focusing on changes in compensation from the pre to post section 162(m) period, tests which of the two alternatives is more likely.

$$\Delta BSV_{it} = \alpha_0 + \alpha_1\Delta SAL_i + \alpha_2\Delta BONUS_i + \alpha_3 DUM2_i + \alpha_4 DUM3_i + \alpha_5\Delta SAL{*}DUM2_i + \alpha_6\Delta BONUS{*}DUM2_i + \alpha_7\Delta BONUS{*}DUM3_i + \alpha_{8\text{-}11} RANK_i + \alpha_{12}\Delta RANK_i + \alpha_{13}\Delta DIVYIELD_i + \alpha_{14}\Delta SIZE_i + \alpha_{15}\Delta TRS_i + \alpha_{16}\Delta ROA_i + \alpha_{17}\Delta VARROA_i + \alpha_{18}\Delta RISK_i$$

$+ \alpha_{19}\Delta CONSTRAINT_i + \alpha_{20}\Delta FCF_i + \alpha_{21}\Delta BKM_i + \alpha_{22}\Delta VALUE_{it-1} + \alpha\sum IND + \varepsilon_{it}$
(2)

One difference between models (1) and (2) is that while model (1) is a levels regression, model (2) is a changes regression.[8] The dependent variable is ΔBSV, the percentage change in the Black-Scholes value of the option grants. Further, since the dependent variable can be either positive or negative, ordinary least squares is used rather than the Tobit model used above. . Model (2) also includes, as independent variables, ΔSAL, the percentage change in salary, i.e., (salary-lag(salary))/lag(salary), and ΔBONUS, the percentage change in bonus and their interactions with DUM2. In this model, the coefficient on DUM2 indicates the incremental change in the Black-Scholes value of the options granted to affected executives independent of any changes in the salary and bonus components of compensation, while the coefficients on ΔSAL and ΔBONUS indicate the unconditional association of the change in salary and bonus on the change in the Black-Scholes value of the options granted to executives – which are normally expected to be positive. Two additional variables are included: an indicator variable taking the value of one if the executive is affected and if the firm qualified its short term bonus plan (DUM3), and an interaction variable, ΔBONUS*DUM3. The coefficients of primary interest are those on the interactions between DUM2 and ΔSAL, DUM2 and ΔBONUS, and DUM3 and ΔBONUS, which are the incremental effects of the change in salary and change in bonus on change in option compensation for affected executives.

This analysis is conducted using the change between the last year pre-section 162(m), and the first year post-section 162(m). Section 162(m) applies to compensation that is otherwise deductible in any taxable year beginning on or after January 1, 1994. Consequently, for December fiscal year end companies, the last year prior to (first year after) section 162(m) would be 1993 (1994), while for non-December fiscal year end companies, the last year prior to (first year after) section 162(m) would be 1994 (1995).

SAMPLE SELECTION

The source for the sample is Standard & Poor's ExecuComp, which includes the firms in the S&P 500, Mid-Cap, and Small-Cap indexes. The data available on ExecuComp was augmented with financial data from Standard & Poor's Compustat and data on bonus plan qualification was hand collected from corporate proxy statements. As the sample firms are the largest publicly held U.S. corporations, they are the ones most likely to be affected by section 162(m). At the time of the analysis, ExecuComp had compensation data on 125,122 executives over the period 1992 to 2002. The test sample is reduced to 59,698 observations due to missing data. In particular, almost 40,000 observations are lost due to the lagged data required for the VALUE variable.[9] However, as shown in the right hand column of table 4, rerunning the analysis without the VALUE variable and hence on the larger data set does not affect the results.

Table 3 provides some descriptive statistics about the sample. In roughly 20 percent (the mean of DUM1 is .20) of executive year observations, the individual earned more than $900,000 in cash compensation, making him/her affected (according to our definition) by section 162(m). Options were a significant part of the compensation package (PERCENTOPT), as they comprised a mean (median) 53 (28) percent of total compensation and 117 (48) percent of cash compensation, with the mean (median) grant valued at $900,050 ($223,850). The mean (median) dividend yield is 1.36 percent (0.54 percent) and the mean (median) one-year return to shareholders is 18.03 (8.44) percent. The mean (median) income before extraordinary items and discontinued operations

deflated by total assets (ROA) is 4 (5) percent, while the mean (median) change in ROA (income before extraordinary items and discontinued operations deflated by total assets) was 0 (1) percent. The mean (median) variance of ROA (VARROA) is 1 (0) percent. Sixteen percent of the firm year observations in the sample had a loss in the current year, 37 percent had income lower in the current year than in the prior year, and 62 percent of the sample is earnings constrained (the mean of CONSTRAINT).[10] The mean (median) ratio of free cash flow to total assets is 1 (0) percent and the mean (median) value book to market value is 51 (43) percent.

TABLE 3
Descriptive Statistics

Variables	*Observations*	*Mean*	*Std Dev*	*1st Quartile*	*Median*	*3rd Quartile*
PERCENTOPT	59698	0.53	1.09	0.05	0.28	0.51
PERCENTOPT2	59619	1.17	1.94	0.06	0.48	1.28
BSVAL	59698	900.05	1,946.03	19.62	223.85	784.62
NUMGRT	59698	74.87	135.52	5.00	25.00	75.00
DUM1	59698	0.20	0.40	0.00	0.00	0.00
DUM2	59698	0.19	0.39	0.00	0.00	0.00
DIVYIELD	59698	1.36	2.21	0.00	0.54	2.09
SIZE	59698	7.15	1.58	5.97	7.01	8.22
TRS	59698	18.03	69.33	-15.83	8.44	35.48
TRS3YR	59698	9.16	27.56	-5.72	9.39	24.56
TRS5YR	59698	7.41	21.37	-5.42	9.21	20.46
ROA	59698	0.04	0.09	0.02	0.05	0.08
PCROA	59698	0.00	0.08	-0.01	0.01	0.03
LOSS	59698	0.16	0.36	0.00	0.00	0.00
LESS	59666	0.37	0.48	0.00	0.00	1.00
VARROA	59698	0.01	0.05	0.00	0.00	0.00
RISK	59698	0.40	0.18	0.27	0.36	0.50
CONSTRAINT	59698	0.62	0.48	0.00	1.00	1.00
FCF	59698	0.01	0.10	-0.05	0.00	0.06
BKM	59698	0.51	0.61	0.26	0.43	0.66
VALUE	59698	584.07	87,217.67	0.83	2.25	6.11

Where

$PERCENTOPT_{it}$ = the Black-Scholes value of option grants to executive i in year t divided by executive i's total compensation, where both the Black-Scholes value and total compensation are provided by ExecuComp;

$PERCENTOPT2_{it}$ = is the Black-Scholes value of option grants to executive i in year t divided by executive i's total cash compensation, where both the Black-Scholes value and total cash compensation are provided by ExecuComp;

$BSVAL_{it}$ = is the Black-Scholes value of the options granted to executive i in year t as provided by ExecuComp;

$NUMGRT_{it}$ =the total number of options granted to executive i in year t;

$DUM1_{it}$	=is an indicator variable taking the value of 1 if cash compensation of executive i is greater than $900,000 in year t, 0 otherwise;
$DUM2_{it}$	=is an indicator variable taking the value of 1 if cash compensation of executive i is greater than $900,000 in year t and year t is 1994 or later, 0 otherwise;
$DIVYIELD_{it}$	= the dividend yield of executive i's firm in year t;
$SIZE_{it}$	= the log of assets of executive i's firm in year t;
TRS_{it}	= the return to shareholders of executive i's firm in year t;
$TRS3YR_{it}$	= the return to shareholders of executive i's firm for three years ending with year t;
$TRS5YR_{it}$	= the return to shareholders of executive i's firm for three years ending with year t;
ROA_{it}	= net income before extraordinary items and discontinued operations deflated by total assets for executive i's firm for year t;
$PCROA_{it}$	= change in net income before extraordinary items and discontinued operations deflated by total assets for executive i's firm in year t;
$LESS_{it}$	= indicator variables taking the value of one if net income before extraordinary items and discontinued operations was less than prior year, and zero otherwise for executive i's firm in year t;
$LOSS_{it}$	= indicator variables taking the value of one if net income before extraordinary items and discontinued operations was less than zero, and zero otherwise for executive i's firm in year t;
$VARROA_{it}$	= variance of NIBEX using all available observations for company i. Minimum number of observations is 6.
$RISK_{it}$	=the volatility measure (60 month) used by ExecuComp to calculate the Black-Scholes values for executive i's firm in year t ;
$CONSTRAINT_{it}$	= indicator variable taking the value of 1 when retained earnings plus the value of cash dividends and stock repurchases in the current year divided by cash dividends and stock repurchases in prior year is less than two and 0 otherwise;
FCF_{it}	= ratio of free cash flow to total assets;
BKM_{it}	= book to market value of equity; and
$VALUE_{it}$	= value of shares owned, plus intrinsic value of options held, deflated by total direct compensation – all measured at end of previous year.

EMPIRICAL RESULTS

Model (1): Increased Use of Stock Options

Table 4 presents the results of the Tobit regression analysis for model (1), as well as a model which excludes VALUE and hence, allows the incorporation of 1992 into the analysis.[11,12] In both regressions the coefficient on DUM2 is, as predicted, positive and significant.[13] This provides support for the hypothesis that there was a positive incremental effect of section 162(m) on the amount of stock options in the compensation package of affected individuals. The coefficient on the indicator variable, DUM1 is significant, but surprisingly negative. The sign of this coefficient may be driven by the definition of highly paid executives, which is based upon

cash compensation – ceteris paribus, the higher cash compensation the lower stock-based compensation.

To test this alternative, highly paid executives are defined based upon total compensation in an un-tabulated analysis. The coefficient on DUM1 becomes positive and significant, while that on DUM2 remains positive and significant. The results for the RANK indicator variables are as expected. Higher ranked executives receive a higher proportion of their compensation in the form of options; thus both RANK1 and RANK2 are significant and positive, RANK3 is insignificant and RANK4 is significant, but negative. The control variable, VALUE is negative as expected, but only marginally significant ($p<0.11$).

All of the firm related control variables are significant. The coefficients on DIVYIELD and SIZE are negative ($p<0.0001$) and positive ($p<0.0001$) respectively, consistent with the proportion of stock in the compensation package being inversely related to dividend yield and positively associated with firm size. The coefficients on the performance measures are mixed, as the coefficient on ROA is positive and significant ($p<0.0001$), while the coefficient on TRS is negative and significant ($p<0.0001$). The coefficient on RISK is positive and significant ($p<0.0001$) consistent with the positive effect of risk on the value of the option being associated with an increase in the proportion of stock in the compensation package. The other risk related measure, the variability of income, VARROA is also positive and significant ($p<0.0001$), consistent with an increased use of options when accounting based bonuses are more risky. Consistent with the findings of prior research, FCF and CONSTRAINT are positive and significant and BKM is significant and negative ($p<0.0001$). These results indicate that firms are more likely to use stock options to compensate managers when they have less free cash flow, are constrained with respect to earnings, or have greater investment opportunities.

The year and industry indicator variables provide a control for industry wide and macro economic effects. While the coefficients on these indicator variables are omitted for brevity, they are discussed here. The coefficients associated with the years 1994 and 1995 are insignificant, for the years 1996 through 2001 are significant and positive and for the year 2002 is significant and negative. With a lag, these coefficients seem to track overall market stock price movements. That is, while stock returns were flat in 1994, beginning in 1995 stock prices increased through the beginning of 2000, at which point a bear market began. The results are consistent with overall market performance affecting the desirability of stock options to executives and their use by corporations. While most of the coefficients on the industry controls are significant and negative, consistent with expectations, those associated with high technology industries are significant and positive.

TABLE 4
Tobit Regression Results

$$PERCENTOPT_{it} = \alpha_0 + \alpha_1 DUM1_{it} + \alpha_2 DUM2_{it} + \alpha_3 DIVYIELD_{it} + \alpha_4 SIZE_{it} + \alpha_5 TRS_{it} + \alpha_6 ROA_{it} + \alpha_7 VARROA_{it} + \alpha_8 RISK_{it} + \alpha_9 CONSTRAINT_{it} + \alpha_{10} FCF_{it} + \alpha_{11} BKM_{it} + \alpha_{12} VALUE_{it-1} + \alpha_{13\text{-}16} RANK_{it} + \alpha \sum YEAR + \alpha \sum IND + \varepsilon_{it}$$

	Model w/VALUE	Model w/o VALUE
Variable name	***COEFFICIENT (Chi-square)***	***COEFFICIENT (Chi-square)***
INTERCEPT	-2.3394	-2.1014
	*** (370.22)	***(545.19)
DUM2	0.2805	0.2698
	*** (24.66)	***(43.54)
Executive related control variables		
DUM1	-0.3774	-0.2504
	*** (47.02)	***(41.09)
RANK1	0.4339	0.5613
	*** (576.95)	***(1410.55)
RANK2	0.1800	0.2154
	*** (80.61)	***(181.93)
RANK3	-0.0197	0.0097
	(0.82)	(0.34)
RANK4	-0.0898	-0.0867
	*** (13.79)	***(24.56)
VALUE	-0.0000	
	(2.49)	
Firm related control variables		
DIVYIELD	-0.0343	-0.0342
	*** (142.80)	***(226.32)
SIZE	0.3335	0.2536
	*** (3665.69)	***(3792.76)
TRS	-0.0004	-0.0003
	*** (21.25)	***(31.00)
ROA	1.7415	1.0604
	*** (419.81)	***(293.55)
RISK	3.6876	3.2913
	*** (3951.78)	***(5563.75)
VARROA	1.4143	1.0082
	*** (115.85)	***(103.51)
CONSTRAINT	0.2349	0.1969
	*** (224.03)	****(266.66)
FCF	0.8592	0.7376
	*** (182.43)	***(242.77)
BKM	-0.3168	-0.2570
	*** (624.22)	***(771.89)
YEAR	NR	NR
IND	NR	NR
N	59,698	99,681

*** denotes significance at p value < .01
Variable definitions are provided at the bottom of table 3
We omit the coefficients for the year and industry dummies for brevity.

Sensitivity Analysis

Murphy (1998) notes that about 40 percent of firms grant a fixed number of options each year, while another 40 percent of firms grant options with fixed value each year. In the former situation, there would be a mechanical relation between the Black-Scholes value of option grants and share price. Consequently, in a rising market and independent of any other incentives, BLK_VALU and PERCENTOPT will increase, on average. For that reason, the analysis in table 5 is rerun using three alternative dependent variables: PERCENTOPT2, BLK_VALU, and SOPTGRT. PERCENTOPT2 is the Black-Scholes value of options granted divided by the executive's total cash compensation, while BLK_VALU is simply the Black-Scholes value of the options granted, and SOPTGRT is the total number of options granted to the executive. While the first two alternative measures are subject to the same mechanical relation between option value and share price, the last is unaffected by it. That is, any changes observed in SOPTGRT are the result of a conscious decision by the compensation committee to increase or decrease the number of options granted. The results for all three alternative dependent variables are consistent with the original model. In all of the analyses, the coefficient on DUM2 is positive and significant ($p<0.0001$). Except for the variable, VALUE, the control variables remain significant; although some signs change. For instance, the coefficient on the DUM1 variable is positive and significant, in the regressions with BLK_VALU and SOPTGRNT as dependent variables.

TABLE 5
Tobit Regression Results for Alternative Dependent Variables

$DEPEND_{it} = \alpha_0 + \alpha_1 DUM1_{it} + \alpha_2 DUM2_{it} + \alpha_3 DIVYIELD_{it} + \alpha_4 SIZE_{it} + \alpha_5 TRS_{it} + \alpha_6 ROA_{it} + \alpha_7 VARROA_{it} + \alpha_8 RISK_{it} + \alpha_9 CONSTRAINT_{it} + \alpha_{10} FCF_{it} + \alpha_{11} BKM_{it} + \alpha_{12} VALUE_{it-1} + \alpha_{13-16} RANK_{it} + \alpha \sum YEAR + \alpha \sum IND + \varepsilon_{it}$

Dependent variable	*PERCENTOPT2*	*BLK_VALU*	*SOPTGRNT*
Variable name	COEFFICIENT (Chi-square)	COEFFICIENT Chi-square)	COEFFICIENT (Chi-square)
INTERCEPT	-5.3058	-7529.7000	-396.3115
	*** (729.65)	*** (1359.18)	*** (810.10)
DUM2	0.4269	1833.5000	79.9039
	*** (21.51)	*** (363.12)	*** (135.21)
Executive related control variables			
DUM1	-0.7031	317.3985	71.0117
	*** (61.64)	*** (11.52)	*** (125.33)
RANK1	0.8263	1184.0000	95.9944
	*** (787.72)	*** (1461.85)	*** (2093.52)
RANK2	0.3385	470.0726	32.6146
	*** (107.63)	*** (190.95)	*** (198.41)
RANK3	-0.0428	-122.5160	-20.4406
	(1.45)	*** (10.95)	*** (65.89)
RANK4	-0.1504	-116.3133	-17.2007
	*** (14.55)	*** (8.06)	*** (37.88)
VALUE	-0.0000	-0.0000	-0.0000
	(2.43)	(0.06)	(0.07)
Firm related control variables			
DIVYIELD	-0.0632	-56.8137	-1.2296
	*** (189.73)	*** (128.81)	*** (13.95)

SIZE	0.6313	824.8847	42.4815
	*** (4969.29)	*** (7966.08)	*** (4656.33)
TRS	-0.0005	1.0602	-0.0346
	*** (11.10)	*** (46.73)	*** (10.23)
ROA	2.8155	2953.6000	-48.6752
	*** (423.01)	*** (416.50)	*** (23.15)
RISK	7.0420	5415.7000	338.5982
	*** (5388.19)	*** (2976.40)	*** (2530.59)
VARROA	2.1850	2609.3000	325.73
	*** (104.63)	*** (135.12)	*** (437.10)
CONSTRAINT	0.3581	335.5600	23.1464
	*** (195.02)	*** (159.34)	*** (166.05)
FCF	1.5787	557.1492	-29.7300
	*** (230.53)	*** (25.83)	*** (15.75)
BKM	-0.5865	-425.1669	-19.1967
	*** (832.23)	*** (420.64)	*** (197.86)
YEAR	NR	NR	NR
IND	NR	NR	NR
N	59,619	59,698	59,698

Notes:
*** denotes significance at p value < .01
Variable definitions are provided at the bottom of table 3
We omit the coefficients for the year and industry dummies for brevity.

The effect of some alternative performance measures, reported in table 6, are also examined. For accounting based performance measures, ROA is replaced first with LESS (an indicator variable equal to one if net income before extraordinary items and discontinued operations was less than in the prior year) and then with LOSS (an indicator variable taking the value of one if net income before extraordinary items and discontinued operations was less than zero). For stock based performance measures, the total return to shareholders over one year is replaced with total returns to shareholders over three (TRS3YR) and five (TRS5YR) year periods. In all permutations, the coefficient on DUM2 is positive and significant ($p<0.0001$). The major difference when the accounting performance variable is varied is the coefficient on that variable. That is, in the base model, the coefficient on ROA is positive and significant, as it is when LESS is used as the performance measure. But when LOSS is used, the coefficient becomes negative, but not significant. The major difference when the market variable is varied is that, while in the one year window, the coefficient on TRS is negative and significant, in the longer windows, TRS3YR and TRS5YR, it is positive and significant.

TABLE 6
Tobit Regression Results with Alternative Performance Measures
The dependent variable is PERCENTOPT

Variable name	***COEFFICIENT (Chi-square)***			
INTERCEPT	-2.2663	-2.2222	-2.4100	-2.3875
	***(346.81)	***(322.90)	***(397.59)	***(390.39)
DUM2	0.2794	0.2831	0.2901	0.2856
	***(24.26)	***(24.94)	***(26.38)	***(25.61)
Executive related control variables				
DUM1	-0.3440	-0.3580	-0.3990	-0.3962
	***(38.74)	***(42.00)	***(52.55)	***(51.90)
RANK1	0.4276	0.4286	0.4320	0.4344
	***(556.75)	***(559.16)	***(573.01)	***(579.74)
RANK2	0.1866	0.1832	0.1754	0.1809
	***(85.91)	***(82.81)	***(76.58)	*** (81.64)
RANK3	-0.0207	-0.0220	-0.0271	-0.0281
	(0.89)	(1.01)	(1.54)	(1.66)
RANK4	-0.0810	-0.0837	-0.0964	-0.0967
	*** (11.13)	*** (11.89)	*** (15.91)	*** (16.02)
VALUE	-0.0000	-0.0000	-0.0000	-0.0000
	(1.91)	(2.09)	(2.65)	(2.44)
Firm related control variables				
DIVYIELD	-0.0333	-0.0327	-0.0320	-0.0311
	*** (141.40)	*** (133.24)	*** (118.30)	*** (111.69)
SIZE	0.3144	0.3182	0.3304	0.3254
	*** (3261.42)	*** (3346.5)	*** (3595.5)	*** (3448.9)
TRS	-0.00	-0.0002		
	(0.10)	(3.51)		
TRS 3 yr			0.0028	
			*** (134.21)	
TRS 5 yr				0.0041
				*** (174.21)
ROA			1.4487	1.4821
			*** (279.70)	*** (300.35)
LESS	0.0889			
	*** (41.62)			
LOSS		-0.0248		
		(1.58)		
RISK	3.3662	3.4184	3.6366	3.6571
	*** (3471.70)	*** (3378.6)	*** (3892.5)	*** (3956.5)
VARROA	0.8644	0.9039	1.4714	1.4960
	*** (45.76)	*** (49.37)	*** (123.91)	*** (128.68)
CONSTRAINT	0.2454	0.2422	0.2449	0.2623
	*** (243.14)	*** (236.82)	*** (242.58)	*** (274.15)
FCF	0.4953	0.5241	0.8306	0.8568
	*** (64.28)	*** (71.79)	*** (170.64)	*** (182.48)
BKM	-0.3840	-0.3729	-0.2712	-0.2767
	*** (987.80)	*** (896.27)	*** (441.05)	*** (472.19)
YEAR	NR	NR	NR	NR
IND	NR	NR	NR	NR
N	59,698	59,698	59,698	59,698

*** denotes significance at $p < 0.01$
Variable definitions are provided at the bottom of table 3.
We omit the coefficients for the year and industry dummies for brevity.

TABLE 7
OLS Regression Results for Change Model
The dependent variable is the change in the Black Scholes value of options

$\Delta BSV_{it} = \alpha_0 + \alpha_1 \Delta SAL_i + \alpha_2 \Delta BONUS_i + \alpha_3 DUM2_i + \alpha_4 DUM3_i + \alpha_5 \Delta SAL*DUM2_i + \alpha_6 \Delta BONUS*DUM2_i + \alpha_7 \Delta BONUS*DUM3_i + \alpha_{8-11} RANK_i + \alpha_{12} \Delta RANK_i + \alpha_{13} \Delta DIVYIELD_i + \alpha_{14} \Delta SIZE_i + \alpha_{15} \Delta TRS_i + \alpha_{16} \Delta ROA_i + \alpha_{17} \Delta VARROA_i + \alpha_{18} \Delta RISK_i + \alpha_{19} \Delta CONSTRAINT_i + \alpha_{20} \Delta FCF_i + \alpha_{21} \Delta BKM_i + \alpha_{22} \Delta VALUE_{it-1} + \alpha \sum IND + \varepsilon_{it}$ (2)

Variable	*Coeff*	*(t-stat)*	*Coeff*	*(t-stat)*
INTERCEPT	-12.1822	-0.24	-12.6011	-0.25
ΔSAL	73.0343	***61.40	73.0450	***61.41
ΔBONUS	0.9531	***9.27	0.9524	***9.27
DUM2	23.2195	***2.96	20.9733	**2.51
DUM3			12.9285	0.74
ΔSAL*DUM2	12.1554	***4.16	11.5066	***3.92
ΔBONUS*DUM2	-0.8883	***-4.20	-0.9394	***-4.40
ΔBONUS*DUM3			0.7277	1.96
RANK1	19.0852	**2.17	18.8834	**2.15
RANK2	8.0037	0.79	7.8686	0.77
RANK3	-2.1867	-0.20	-2.0851	-0.19
RANK4	5.1479	0.44	5.1350	0.44
ΔRANK	-1.3885	-0.41	-1.3927	-0.41
ΔDIVYIELD	-11.1006	***-5.15	-11.0634	***-5.14
ΔSIZE	59.0416	***6.88	58.8093	***6.85
ΔTRS	-18.2960	-1.01	-17.9035	-0.99
ΔROA	1.6451	1.49	1.6486	1.49
ΔRISK	0.0000	***4.12	0.0000	***4.16
ΔVARROA	-0.2094	-0.80	-0.2149	-0.82
ΔCONSTRAINT	-57.1407	-1.11	-55.0935	-1.07
ΔFCF	0.0579	0.20	0.0491	0.17
ΔBKM	12.3386	1.55	12.0442	1.51
IND		NR		NR

Notes:
*** denotes significance at $p < 0.01$.
Where DUM3 is an indicator variable that takes the value of 1 if the executive is defined as affected (i.e., DUM2=1) and the firm has qualified its short-term bonus plan and all other variables are defined at the bottom of table 3.
The symbol Δ in a variable name denotes a change in the value of the variable from the last year pre-section 162(m) to the first year post-section 162(m). For December fiscal year end companies, the last year prior to (first year after) section 162(m) would be 1993 (1994), while for non-December fiscal year end companies, the last year prior to (first year after) section 162(m) would be 1994 (1995).
We omit the coefficients for the industry dummies for brevity.

Model (2): Substitution Effect

Table 7 presents the results of the analysis of model (2). The model without the qualification variable is presented to serve as a baseline. The coefficients on ΔSAL and ΔBONUS are positive, indicating that the change in option compensation is positively associated with the change in salary and bonus compensation. Interestingly, while the coefficient on the change in bonus (0.9531) is significantly greater than zero, it is insignificantly different from one. This indicates a one dollar increase in bonus is associated with a one dollar increase in option compensation. In contrast, the coefficient on the change in salary (73.0343) is significantly greater than one, indicating a one dollar increase in salary is associated with a 73 dollar increase in option compensation. The coefficient on DUM2 is positive and significant, indicating an increase in option compensation independent of any other changes in the compensation package for affected executives. The coefficient on ΔSAL*DUM2 (12.1554) is significantly greater than zero, while that on ΔBONUS*DUM2 (-0.883) is significantly less than zero. The former indicates the multiplier on a dollar increase in salary increases from 73.0343 for unaffected executives to 85.1897 for affected executives, and is consistent with firms substituting larger increases in stock options for increases in salary for affected executives. The latter indicates the coefficient on bonus for affected executives, the sum of 0.9531 and -0.8883, is insignificantly different from zero, i.e., there is no relation between the change in bonus and the change in options in affected firms.

The results of the regression including the qualification variable (DUM3) are in the right most columns of table 7. As with the first regression in table 7, the coefficients on ΔSAL, ΔBONUS, DUM2, and ΔSAL* DUM2, are positive and the coefficient on ΔBONUS *DUM2 is negative. The magnitudes, as well as the interpretations, of the coefficients are almost identical to those in the earlier model. Of the additional variables, the coefficient on DUM3 is positive, but insignificant, while the interaction, ΔBONUS* DUM3, is positive and significant. The latter, when summed with the coefficients on the level variable, ΔBONUS, and the interaction, ΔBONUS*DUM2, is also positive and significant, indicating that for affected executives at firms which qualified their annual bonus plans, there is a positive and significant association between the change in bonus and change in option compensation.

The association between change in option compensation and change in bonus is positive and significant, and the coefficient is insignificantly different from one for unaffected executives and affected executives in firms with qualified annual bonus plans. This is consistent with both bonuses and option grants varying with performance, i.e., assuming that bonuses are based upon performance, which seems reasonable for at least the firms with qualified bonus plans. In contrast, when the firm has not qualified its bonus plan, the association between the change in option compensation and the change in bonus is insignificantly different from zero. That is, for affected executives, changes in options appear to be independent of changes in bonuses. There is no evidence that firms substitute options for bonuses.

SUMMARY

This paper extends the prior research on the effect of section 162(m) on executive compensation by focusing on the use of stock options. The congressional intent of section 162(m) was to strengthen the relationship between executive compensation and firm performance. As a consequence, the section tends to favor stock option compensation relative to other forms of compensation. Under 162(m), when compensation is in excess of the million dollar limit, additional salary is not deductible and firms must put bonus compensation at risk for the bonus to qualify as

deductible. This is a significant change from most firms' practices in previous years. In contrast, section 162(m) required little or no change in compensatory stock option plans because such plans generally met the definition of 'performance-based' under section 162(m). Section 162(m), thus increased the risk of annual cash bonuses relative to option compensation. The results of this study provide evidence that section 162(m) has led to increases in the use of stock options by affected firms, presumably to maximize their deductible compensation. In addition, there is evidence of a substitution effect for salary increases for affected executives, but no evidence for annual cash bonuses.

There is a growing recognition that section 162(m) spurred the increase of stock option compensation, but also that such compensation has lead to some significant unintended consequences. For example, recent empirical work demonstrates a linkage between earnings manipulation and the use of executive stock option compensation (e.g., Burns and Kedia, 2006; Bergstresser and Philippon, in press). The Financial Economists Roundtable (2003, 5) believes that section 162(m) "is a clumsy attempt to regulate the level and structure of executive compensation" and has called for its repeal. Thus, while firms and their executives are acting in a way consistent with the incentives of section 162(m), those actions may not be as originally intended by Congress.

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Notes

[1] Both Matsunaga (1995, note 6) and Murphy (1998) find about 95 percent of corporations granting options with an exercise price equal to grant-date fair market value .

[2] As noted in the sensitivity analysis, the dependent variable is alternatively defined (1) as the Black-Scholes value of options granted divided by total cash compensation, (2) as the un-deflated Black-Scholes value of options granted, and (3) as the number of options granted, with no change in results.

[3] Cash compensation is used rather than total compensation to define affected executives following the previous literature, e.g., Perry and Zenner (2001), Balsam and Ryan (2004), Balsam and Yin (2005). The cutoff of $900,000 avoids missing firms that reduced compensation because of section 162(m). The results are not affected by the use of other cutoffs, i.e., $950,000 or $1,000,000. In addition, the results are qualitatively the same if salary or total direct compensation is used to define affected executives. Consequently, while the choice of affected executives could potentially bias the results, the fact that the results are robust to alternative cutoffs and ways of measuring affected executives provides reassurance that this is not the case.

[4] Rank 5 is incorporated into the intercept. The results are the same if rank 1 is the intercept.

[5] The conclusions remain when other performance measures are used instead of ROA.

[6] The year 1993 is incorporated into the intercept. The results are the same if 2002 is used as the intercept.

[7] While the bonus has to be based on objective performance measures, there is no requirement that these measures be accounting based.

[8] The current level of executive rank is included as an independent variable because the rate of compensation change can differ across executive ranks, and the change in executive rank is included as

an additional independent variable because a promotion (or demotion) will affect the rate of compensation change.

[9] Information on each executive's prior year stock and option holdings is needed to compute the variable, VALUE. Consequently, observations are lost in those instances where prior year information on the executive's holdings is not available because the executive was not a listed officer in the company in the prior year.

[10] The difference between the 62 percent reported here and the 44 percent reported in Core and Guay (1999) is driven by the decision to classify those firms that do not pay dividends or repurchase shares as constrained. If such firms are reclassified as unconstrained, the percentage of firms classified as constrained drops to 47 percent. Most importantly, reclassifying those firms does not affect the results.

[11] Recall that in the model, this period's equity compensation is based in part, on the equity and option holdings at the end of the period, i.e., VALUE is lagged, causing the loss of the earliest year for which data is available.

[12] One advantage of incorporating 1992 into the analysis is that the percentage of the observations in the pre section 162(m) period increases from 11.42 percent to 18.90 percent of the sample.

[13] The coefficient on VALUE is insignificant and does not affect the significance of the coefficients on any of the other variables in the model.

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ELSEVIER Journal of Accounting and Public Policy 24 (2005) 300–324
Journal of Accounting and Public Policy
www.elsevier.com/locate/jaccpubpol

Explaining firm willingness to forfeit tax deductions under Internal Revenue Code Section 162(m): The million-dollar cap

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Abstract

We examine firms' willingness to forfeit tax deductions in response to Internal Revenue Code Section 162(m). Using a sample of firms over the five-year period subsequent to the effective date of Section 162(m), we find firms forfeit deductions in almost 40% of firm year observations. In particular we find that firms with higher recontracting costs are more likely to forfeit deductions, while firms with higher tax benefits and political costs are more likely to fully preserve deductions. In documenting the willingness of corporations to forfeit deductions,we add to the body of evidence that suggests Section 162(m) is not totally successful in using tax policy to curb executive pay.
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Keywords: IRC Section 162(m); Executive compensation; Tax deductibility; Costs and benefits

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doi:10.1016/j.jaccpubpol.2005.05.003

1. Introduction

The Revenue Reconciliation Act of 1993 added Internal Revenue Code Section 162(m), limiting the corporate tax deduction for executive compensation to $1 million per individual for the top five executives of a corporation, providing an exception for compensation in excess of $1 million if it qualifies as "performance-based". Balsam and Ryan (1996) and Johnson et al. (2001) examine the propensity of firms to qualify their compensation plans to meet this performance-based exception. The assumption underlying their studies is that firms that qualify their compensation plans preserve tax deductions, while those that do not qualify forfeit deductions. In reality neither need hold.

It is possible for a firm to modify one or more components of its compensation package and still forfeit tax deductions. This can occur for at least three reasons. The first reason is that firms pay salary, which by definition cannot be linked to performance, in excess of $1 million. The second reason is that firms modify some, but not all components of the compensation package, and consequently lose tax deductibility for a non-modified component. An example is Caterpillar, which qualified its long-term, but not short-term plans. Because salary plus short-term bonus exceeded $1 million from 1995 through 1998, it lost deductions each year. The final reason is that although firms modify a particular compensation plan to meet the requirements of Section 162(m), they elect to pay amounts not authorized by the plan or otherwise do not follow the requirements of Section 162(m). An example is RJR Nabisco, which had a qualifying short-term plan, but during 1998 changed the parameters mid-year, with the result being payments from the plan did not meet the performance-based exception under Section 162(m).[1] Of the 151 firm-year observations in our sample in which we note that firms forfeited deductions, 135 or 90% occurred even though the firms had qualified one or more of their plans.

Similarly, it is possible for a firm not to formally link pay to performance yet preserve deductions by reducing compensation and/or deferring otherwise non-deductible compensation to a future period when the individual involved is no longer one of the top five executives of the corporation. An example is Goodyear Tire & Rubber, which in its proxy statement dated February 28, 1995 stated "Any compensation which would be subject to the Section 162(m) limitation has been or will be automatically deferred until the payment of such compensation would be deductible by the Company". Consequently, while modification of compensation plans does not guarantee that the firm will

[1] To qualify for the performance-based exception under Section 162(m), plan parameters must be set at the beginning of the year. See Drucker (2004) for more examples of companies changing plan parameters once the year has begun.

preserve full deductibility, failure to modify does not necessarily mean it will forfeit deductions.

This paper extends the prior research on the effect of Internal Revenue Code Section162(m) on executive compensation by looking not at the decision to qualify, but whether or not firms actually forfeit deductions as a result of the section. We feel that examining the actual tax status of compensation is important as it more accurately describes firms' responses to Section162(m) and tells us whether Section 162(m) achieved its stated goals. For example, prior research by Westphal and Zajac (1994) suggested that corporations may adopt incentive compensation plans for symbolism rather than substance. Our finding of some forfeiture in almost 40% of firm year observations, combined with our observation that the vast majority of those firms adopt one or more qualifying plans, adds to the evidence that Section 162(m) is not totally successful in using tax policy to curb executive pay, and is consistent with those plans being adopted, in part at least, for symbolic purposes.

Our other contribution is that we investigate firm characteristics that explain the decision to forfeit or preserve tax deductions. We provide detailed descriptions of the tax deductibility of compensation, firms' actions to preserve that deductibility, and types of plans qualified. While firms disclose in their proxy statements whether or not they forgo tax deductions, they are not required to reveal the source, nor the amount of those forgone amounts. Thus, while we observe that compensation is not fully deductible, we do not know the amounts lost. We find that firms with higher recontracting costs, i.e., larger amount in question, measured as the sum of amounts exceeding $1 million for the top five executives, more affected executives under Section 162(m), and a riskier business environment, are more likely to forfeit tax deductions for executive compensation. In contrast, consistent with firms being responsive to their political costs, we find that firms are more likely to claim full deductibility and thus preserve tax deductions for compensation when firm size is larger and CEO compensation is high relative to performance. We also find that firms are more likely to claim full deductibility when the tax benefit is greater, when CEO tenure is lengthy, when the firm has taken steps to qualify their short-term bonus plans, when the firm reports that executives have deferred portions of their salary and/or bonus, and when the firm reports higher ROA. Surprisingly we find that firms that have qualified their stock option plans are more likely to forfeit tax deductions. In general our findings are consistent with firms trading off the benefits of preserving deductions against the costs of doing so.

This study continues in Section 2 with a discussion of Section 162(m), and a review of the relevant literature in Section 3. Section 4 develops our hypotheses, while Section 5 elaborates on the empirical model. Section 6 discusses our sample selection. Section 7 presents the empirical results explaining the willingness of firms to forfeit deductions. Section 8 contains sensitivity tests, and the findings of the study are summarized in Section 9.

2. Section 162(m)

Internal Revenue Code Section 162(m) was a response to the concern about the perceived link between the international competitiveness of United States industries and the substantial salaries paid to United States executives (Brownstein and Panner, 1992). Critics (e.g., Crystal, 1992; McCarroll, 1993) argued that executive compensation was excessive, in comparison to that paid to lower level employees and that paid to overseas executives, and that executives were setting their own pay with no shareholder input. Congress believed that this provision (Section 162(m)) would reduce excessive, non-performance based compensation (US Congress, House, 1993).

Section 162(m) places a $1 million cap on the annual deduction for compensation to the chief executive officer (hereafter CEO) and the next four highest compensated officers. Executive compensation generally consists of salary, fringe benefits, annual cash incentives, and long-term cash or stock-based incentives. The Section 162(m) limit does not apply to (1) commissions, (2) non-taxable fringes and qualified retirement plan contributions, and (3) performance-based compensation.

Prior to the imposition of Section 162(m), most firms claimed to tie compensation to performance, however compensation committees had substantial discretion. Under Section 162(m), to qualify for the performance-based exception, firms must develop a performance-based compensation plan that is based on the executive's attainment of one or more performance goals that are established ex ante by a compensation committee composed of independent directors. The performance goals must be based on objective formulae and the material terms of the plan must be disclosed to and approved by shareholders. The compensation committee, which has the discretion to award less, but not more than the objectively determined amount, must certify that the performance goals have been met before payment is made. Any compensation awarded by the committee in excess of the objectively determined amounts does not qualify.

By definition, salary will not qualify as performance-based since it is not contingent on the attainment of any criteria. Thus, any salary amounts earned in excess of $1 million are not deductible unless payment is deferred until after the executive's retirement or unless paid under a contract executed prior to February 17, 1993.[2] Annual cash bonuses will qualify under the performance-based exception if the firm adopts a bonus plan consistent with the Section 162(m) requirements discussed above. Employee stock options qualify as performance-based under Section 162(m) if the options have exercise prices equal to or greater than the market price at the time the award is made and

[2] We find 16 firm-year (out of a total of 397) observations with salaries that are grandfathered.

the plan states the maximum number of shares that can be granted during a specified period.

3. Literature review

There is a growing body of research that shows Section 162(m) has had some impact on firms' compensation practices, albeit perhaps not the intended impact. For example, Balsam and Ryan (1996) examined the propensity of firms to qualify their short-term bonus plans to meet the requirements of Section 162(m), finding that many firms were sensitive to the potential tax and political costs of not qualifying. However, they showed firms more likely to qualify were those that had already tied compensation to performance—a formalization of existing policy. Further, approximately half of the firms in their sample chose not to qualify, and many of those that did conform expressly reserved their right to pay non-deductible compensation. Reitenga et al. (2002) noted that since qualifying plans reduces compensation flexibility, some firms were willing to give up the tax deductions to retain flexibility in their bonus plans. They observed that many firms elected not to qualify their compensation plans on the grounds that executive performance could not be evaluated using a fixed formula and that reserving the use of discretion in determining executive pay was in the best interest of the firm. They found that when firms qualified their bonus plans, extreme firm performance resulted in lower CEO bonus payments relative to CEO bonus payments in firms that did not qualify their plans.

Johnson et al. (2001), Perry and Zenner (2001), Balsam and Ryan (2001), and Balsam (2002) examined affected firms and found that all components of the compensation package increased after 1993, with the largest increase coming in the form of stock option grants. The finding that compensation increased post Section 162(m) is consistent with the theoretical predictions of Halperin et al. (2001), i.e., compensation will increase to compensate risk-averse executives for bearing additional risk. Harris and Livingstone (2002) examined firms whose CEOs earned less than $1 million, the "unaffected firms," and found Section 162(m) had the perverse effect, because it set a target, of raising the compensation of those CEOs.

While research shows that Section 162(m) has not led to a reduction in executive compensation, there is some limited (and mixed) evidence that compensation has become more responsive to firm performance. Examining the sensitivity of pay to performance, Johnson et al. (2001), Perry and Zenner (2001), and Balsam and Ryan (2001) all found some evidence of an increased sensitivity of compensation to performance after 1993. While Johnson et al. (2001) did not attribute this increased sensitivity to Section 162(m), Perry and Zenner (2001) did, "especially for firms with million-dollar pay packages." Similarly, Rose and Wolfram (2000, p. 201) provided some evidence that the

162(m) limit "has led firms near the $1 million cap to restrain their salary increases and perhaps to increase the performance components of their pay packages". However in a later paper Rose and Wolfram (2002, p. S138) concluded "There is little evidence that the policy significantly increased the performance sensitivity of chief executive officer (CEO) pay at affected firms. We conclude that corporate pay decisions have been relatively insulated from this policy intervention".

None of the prior studies have examined the tax consequences *directly*, i.e., whether or not corporations actually forfeit tax deductions. Prior studies assume that by qualifying compensation plans, firms will meet the deductibility requirements. However, as discussed above, a firm may qualify one or more components of the compensation package without preserving the full tax deductibility of compensation, or alternatively, they may preserve deductibility without qualifying. By identifying the actual tax status of executive compensation, we can investigate determinants of firms' decisions to forgo tax deductions and evaluate the effect of Section 162(m) on compensation practices more accurately.

4. Development of hypotheses

We begin by developing a model using contracting and political costs to explain firms' willingness to forfeit deductions.[3] As with all decisions, the firm, or more importantly, the decision makers in the firm, trade off the benefits of preserving deductions against the costs of doing so. The benefits of preserving deductions include the tax savings, which we estimate averages a little less than $300,000 per firm-year (see Table 5), as well as a reduction in the political costs of the executive and firm. The costs include the costs of rewriting executive compensation contracts, costs of seeking shareholder approval of performance-based compensation plans,[4] the adverse effect on firm value of the changed incentives of the executives involved,[5] and paying additional compensation to compensate those executives for additional risk. In theory, each firm will modify its compensation contracts up to the point where the benefits equal the costs. For some firms this may mean no modification at all, i.e., they forfeit

[3] Section 162(m) increases monitoring by increasing the visibility of compensation with both shareholders and directors. With the former it increases visibility by forcing additional votes and disclosures. With the latter it increases visibility and oversight as they are forced to set goals at the beginning of the year and certify that the goals are met in order for compensation to meet the performance-based exception. However identifying a proxy for the increased level of monitoring associated with Section 162(m) may not be possible.

[4] To meet the Section 162(m) requirements firms must obtain director and shareholder approval of the compensation plan.

[5] The assumption is that the unconstrained contract is optimal from the view of the firm.

all non-performance-based amounts in excess of $1 million per executive; for other firms this may mean modification to preserve all deductions; and for a third group of firms this may mean modification to preserve some but not all deductions.

4.1. Contracting costs

The amount in question, i.e., excess of compensation over $1 million for executives covered under the section, should influence a firm's willingness to forfeit deductions, as the larger the amount in question the greater the tax benefit of modifying executive compensation. However, the larger the amount in question, and/or the greater the number of executives involved, the costlier it is to restructure the compensation contract in a way that preserves its goals, e.g., incentives, without changing the risks to the executives.

Contracting costs include the opportunity cost of the executive time involved and the cash outflow to lawyers and compensation consultants to rewrite/renegotiate contracts, the negative effects on incentives from moving to a less optimal contract, and the additional compensation, if any, required by the executive to compensate him/her for additional risk. While the costs of rewriting/renegotiating the contract may contain a fixed component, they should increase with the value of the contract as more resources will be devoted to, for example, renegotiating a $5 million contract with $4 million of deductions at stake than a $2 million contract with $1 million of deductions at stake. Similarly, the other costs will increase as the excess of compensation over $1 million increases. For example, assuming the executive needs to be compensated for additional risk, if restructuring the contract to preserve deductions increases the executive's risk, in equilibrium additional compensation is required. This additional compensation required should increase with the magnitude of compensation that is put at risk (amount over $1 million). While we expect each of the costs to increase with the amount involved, we cannot specify the shape of the curve, i.e., whether the increase will be linear or nonlinear.

If the costs (benefits) exceed the benefits (costs) the firm will forfeit (preserve) the deduction. However, a firm need not forfeit or preserve all deductions. Rather the firm would modify its compensation package till the point where the costs exceed the benefits. For example, it is relatively low cost for a firm to modify its stock option plans to qualify for deductibility under Section 162(m) without affecting executive incentives or risk. So a firm might choose to modify its stock option plan but not its bonus plan.[6] Similarly, if

[6] Consistent with this, Table 4 shows that even among firms that forfeit deductions, almost all modify their stock option plans while fewer modify their short-term bonus plans.

the amounts involved are relatively small, the contract can be reconfigured with minimal effect on incentives and minimal additional risk imposed upon the executive, making modification likely. However as the amounts involved increase, redesigning the contract without changing executive incentives or imposing additional risk on the executive is unlikely. Overall we expect the likelihood of forfeiture to be positively related to the excess amount. Hypothesis 1 is then:

H1. As the excess of cash compensation over $1 million increases so does the likelihood of the firm forfeiting deductions.

We also examine the effect of the number of affected executives, i.e., executives earning more than $1 million in cash compensation, on the decision to forfeit. As the number of affected executives increases, so does the cost of rewriting contracts, and hence contracting costs. While this relationship need not be linear as there are economies of scale in rewriting contracts, the cost of rewriting two contracts always exceeds the costs of rewriting one, etc. This leads to our second hypothesis:

H2. As the number of executives earning more than $1 million in cash compensation increases so does the likelihood of the firm forfeiting deductions.

Prior literature has shown that firm risk affects both executive compensation (Aggarwal and Samwick, 1999; Core et al., 1999; Smith and Watts, 1992), as well as executive decision making. To meet the requirements of Section 162(m) and preserve deductions for executive compensation, firms need to tie compensation to performance. However as firm risk increases, executives are less willing to take variable performance-based compensation in place of fixed compensation. Or to put it another way, as firm risk increases, the amount of performance-based compensation the firm must offer in place of fixed compensation increases. Once again, while we expect a positive relation between firm risk and the additional compensation required, we cannot specify the shape of the relation, i.e., whether it is linear or nonlinear. However the greater the amount of additional compensation required the more likely the costs of preserving the deductions will exceed the benefits. Hence the likelihood of firms' forfeiting deductions increases with firm risk. Our third hypothesis is:

H3. As firm risk increases, so does the likelihood of the firm forfeiting deductions.

Age and tenure affect both executive compensation (Gibbons and Murphy, 1992; Lewellen et al., 1987) and executive decision making (Dechow and Sloan, 1991). Consequently it is possible they will affect the decision to forfeit deductions, although not necessarily in the same direction. In particular, as age

increases and the executive approaches retirement, the cost/risk to the executive of deferring otherwise non-deductible compensation decreases. Alternatively as tenure, which is highly correlated with age, increases the firm may be more likely to forfeit deductions by not recontracting. This can occur for at least two reasons. First, as the CEO gets closer to retirement, the fixed costs of recontracting are more likely to exceed the present value of the future tax benefits. Alternatively, and not mutually exclusive, as tenure increases the CEO may become more entrenched, e.g., because he or she has appointed a majority of the board of directors. Thus while we believe age and tenure affect the forfeiture decision, we cannot say which effect will predominate. This leads to our fourth hypothesis:[7]

H4. Age and tenure will affect the likelihood of the firm forfeiting deductions.

4.2. Political costs

We expect the disclosure that the firm forfeits tax deductions because of executive compensation will result in political costs to both the firm and executive.[8] Consequently, the political costs of the firm and the executive may influence decisions with respect to Section162(m). Balsam and Ryan (1996) found that larger, more politically sensitive firms were more likely to qualify in an attempt to avoid increased political costs. However, as shown by Balsam (2002) among others, compensation increases with firm size. As noted above, as compensation increases, it becomes harder and more costly to restructure contracts to preserve incentives and thus larger firms may be more likely to forfeit deductions. Thus while we include firm size as our proxy for the political costs of the firm, we do not predict its effect on the likelihood of forfeiture. Our fifth hypothesis is:

H5. Firm size affects the likelihood of the firm forfeiting deductions.

Balsam and Ryan (1996) also found that firms where CEOs were overpaid relative to performance were also more likely to qualify. CEOs receiving excessive compensation fear shareholder dissatisfaction over their pay and/or demands from the government for increased taxation. Further, excessive

[7] Because the two variables are so highly correlated (Pearson correlation coefficient is 0.546) we combine them into the same hypothesis.

[8] We expect there will be a cost to disclosing that the firm has forfeited deductions, as well as a variable cost that would increase with the amount forfeited. However, while we expect political costs to increase with the amount forfeited, as discussed above, we are unable to identify that amount, as are presumably shareholders and other constituencies of the corporation.

executive compensation may lead to demand from labor for higher wages (Hill et al., 2002). However, as pay and performance get further out of line, the cost of conforming to Section 162(m) increases (note that Balsam and Ryan, 1996, found that firms most likely to conform were those that already tied pay to performance). Consequently, while we expect the degree to which a firm's CEO[9] is overpaid relative to his/her peers will affect the decision to forfeit, we do not make a prediction as to the sign of the coefficient. Formally the sixth hypothesis is:

H6. The degree to which the firm's CEO is overpaid will affect the likelihood of the firm forfeiting deductions.

5. Model

5.1. Test variables

To test hypothesis 1, we calculate Log(EXCESS), the natural logarithm of the amount of cash compensation over $1 million summed over the top five executives (those covered by Section 162(m)). We expect the probability the firm forfeits deductions will increase with Log(EXCESS). To test hypothesis 2, we use NUM, the number of executives earning more than $1 million in cash compensation. We expect the probability the firm forfeits deductions will increase with NUM. To test hypothesis 3, we measure risk (RISK) as the standard deviation of stock returns over the prior five years as in Core et al. (1999). We expect the probability the firm forfeits deductions will increase with RISK.

As discussed above, we use two variables, age and tenure to test hypothesis 4. Since age and tenure are highly correlated, to mitigate the effect of that correlation on the regression, rather than define age as a continuous variable, we define it as a discrete variable. To do so we use AGE_D, a variable that takes the value of 1 if the CEO is 64 or 65 and zero otherwise, as in Murphy and Zimmerman (1993). TENURE is measured as the number of years the CEO has been in his/her job. We do not have a directional expectation as to the effect of AGE_D and TENURE on the probability of forfeiture.

To test hypothesis 5, we use Log(ASSETS), measured as the natural logarithm of the firm's total assets. To test hypothesis 6, we use RESIDUAL, the degree to which a firm's CEO is overpaid. We use the residual from a

[9] While Section 162(m) applies to the CEO and the next four highest paid employees, we focus on the CEO for the following reasons. First the CEO is the most visible person in the company, i.e., among other things it is his/her compensation that is reported in the surveys by business publications. Hence it is the political costs of the CEO that matter most. Second, the CEO is usually the highest paid executive and in most of our sample companies the CEO is the only executive who makes more than $1 million in cash compensation (see Table 5), so we believe if the company does forfeit deductions, it will be because of the CEO.

cross-sectional regression of cash compensation on the economic determinants of compensation identified in Core et al. (1999) as RESIDUAL:

$$\mathrm{Log(TCC)}_i = a + b_1\mathrm{ROA}_i + b_2\mathrm{Log(ASSETS)}_i + b_3\mathrm{MTB}_i + b_4\mathrm{RET}_i + b_5\mathrm{STDROA}_i + b_6\mathrm{STDRET}_i + e_i \quad (1)$$

where Log(TCC) is the natural logarithm of total cash compensation; ROA, return on assets; Log(ASSETS), the natural logarithm of total assets at the beginning of the year; MTB, market-to-book value of assets; RET, raw stock returns; STDROA, standard deviation of annual ROA for the past five years; STDRET, standard deviation of raw returns for the past five years; e, the error term; and i represents firm.

This model is estimated cross-sectionally for the year 1993 to remove the effects of the tax law change. The error term (RESIDUAL) represents the CEOs' over/under payments of cash compensation compared to their peers. We do not have a directional expectation as to the effect of Log(ASSETS) and RESIDUAL on the probability of forfeiture.

5.2. Control variables

In addition to using variables to proxy for the effects hypothesized above, we include additional variables in our model to control for other reasons a firm may forfeit deductions. As discussed above, while qualifying their compensation plan may be an indication that the firm will be paying deductible compensation, it does not guarantee that the firm will not forfeit deductions. If a firm qualifies its plan and does not meet the performance goals set forth in the plan, it may elect to pay non-deductible compensation. Alternatively, a firm may qualify one or more plans for political purposes only, i.e., not to preserve the tax deductions but to minimize political costs. Still we expect that firms that qualified their plans will be less likely to forfeit deductions. Consequently we include as independent variables, two indicator variables that take the value of 1 if a firm qualifies its short-term bonus (QSTB) or option plan (QOPT), and zero otherwise.[10]

Also as discussed above, a firm may elect not to qualify its plan(s) and yet retain deductibility via deferral of all otherwise non-deductible amounts. Consequently we include an indicator variable that takes the value of 1 if the firm discloses that compensation is deferred(DEFER) and zero otherwise.[11]

[10] Balsam (2002) shows that about 80% of firms pay short-term bonuses to their CEO in a given year, with a similar percentage granting the CEO stock options. In contrast about 20% pay long-term bonuses or grant restricted stock. Thus the focus is on firms that qualify their short-term bonuses and option plans.

[11] More precisely we look for evidence of deferral of salary and/or bonus and not merely deferrals via retirement plans.

We include the return on assets (ROA) as a measure of firm performance. Performance can directly influence the deductibility of compensation via the qualified plans, or indirectly, via the political process. That is, the better performance, the more likely compensation will be exempt under shareholder-approved plans, and hence the less likely the firm is to forfeit deductions.

The firm's estimated tax savings from complying are also an explanatory variable. As the firm's tax rate increases, forfeiting deductions becomes more costly. Thus, we expect that the higher the amount involved the less likely the firm is to forfeit deductions. We define Log(TAXBEN) as the natural logarithm of the product of EXCESS and (1 + MTR),[12] where MTR is simulated marginal tax rates as calculated in Graham (1996).[13]

Insider ownership has been shown to affect both compensation (Beatty and Zajac, 1994; Core et al., 1999; Cyert et al., 2002) and decision making. Jensen and Meckling (1976) show that as their ownership increases, managers are more likely to behave like owners. Consequently as insider ownership increases we predict firms will be less likely to forfeit deductions. We measure insider ownership (INSIDEOWN) as the percentage of shares owned by officers and directors.

5.3. Model

Given that the dependent variable is discrete,[14] we use a logistic regression to explain the choice. Our formal model, which includes variables to test the hypotheses above, plus the control variables, is

$$\begin{aligned}\text{FORFEIT}_{it} = {} & \alpha_0 + \alpha_1 \text{Log}(\text{EXCESS})_{it} + \alpha_2 \text{NUM}_{it} + \alpha_3 \text{RISK}_{it} \\ & + \alpha_4 \text{AGE_D}_{it} + \alpha_5 \text{TENURE}_{it} + \alpha_6 \text{Log}(\text{ASSETS})_{it} \\ & + \alpha_7 \text{RESIDUAL}_{it} + \alpha_8 \text{QSTB}_{it} + \alpha_9 \text{QOPT}_{it} \\ & + \alpha_{10} \text{DEFER}_{it} + \alpha_{11} \text{ROA}_{it} + \alpha_{12} \text{Log}(\text{TAXBEN})_{it} \\ & + \alpha_{13} \text{INSIDEOWN}_{it} + \varepsilon_{it} \qquad (2)\end{aligned}$$

where FORFEIT is coded 1 if the firm forfeits *any* deductions because of Section 162(m) and 0 if compensation is fully deductible.

[12] We use 1 + MTR to avoid taking the log of zero which is undefined, i.e., when MTR is zero.

[13] Graham (1996) extends "Shevlin (1990), who simulates marginal tax rates over a forecasted stream of taxable income to account for the carryforward and carryback tax opportunities related to net operating losses" by incorporating "the effect of investment tax credits and the alternative minimum tax." We thank John Graham of Duke University for providing tax rates calculated using his formulation. Our results do not change if we use an indicator variable for whether or not the firm has a net operating loss carryforward in place of Graham's marginal tax rate.

[14] As explained before, firms only disclose whether compensation expense is deductible or not and are not required to disclose the amount of forfeiture in their proxy statements.

6. Sample selection

We first identified a sample of affected firms. Affected firms are those that paid at least one of their top five executives more than $1 million in cash compensation (they are affected because, unless they meet certain conditions, they will not be able to deduct amounts in excess of $1 million). We focus on cash compensation because, as discussed in detail in Balsam and Ryan (2001), cash compensation is most affected by the deduction limitation in Section 162(m). We searched the 1999 ExecuComp database and identified firms that paid one or more executives at least $1 million in cash compensation in a previous year.[15] Requests were mailed to these corporations asking for proxy statements for the fiscal years 1994 through 1998. A random selection of the proxies received were coded and examined in detail.[16] As described in Table 1, this sample was further reduced by the elimination of firm year observations where cash compensation is less than $1 million;[17] firm year observations where CEO compensation represents less than a full year, for example, the CEO is appointed in the middle of the year; firm year observations where we cannot determine whether compensation is fully deductible or not; firm-year observations where firms did not disclose their qualifying decisions; and firm year observations with insufficient data on COMPUSTAT.[18] Our final sample size is 119 firms and 397 firm year observations.

Table 2 provides information, by year, firm, firm size, and level of compensation, on the decision to forfeit or preserve full deductibility of executive compensation. Overall, firms report that compensation is fully deductible in 62% of firm year observations, with this percentage trending downward slightly over the time period examined (Panel A). As might be expected, the percentage of firms reporting that compensation is fully deductible decreases with firm size (Panel C) and the level of compensation (Panels D and E). Of the firms that claim full deductibility, Table 3 shows that 78% do so by qualifying their plans, 1% by deferring compensation, and 15% by a combination of the two.[19]

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[15] ExecuComp coverage begins in 1992.

[16] We acknowledge that relying on firms to mail us proxies potentially biases our results. We did so because of one author's preference for working with hard copies, which partially arose because of the problems of accurate text/table alignments in 1990s filings. Using Compustat we were able to examine the financial performance of the firms which responded and those that did not, and found no significant difference between the two groups.

[17] Theoretically a firm could cut compensation to preserve deductions. The effect may be to bias our results by excluding firms that decreased cash compensation to preserve deductions. To examine this possibility, in our sensitivity analysis we include firm year observations with cash compensation as low as $900,000. Our results do not change.

[18] We collect data from proxy statements, Compustat, ExecuComp, and Compact Disclosure.

[19] These numbers do not add up to 100% because for 6% of firms we cannot determine why compensation is fully deductible given information disclosed in company proxy statements.

Table 1
Sample selection

	Firm-year observations
Full sample (1994–1998)	660
Proxy statements unavailable	(1)
Missing ExecuComp data	(15)
Cash compensation < 1 million	(161)
Partial-year compensation data	(22)
Deductibility of compensation cannot be determined	(4)
Qualifying decisions cannot be determined	(59)
Missing financial data	(1)
Final sample (119 firms)	397

Table 2
Deductibility of executive compensation

Panel A: By year

Year	Forfeit		Fully deductible		Total	
	n	%	*n*	%	*n*	%
1994	18	37	31	63	49	100
1995	23	35	43	65	66	100
1996	30	35	56	65	86	100
1997	43	41	62	59	105	100
1998	37	41	54	59	91	100
Total	151	38	246	62	397	100

Panel B: By firm

	n	%	*n*	%
Never forfeit			60	50.4
Forfeited				
Once	15	12.6		
Twice	19	16.0		
Three times	10	8.4		
Four times	7	5.9		
Five times	8	6.7		
			59	49.6
Total firms			119	100

Panel C: By firm size

Assets	Forfeit		Fully deductible		Total	
	n	%	*n*	%	*n*	%
Under $5 billion	60	34	117	66	177	100
$5–15 billion	55	38	89	62	144	100
Over $15 billion	36	47	40	53	76	100
Total	151	38	246	62	397	100

(*continued on next page*)

Table 2 (*continued*)

Panel D: By total cash compensation

Amount	Forfeit		Fully deductible		Total	
	n	%	*n*	%	*n*	%
1,000,000–1,999,999	96	33	195	67	291	100
2,000,000–2,999,999	24	39	38	61	62	100
3,000,000–3,999,999	15	60	10	40	25	100
4,000,000–4,999,999	12	86	2	14	14	100
5,000,000 and above	4	80	1	20	5	100
Total	151	38	246	62	397	100

Panel E: By total compensation

Amount	Forfeit		Fully deductible		Total	
	n	%	*n*	%	*n*	%
1,000,000–1,999,999	28	37	48	63	76	100
2,000,000–2,999,999	37	36	65	64	102	100
3,000,000–3,999,999	17	29	41	71	58	100
4,000,000–4,999,999	8	18	36	82	44	100
5,000,000 and above	61	52	56	48	117	100
Total	151	38	246	62	397	100

Table 3
Details of responses to Section 162(m) by firm-years with fully deductible executive compensation

Responses	*n*	%
Qualification	191	78
Deferral	2	1
Both qualification and deferral	38	15
Cannot be determined	15	6
Total	246	100

As shown in Table 2, in 38% of firm years, firms choose to forgo tax deductions associated with executive compensation. A total of 59 different firms, or almost exactly 50% of our sample, forfeit deductions in one or more years, with 15 firms forfeiting once, 19 firms forfeiting twice, 10 firms forfeiting three times, seven firms forfeiting four times, and eight firms forfeiting in all five years (Panel B).

Table 4 provides some analysis of firm year observations in which compensation is not fully deductible. Of the 151 firm year observations in which firms

Table 4
Details of firm-years in which firms forfeit executive compensation

	n	%
Panel A: Salary		
Salary > $1 million	53	35
Salary ⩽ $1 million	98	65
Total	151	100
Panel B: Firm responses to Section 162(m)		
Qualification	131	87
Deferral	2	1
Both qualification and deferral	4	3
Cannot be determined	14	9
Total	151	100
Panel C: Types of plans qualified (total firm-years with qualified plans = 131)		
Short-term bonus	53	40
Long-term bonus	101	77
Stock options	127	97
Restricted stock	99	76

forfeit deductions, in 35% of the cases, salary alone exceeds $1 million.[20] Surprisingly, 87% (131 of 151) of forfeiting firms qualify one or more of their plans, although upon further analysis, only 40% (53 of 131) of those qualify their short term bonus plans whereas 97% (127 of 131) qualify their option plans. 35 of the 53 firms that qualify their short-term bonus plans yet report non-deductible compensation pay their CEO salary in excess of $1 million, which may explain why their compensation is not fully deductible. The other 18 may pay non-deductible bonuses, which even though they have a qualified plan, is not precluded. For example, they could pay a bonus in excess of that allowed by the plan. Unfortunately, disclosure in the proxy statement is not detailed enough for us to determine why the deductions were lost. Thus, while we know they forfeit deductions, we do not know if it is because they pay salary in excess of $1 million, bonuses in excess of that allowed by the qualified plan, other non-qualifying compensation, or some combination of the three.

7. Determinants of willingness to forfeit deductions

Table 5 provides descriptive statistics and results of univariate tests comparing firms that forfeit tax deductions versus those that claim full deductibility.

[20] Because of the way the sample was constructed all firms have cash compensation exceeding $1 million.

Table 5
Descriptive statistics

Panel A: Full sample (n = 397)

Variable	Mean	Standard deviation	Lower quartile	Median	Upper quartile
EXCESS	1151.203	1415.189	260.170	571.290	1325.000
NUM	1.741	1.122	1	1	2
RISK	0.281	0.165	0.168	0.250	0.331
TENURE	9.355	7.592	4	7	11
ASSETS	6822.590	8385.773	1506.913	3215.204	8869.770
RESIDUAL	0.061	0.345	−0.179	0.055	0.290
QSTB	0.642	0.480	0	1	1
QOPT	0.912	0.284	1	1	1
DEFER	0.116	0.320	0	0	0
AGE_D	0.073	0.261	0	0	0
ROA	0.061	0.031	0.040	0.058	0.080
TAXBEN	296.849	441.969	23.018	124.789	298.810
INSIDEOWN(%)	5.212	8.815	0.440	1.700	5.410
SAL	808.611	259.320	636.660	770.000	935.100
BONUS	958.614	566.400	590.590	800.000	1151.150
TCC	1773.740	716.156	1253.930	1537.500	2030.500
BLKVAL	1665.515	2086.435	370.200	955.530	1956.980
TDC	4653.211	3710.960	2186.000	3485.520	5531.040

Panel B: By deductibility status

Variable[a]	Forfeit ($n = 151$)		Fully deductible ($n = 246$)		Student t-value[b]	Wilcoxon z-value[b]
	Mean	Median	Mean	Median		
EXCESS	1571.649	660.000	893.125	548.665	4.17***	1.35
NUM	1.947	1	1.614	1	2.70***	2.14**
RISK	0.285	0.274	0.279	0.238	0.32	1.72*
TENURE	7.841	6	10.285	8	−2.65***	−2.07**
AGE_D	0.086	0	0.065	0	0.76	0.78
ASSETS	7139.698	3646.600	6627.943	2888.533	0.59	1.06
RESIDUAL	0.092	0.139	0.045	0.017	1.05	1.55
QSTB	0.358	0	0.817	1	−9.93***	−9.26***
QOPT	0.868	1	0.939	1	−2.26**	−2.43***
DEFER	0.040	0	0.163	0	−4.32***	−3.71***
ROA	0.056	0.055	0.064	0.062	−2.37**	−2.31**
TAXBEN	441.876	110.299	210.219	128.322	4.24***	1.21
INSIDEOWN(%)	4.619	1.090	5.561	2.030	−1.04	−2.55***
SAL	890.204	800.000	758.528	751.000	4.51***	3.02***
BONUS	1042.772	772.800	906.956	800.000	2.13**	0.33
TCC	1938.486	1572.800	1672.615	1511.935	3.30***	1.24
BLKVAL	1864.548	959.860	1541.835	951.200	1.43	0.53
TDC	5388.190	3754.160	4198.370	3434.120	2.89**	1.80*

EXCESS = excess of cash compensation over $1 million summed over the top five executives, in thousands; NUM = number of executives earning more than $1 million in cash compensation in a firm; RISK = standard deviation of annual stock returns for the prior five years; TENURE = CEO tenure; AGE_D = 1 if CEO's age is 64 or 65, and 0 otherwise; ASSETS = total assets at the

Table 5 (*continued*)

beginning of the year, in millions; RESIDUAL = residual is estimated from the following equation: $\text{LN(TCQ)} = b_0 + b_1\text{ROA}_i + b_2\text{RET}_i + b_3\text{LN(ASSETS}_i) + b_4\text{MTB}_i + b_5\text{STDROA}_i + b_6\text{STDRET}_i + e$, where TCC is total cash compensation, ROA return on assets, ASSETS total assets at the beginning of the year, MTB market-to-book value of assets, RET raw returns, STDROA standard deviation of annual ROA for the past five years, STDRET standard deviation of raw returns for the past five years, e the error term, and i represents firm. This model is estimated cross-sectionally for the year 1993; QSTB = 1 if a firm qualifies its short-term bonus plan, and 0 otherwise; QOPT = 1 if a firm qualifies its option plan, and 0 otherwise; DEFER = 1 if a firm defers compensation, and 0 otherwise; ROA = return on assets or the ratio of earnings before interest and taxes to lagged total assets; TAXBEN = excess amounts of cash compensation over $1 million summed over the top five executives × marginal tax rate (Graham, 1996); INSIDEOWN = percent of outstanding stock owned by officers and directors; SAL = CEO salary as reported in Standard & Poor's ExecuComp; BON = CEO bonus as reported in Standard & Poor's ExecuComp; TCC = CEO total cash compensation as reported in Standard & Poor's ExecuComp; BLKVAL = Black-Scholes value of stock options granted to CEO as calculated by Standard & Poor's ExecuComp; and TDC = total direct compensation as calculated by Standard & Poor's ExecuComp.

[a] Paired sample t-tests for means and Wilcoxon signed rank tests are performed to compare the two groups.

[b] ***,**,* indicate significant levels of 1%, 5% and 10%, two-tailed.

Beginning with our proxies for recontracting costs there is some evidence (i.e., t-statistics is significant while Wilcoxon is not) that EXCESS is higher for firms that forfeit tax deductions for executive compensation, consistent with the hypothesis that as the amounts involved increase, the less likely firms are to restructure their compensation to preserve full deductibility. Also consistent with increased recontracting costs increasing the likelihood of forfeiture, the number of executives receiving cash compensation in excess of $1 million (NUM) is higher for firms that forfeit tax deductions for executive compensation (although the median is one for both groups of firms). There is also some evidence (Wilcoxon significant but t-test is not) that firms with higher risk are more likely to forfeit tax deductions. Overall these results provide mixed evidence for hypotheses 1–3. While TENURE is significantly lower for firms that forfeit deductions, AGE_D does not differ between the two groups. Similarly, when we look at our proxies for political costs (hypotheses 5 and 6), we do not see a difference between the two groups in either firm size or the degree to which the CEO is overpaid.

Turning to our control variables, we find that firms are less likely to forfeit deductions if they have qualified their short-term bonus and stock option plans, or when they report they defer compensation. They are also less likely to forfeit deductions when ROA and INSIDEOWN (only the Wilcoxon is significant) are high.

Looking at compensation itself, we see salary and total direct compensation are higher for firms that forfeit deductions and some evidence (only t-tests are

significant) that bonus and total cash compensation are higher for firms that forfeit deductions. There was no difference between the two groups in the value of stock options granted.

Generally speaking, the above findings are intuitive, e.g., firms forfeiting deductions are less likely to qualify their compensation plans, pay higher levels of compensation, have more deductions that could be potentially forfeited due to Section 162(m), and have more executives affected by Section 162(m).

Table 6 presents the results from estimating model (1) using a logistic regression.[21] The model is highly significant with a pseudo R^2 of almost 80%. Of the independent variables examined, nine [Log(EXCESS), TENURE, RESIDUAL, QSTB, QOPT, DEFER, ROA, Log(TAXBEN) and INSIDEOWN] are significant at 1% or less (one-tailed tests), one [Log(ASSETS)] is significant at 5%, and three (NUM, RISK, and AGE_D) are significant at 10%. Starting with our directional hypotheses (H1–H3), our regressions provide support for H1 through H3. The coefficient on Log(EXCESS) is positive and significant (5.674, $p < 0.001$), consistent with firms being more likely to forfeit tax deductions when the cost of restructuring the compensation package is greater. This supports H1. The coefficient on NUM is positive and significant (0.558, $p = 0.054$), consistent with firms being more likely to forfeit tax deductions the greater the number of affected executives. This supports H2. The coefficient on firm risk, RISK, is positive and significant (2.822, $p = 0.094$), indicating that firms are more likely to forfeit deductions when the business environment is riskier—as predicted by H3.

Turning to our non-directional hypotheses, for H4 we find the probability of forfeiture decreases with CEO tenure (−0.296, $p < 0.001$), and increases for CEOs approaching the traditional retirement age (2.053, $p = 0.097$). In examining H5 and H6 we find that the probability of forfeiture decreases with increases in our proxies for both the firm's [Log(ASSETS)] and executive's (RESIDUAL) political costs. The coefficient on Log(ASSETS) is negative and significantly (−0.744, $p = 0.031$) related to the decision to forfeit, indicating that larger firms are less likely to forfeit deductions. Similarly, the coefficient on RESIDUAL is negative and significant (−3.592, $p < 0.001$), indicating that firms in which the CEO is overpaid relative to performance are less likely to forfeit deductions.

Not surprisingly, the coefficients on QSTB (−14.151, $p < 0.001$) and DEFER (−15.740, $p < 0.001$) are negative and significant indicating that when a firm qualifies its short-term bonus plan and when it defers compensation, it is less likely to forfeit deductions. Somewhat surprisingly, the coefficient on QOPT is positive (10.443, $p < 0.001$) which indicates that, after controlling

[21] Diagnostic tests are conducted for all regressions with influential observations (absolute value of studentized residual > 2) being removed based on the procedure outlined in Belsley et al. (1980).

Table 6
Cross-sectional logit analysis: Explaining firm willingness to forfeit tax deductions

Model: FORFEIT_{it}

$$= \alpha_0 + \alpha_1 \text{Log(EXCESS)}_{it} + \alpha_2 \text{NUM}_{it} + \alpha_3 \text{RISK}_{it} + \alpha_4 \text{TENURE}_{it} + \alpha_5 \text{AGE_D}_{it} + \alpha_6 \text{Log(ASSETS)}_{it} + \alpha_7 \text{RESIDUAL}_{it} + \alpha_8 \text{QSTB}_{it} + \alpha_9 \text{QOPT}_{it} + \alpha_{10} \text{DEFER}_{it} + \alpha_{11} \text{ROA}_{it} + \alpha_{12} \text{Log(TAXBEN)}_{it} + \alpha_{13} \text{INSIDEOWN}_{it} + \varepsilon_{it} \quad (1)$$

Variable[a]	Parameter estimate	p-Value[b]
INTERCEPT	−5.215	0.107
Log(EXCESS)	5.674	<0.001***
NUM	0.558	0.054*
RISK	2.822	0.094*
TENURE	−0.296	<0.001***
AGE_D	2.053	0.097*
Log(ASSETS)	−0.744	0.031**
RESIDUAL	−3.592	<0.001***
QSTB	−14.151	<0.001***
QOPT	10.443	<0.001***
DEFER	−15.740	<0.001***
ROA	−17.646	0.005***
Log(TAXBEN)	−3.569	<0.001***
INSIDEOWN	0.124	0.003***
Pseudo R^2	78.69%	

FORFEIT = 1 if the firm loses some deductions for executive compensation, and 0 otherwise; Log(EXCESS) = natural logarithm of excess amounts of cash compensation over $1 million summed over the top five executives; NUM = number of executives earning more than $1 million in cash compensation in a firm; RISK = standard deviation of annual stock returns for the prior five years; TENURE = CEO tenure; AGE_D = 1 if CEO's age is 64 or 65, and 0 otherwise; Log(ASSETS) = natural logarithm of total assets at the beginning of the year; RESIDUAL = residual is estimated from the following equation: $\text{Log(TCC}_i) = b_0 + b_1\text{ROA}_i + b_2\text{RET}_i + b_3\text{Log(ASSETS}_i) + b_4\text{MTB}_i + b_5\text{STDROA}_i + b_6\text{STDRET}_i + e$, where TCC is total cash compensation, ROA return on assets, ASSETS total assets at the beginning of the year, MTB market-to-book value of assets, RET raw returns, STDROA standard deviation of annual ROA for the past five years, STDRET standard deviation of raw returns for the past five years, e the error term, and i represents firm. This model is estimated cross-sectionally for the year 1993; QSTB = 1 if a firm qualifies its short-term bonus plan, and 0 otherwise; QOPT = 1 if a firm qualifies its option plan, and 0 otherwise; DEFER = 1 if a firm defers compensation, and 0 otherwise; ROA = return on assets; Log(TAXBEN) = natural logarithm of [excess amounts of cash compensation over $1 million summed over the top five executives × (1 + marginal tax rate (Graham, 1996))]; and INSIDEOWN = percent of outstanding stock owned by officers and directors.

[a] Diagnostic tests are conducted for all regressions with influential observations (absolute value of studentized residual > 2) being removed based on the procedure outlined in Belsley et al. (1980).

[b] ***,**,* indicate significance levels of 1%, 5%, and 10%, respectively, p-values are one tailed.

for the other factors in the model, a firm that qualifies its option plan *is* more likely to forfeit deductions. This is consistent with these firms qualifying their

option plans (which has little effect on executive risk and incentives), for political purposes, i.e., to reduce their political costs. It is also however, consistent with the argument posed above with respect to EXCESS, that firms take steps to preserve deductions, e.g., qualifying the option plans, but finds it too costly to preserve all deductions.

The coefficient on ROA is negative and significant (-17.646, $p = 0.005$), consistent with firms being less likely to forfeit deductions when performance is good. Our proxy for the tax savings, Log(TAXBEN) is negative and significant (-3.569, $p < 0.001$), consistent with our expectation that the greater the potential tax benefit, the less likely the firm is to forfeit deductions. Counter to our expectations, insider ownership, INSIDEOWN, is positive and significant (0.124, $p = 0.003$). This is inconsistent with the theory that as the ownership increases, managers tend to behave like owners and consistent with managerial entrenchment, i.e., managers acting as if they are entrenched as their ownership increases.

8. Sensitivity tests

8.1. Using total compensation to calculate residuals

In our primary analysis reported above we measure the degree to which a CEO is over/underpaid using total cash compensation. Alternatively we can calculate the residual using total compensation, where the difference between total compensation and total cash compensation is primarily the value of stock and stock options received by the executive. We calculate the residual using two measures of total compensation, which differ in how they value the stock options in the compensation package. The first values stock options using the grant date Black-Scholes value of options granted that year, whereas the second values stock options using the profits from options exercised in that year.[22] The results using total compensation differ from those using total cash compensation. If total compensation incorporating the grant date Black-Scholes value of options is used RESIDUAL becomes positive and significant, whereas if we use total compensation incorporating the profits from options exercised during the year RESIDUAL is insignificantly different from zero. In either case, the coefficients on our other variables remain unchanged. We attribute the change in the sign of the coefficient to the increased use of options by firms subject to Section 162(m). Balsam and Ryan (2004) argue that because they are easily qualified as performance-based, firms increased option grants to executives subject to Section 162(m) constraints, providing evidence consistent with their

[22] Both of these values are provided on ExecuComp.

hypothesis. In addition, the Financial Economists Roundtable (2003) suggests that section 162(m) "may have unintentionally encouraged the use of stock options." Consequently, firms that expect to forfeit deductions can substitute stock options for other forms of compensation that may not be deductible.

8.2. Omitting QOPT in the Logistic model

Since it is relatively easy to qualify stock option plans and most firms choose to do so, there is little variation in the variable measuring whether option plans are qualified, QOPT. We thus exclude this variable from the Logistic model. The results are similar to that reported above.

8.3. Exclusion of firms in regulated industries

Previous academic work has noted that political constraints affect levels and structure of CEO compensation (e.g., Bryan and Hwang, 1997; Joskow et al., 1993, 1996; Jensen and Murphy, 1990). Direct monitoring and oversight by regulatory authorities may influence the change in compensation policy in response to Section 162(m). Therefore we exclude the finance, transportation, and utilities industries (two-digit SIC codes 60–67 or 40–49) from the sample and rerun our analysis. The results are qualitatively the same.

8.4. Year indicators

The sample used in this study is pooled across five years. This could be problematic if there are shifts in the cross-sectional parameters over time or if the error terms are autocorrelated.

To address this potential problem, we include year indicators in the logit model. Results are the same as above, while the indicator variables are not statistically significant.

9. Summary

This paper provides some evidence on the responses of firms to Internal Revenue Code Section 162(m). Section 162(m) limits the corporate tax deduction for executive compensation to $1 million per individual for the top five executives of a corporation, providing an exception for compensation in excess of $1 million if it is qualified as "performance-based." We find that, in almost 40% of firm-year observations in our sample, executive compensation is not fully deductible, demonstrating a willingness on the part of a substantial number of firms to forfeit tax deductions rather than reduce executive compensation and/or qualify their plans in accordance with Section 162(m). It is

possible that firms feel that the existing compensation contracts are efficient and that any changes to them would increase overall costs, or that the potential loss of tax deductions may have been immaterial (Teruya, 1998). The willingness of corporations to forfeit deductions provides some evidence that Section 162(m) is not successful in using tax policy to curb executive pay. In particular the pattern whereby firms forfeit deductions in some years is consistent with firms setting goals and following bonus parameters when those goals are met, but ignoring them when the goals are not met, i.e., paying compensation regardless of whether the performance goals are met. To this effect we note that our performance measure ROA is negatively associated with the forfeit decision, i.e., poorer performing firms are more likely to forfeit.

This selective compliance, combined with the prior research which shows that compensation increased post Section 162(m), suggests that the provision was unsuccessful in reining in executive pay and in fact may be partially responsible for the ensuing increase in pay. Moreover while there may have been some societal benefits via increased tax collections, the people making those payments, the shareholders of affected corporations were probably not the ones Congress intended to penalize (the same group paying the increased compensation). Consequently Congress needs to revisit this provision realizing that executives have the ability to navigate its provisions and look for other ways, e.g., shareholder approval, to limit executive compensation. Of course, the possibility exists that akin to corporations adopting plans for symbolic purposes (Westphal and Zajac, 1994), Congress may also have adopted Section 162(m) to symbolically deal with the outrage over executive compensation. In addition to the empirical evidence that would support this proposition, a careful analysis of the section shows that qualifying compensation as performance-based does not require high performance, merely meeting a threshold that can be set low enough to be easily achievable, and need not be disclosed to shareholders.[23]

While the evidence presented and discussed above indicates that Section 162(m) was not a total success in reining in executive pay, there were some firms that did elect to preserve deductions. Consequently we also investigate firm characteristics that explain the decision to forfeit or preserve tax deductions, dividing our hypotheses into two groups, contracting and political costs, and find support for them. In particular we find that firms with higher recontracting costs, i.e., larger amount in question, measured as the sum of amounts exceeding $1 million for executives, a larger number of affected executives, and a riskier business environment, are more likely to forfeit tax deductions for executive compensation. In contrast, consistent with firms being responsive

[23] For specific examples, see Institutional Shareholders Services, US Proxy manual, <http://www.governanceanalytics.com/content/menutop/content/subscription/usvmfiles/x9052.html>.

to their political costs, we find that firms are more likely to claim full deductibility and thus preserve tax deductions for compensation when firm size is larger and CEO compensation is high relative to performance. We also find that firms are more likely to claim full deductibility when they have taken steps to qualify their short-term bonus plans, when they report that executives have deferred portions of their salary and/or bonus, when the tax benefit is higher, and when they report higher ROA.

Acknowledgments

We would like to thank Steve Buchheit, Richard Gifford, David Hulse, Ayalew Lulseged, Janet Meade, Austin Reitenga, David Ryan and Debra Sinclair, as well as participants in a Drexel University Accounting Workshop and Temple University Doctoral Research Seminar for their helpful comments.

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From the frontlines, initial firm reaction to SFAS 123R: Share-based Payments

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From the frontlines, initial firm reaction to SFAS 123R: Share-based Payments

Introduction

More than a decade after the Financial Accounting Standards Board initially proposed mandating the expensing of stock options granted to employees, Statement of Financial Accounting Standards 123R: Share-based Payments was passed requiring expensing. SFAS 123R which went into effect for fiscal years beginning after June 15, 2005 has had a major impact on public corporations, as well as their internal and external accountants, and the numerous professionals that assist in the implementation of their stock option programs. The objective of this article is to provide readers with information on how a group of affected corporations are reacting to SFAS 123R, so that they might have some information with which to benchmark their own responses. Using data from a survey conducted by the *Controllers' Leadership Roundtable* in June of 2006, this article addresses issues as diverse as SFAS 123R's effect on compensation structure, valuation models and assumptions, and public disclosure and reporting.

Data

A 36 question survey was sent via email to representatives of the 600+ organizations who belong to the *Controllers' Leadership Roundtable*, one of 40+ programs serving executives at The *Corporate Executive Board (Nasdaq: EXBD).* The Roundtable's membership spans across industries and auditors and includes organizations with annual revenue in excess of $750 million. The initial survey was sent on June 1, 2006, with reminders and copies of the survey included in emails sent on June 14, 2006

and June 26, 2006. A total of 132 corporations responded to the survey, although not all provided answers to each question. The survey was then followed by a Roundtable teleconference on July 26th which both conveyed the results of the survey to Roundtable members and elicited further understanding of the issues and responses.

Impact of SFAS 123R

Many of the objections surrounding the expensing of options initially revolved around its impact on the financial statements of the company. High technology companies, in particular, were concerned about its impact upon their stock price and their ability to raise capital and recruit employees. Consequently, we expect firms would take steps to minimize its impact. They could do so by, among other things, reducing the number of options granted, reducing the per option cost and/or making transparent for financial statement readers the direct impact FAS 123R has on the financials. Per option costs can be reduced by changing the terms of the option or by changing the valuation assumptions.

Effect of SFAS 123R on Compensation Structure

Consistent with our expectations, the survey showed that corporations are responding to SFAS 123R by decreasing their use of options and increasing their use of restricted shares and restricted stock units. Of the companies responding, 39 percent said they had altered their use of options as a result of SFAS 123R. In all cases these firms reduced the use of options, with the most common response, 61 percent, being they eliminated or decreased the use of options at all levels. Another 26 percent eliminated or

decreased use of options for non executives. Overall, respondents reported that 15.7 percent of employees received options prior to SFAS 123R, whereas only 13.2 percent received options afterwards, a decrease of about 16 percent.

To compensate executives/employees for the decreased use of stock options, 44 percent of companies responding reported increasing their use of restricted stock as a result of SFAS 123R. Of the 33 percent of firms that did not utilize restricted stock prior to SFAS 123R, slightly more than half began utilizing it post 123R. This shift is consistent with the intended effect SFAS 123R has had on leveling the accounting playing field and firms reacting accordingly. That is, in response to the FASB taking away the favorable accounting treatment for options, firms are shifting from options to other forms of compensation that may be preferred for other non-accounting reasons. For example, when compared with options, restricted stock usually results in less dilution as since a restricted share, which is effectively an option with a zero exercise price, is worth more than an at-the-money option, fewer shares need to be granted to provide the same level of compensation.

Similar to its effect on stock option grants, SFAS 123R has an effect on stock purchase plans. 26 percent of survey respondents reported that they either eliminated the plan or modified the terms. These modifications include reducing the market discount and/or reducing or eliminating the look back provision.

Valuation Models and Inputs

Although the majority of firms in the study, 56 percent, evaluated the binomial model, the vast majority elected to use the Black-Scholes model. Respondents clearly felt

that the binomial model required more resources to implement vis-à-vis the Black-Scholes model. Additionally, during the Roundtable's July 26 teleconference, one participant conveyed that they were discouraged from using the binomial model by their audit firm, which was concerned about their ability to audit the results – and this sentiment has been conveyed by several other Roundtable members during informal conversations. Consistent with this approach which will minimize the complexity and implementation costs, almost two thirds of responding corporations grouped all employees together in evaluating exercise behavior for the expected life calculation.

Turning to the assumptions, we find the vast majority of firms either use historical volatility or some combination of historical and implied volatility as their volatility input. A substantial portion – 40 percent of the survey respondents, report reducing the volatility assumption post SFAS 123R, which has the effect of decreasing expense. In contrast, only nine percent reported increasing volatility. In contrast, and perhaps the most surprising outcome of the survey, firms are more likely to increase the expected life of their options than decrease them, by a three to one ratio. This of course is surprising because increasing the expected life increases the expense associated with the option. A possible explanation is that more rigor and detail is now attached to the calculation of this input as the expense moved from the footnotes to the balance sheet firms and their auditors more thoroughly evaluated the inputs.

One thing we have not observed yet is firms modifying the terms of their options. For example, while reducing the option term will presumably allow the firm to decrease the option's expected life and the associated expense, only six firms report reducing the options term – all from ten to seven years.

Disclosure

When it comes to the presentation and disclosure of FAS 123R related expenses, we had expected to see a large percentage of companies including either pro forma disclosure excluding the FAS 123R expense or supplemental disclosure detailing such expense amounts. This expectation was based in part on the lack of uniform approach communicated by various ratings agencies and financial analysts with respect to their treatment of FAS 123R related expenses and many companies' opposition to the expensing concept and application of the expense treatment. Company reaction has been fairly consistent with our initial expectations – nearly 60 percent of surveyed companies include either pro forma disclosure excluding the FAS 123R expense or supplemental disclosure detailing such expense amounts. Of those that do make such inclusions, the vast majority of companies, by nearly a 5-to-1 margin, include just supplemental disclosure, rather than pro forma-ing the financials. Also of note, we observed a consistent approach to disclosure by companies within several of the same industries. For example, in the insurance/reinsurance industry, more than 80 percent of those companies ONLY include GAAP numbers, while nearly 90 percent of companies in the business/financial services industry include supplemental information. Interestingly, while we expected to see a more consistent approach among companies in the technology industry, specifically, there is more diversity in their disclosure practices than in several other of the industries.

Conclusion

In this article we have summarized the results of a survey of corporate responses to SFAS 123R. This survey should be useful to readers in benchmarking their own responses.

In concluding we would like to remind the reader that the responses documented are initial, and that it is possible, perhaps even likely, that corporate responses will change over time. For example, at this point we observe few firms modifying the terms of their options. Still the swiftness of the response to date is impressive, perhaps because of the degree to which 123R was anticipated.

Written Statement of
Professor Lucian A. Bebchuk
Harvard Law School
Before the
Committee on Finance
United States Senate
Hearing on Executive Compensation

September 6, 2006

Introduction

Chairman Grassley, Senator Baucus, and distinguished Members of the Committee, thank you very much for inviting me to testify today regarding executive compensation.[1]

The first part of my remarks will focus on the executive retirement plans that I was asked to discuss, and I will then comment on some other issues. My discussion of executive retirement benefits is based on the analysis in a book on executive pay I co-authored with Jesse Fried,[2] as well as on a subsequent empirical study with Robert Jackson.[3]

As explained below, executive retirement plans have provided top executives with large amounts of non-performance compensation that were neither salient to investors nor subject to the limitations on tax deductibility established by Section 162(m). The SEC's recent disclosure reform, which I strongly support, would in the future place these types of compensation on investors' radar screen. However, it will still be possible to use executive retirement plans to provide large amounts of non-performance pay without falling within the scope of Section 162(m).

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[1] The views expressed herein are solely my own and should not be attributed to Harvard Law School, the National Bureau of Economic Research or any other institutions with which I am affiliated.
[2] Lucian A. Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004). This book's analysis of executive retirement benefits also appears as Lucian A. Bebchuk and Jesse M. Fried, "Stealth Compensation via Retirement Benefits," 1 *Berkeley Business Law Journal* 291 (2004), available at http://papers.ssrn.com/abstract_id=583861.
[3] Lucian A. Bebchuk and Robert J. Jackson, Jr., "Executive Pensions," 30 *Journal of Corporation Law* 823 (2005), available at http://papers.ssrn.com/abstract=694766.

Executive Pensions

Because companies have not been reporting a monetary value for executives' pension plans (as the SEC rules have allowed until recently), standard datasets have not included pension values. My empirical study with Robert Jackson demonstrates that this omission has led public officials, investors, and the media to have an inaccurate picture of executive pay.

The study analyzes the pension arrangements of CEOs of S&P 500 companies who were near the retirement age or left their positions during the period under examination. With respect to the two-thirds of the CEOs who had a pension plan, we found that:

(1) The executives' pension plans had a median actuarial value of $15 million;

(2) The pension plan of the median CEO was worth twice as much as the aggregate salary paid during his or her service as CEO; and

(3) The value of the median CEO's pension comprised 35% of the total compensation (including both equity-based and non-equity-based pay) during that executive's service as CEO.

Explaining the Heavy Use of Executive Pensions

The use of executive pensions might seem natural given that firms offer pension plans to many non-executive employees. However, the plans offered to executives and non-executives differ in two important ways that raise questions about why firms use executive pensions so often.

First, the pension plans used for non-executive employees are designed to capture the benefits from the favorable tax treatment of "qualified" pension plans. However, because of the limits on the amount that can be placed in an employee's qualified pension plan, firms cannot use qualified plans to provide executives with pensions that approach the magnitude of their annual compensation. Instead, firms have been providing pensions to executives mainly through nonqualified Supplemental Executive Retirement Plans (SERPs) that do not enjoy a tax subsidy. Firms that provide SERPs to executives generally do not offer such plans to other employees.

Second, while firms have been moving away from defined-benefit plans for non-executive employees, they continue to offer defined-benefit pension plans to most top executives. Unlike defined-contribution plans, defined-benefit plans shift the risk of investment performance to the firm and its shareholders. However, one would expect the defined-benefit structure to be more valuable to regular employees who – relative to executives – are probably less able to bear the investment risks associated with defined-contribution plans.

What then could explain why firms have been making a massive use of defined-benefit pension plans for their top executives while moving away from defined-benefit plans for other employees? One possible explanation is based on the fact that firms have not been required to place a monetary value on SERPs and include this value in the summary compensation tables that are publicly disclosed. As a result, SERPs have provided large amounts of non-performance pay without making them transparent to investors.

Because the SEC's new disclosure requirement will obligate firms to make the value of pensions transparent, another possible explanation for the use of pensions is worth stressing. Because Section 162(m) does not apply to payments made *after* an executive retires, executive pensions have enabled the payment of large amounts of non-performance compensation that is not subject to the $1 million limitation established by section 162(m). For the median CEO in our empirical study of executive pensions, adding the pension value on top of aggregate salary during the CEO's service roughly tripled the amount of the CEO's non-performance pay.

Deferred Compensation Plan

Deferred compensation is another form of compensation that has provided large amounts of performance-insensitive compensation to executives without attracting much shareholder attention or falling within the scope of Section 162(m). The lion's share of firms offer their top executives deferred-compensation programs that permit executives, or sometimes even require them, to defer receipt of compensation until some future date.[4] The deferred compensation "builds" according to a formula devised by the firm, and executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company.

Some deferred compensation plans provide executives with above-market returns. Even when the plan offers only market returns, however, executives can make substantial gains from accumulating investment income tax-free. Depending on the company's tax rate and investment returns, the executive's tax savings come at the expense of the company, the taxpayer, or both.

Because there are limits on how much money can be contributed annually to a 401(k)

4. See, e.g., Clark Consulting, Executive Benefits – A Survey of Current Trends – 2005 Results (reporting that about 90% of public firms surveyed have deferred-compensation plans for executives).

account, firms provide executives with deferred-compensation plans outside the framework of 401(k) plans. Again, as in the case of SERPs, the question arises: Why do firms commonly offer nonqualified deferred-compensation plans to executives but usually not to other employees? If nonqualified deferred compensation is an efficient form of compensation for the executives of certain firms, it should also be an efficient form of compensation for their nonexecutive employees. But firms rarely, if ever, provide nonexecutive employees with the option of participating in nonqualified deferred-compensation plans in addition to their 401(k) plans.

What can explain the massive use of deferred-compensation plans for executives? One possible explanation is that such plans have enabled getting around the limitations on non-performance pay established by Section 162(m). First of all, a firm may give an executive any amount of non-performance compensation, however large, and still not fall within the reach of Section 162(m) – as long as the payment of this amount is deferred until the executive's departure. On top of the original amount deferred, a deferred-compensation plan can provide the executive with additional performance-insensitive gains from a tax-free accumulation of investment returns.

In addition, as in the case of SERPs, deferred-compensation plans have provided large amounts of non-performance compensation that fall below investors' radar screens. Past disclosure requirements have allowed firms to provide little information about executives' deferred compensation plans. Indeed, the information disclosed has been insufficient f r outsiders to be able to quantify — as our empirical study did for executive pension benefits — the gains that executives have been making from deferred compensation plans. We do not have even ballpark estimates of these gains.

In the next proxy season, however, the SEC's disclosure reform will require firms to disclose the amounts credited to executives in deferred-compensation plans. These figures will enable outsiders to estimate for the first time the magnitude of executives' gains. Public officials and investors should pay close attention to the figures that come out.

Non-performance Pay through Bonus Plans

Firms can also use bonus plans to make payments that are barely tied to performance yet do not fall within the scope of Section 162(m). Section 162(m) does not apply to bonus payments as long as the bonus plan satisfies certain formal requirements. In particular, as long as the payment of a bonus amount was not certain, Section 162(m) may not apply even if the threshold for getting a bonus amount is sufficiently low as to make the likelihood of receiving one quite high.

Neither stockholders nor public officials are in a position to assess the magnitude of this problem. Firms often do not disclose the specific numerical thresholds used to determine bonus payments. A firm may disclose that bonuses were paid on the basis of earning targets set in advance by the compensation committee but not disclose the precise numerical targets used.

In my view, firms should be required to provide full and detailed disclosure of the numerical thresholds used to determine bonus payments. Opponents of such disclosure argue that it could help the firm's competitors. Even if this consideration were valid, however, it would at most justify delaying such disclosure to a later proxy statement. This information is necessary for outsiders to be able to assess the extent to which a firm's bonus payments have been meaningfully tied to performance.

Strengthening Shareholder Rights

I would like to conclude with a remark on shareholder rights. Although reform in this area is not the focus of this committee, the weakness of existing shareholder rights should be noted in any examination of executive compensation.

The SEC's recent disclosure reform, as well as the earlier passage of Section 162(m), might have been partly motivated by recognition that, without some push from the outside, corporate boards cannot be expected to adopt pay arrangement that are sufficiently linked to performance. However, as long as shareholder rights are not strengthened as well, neither disclosure requirements nor tax penalties can by themselves address the problem.

Disclosure by itself is insufficient when investors do not have the power to act on the information they obtain. And tax penalties by themselves can have little influence on compensation arrangements; when shareholders' rights are weak, designers of pay arrangements may not feel sufficient pressure to change these arrangements because any tax penalties will be borne largely by shareholders, not executives.

Indeed, the very need to expand disclosure requirements indicates the limits of shareholders' existing rights. Despite the dissatisfaction of investors, companies have continued to avoid making pay arrangements transparent, something they could have done on their own. Their failure to do so made SEC intervention necessary.

What else needs to be done? To ensure that directors focus on shareholder interests, they must be made not only independent of insiders but also dependent

on shareholders. Shareholders' power to remove directors must be turned from a fiction into a reality.[5] Shareholders should be able to place director candidates on the corporate ballot, as well as to vote by secret ballot. All directors should stand for re-election annually, and should not serve if they fail to get a majority of the votes cast.

Furthermore, shareholders should have more power to influence the setting of companies' governance arrangements.[6] Shareholders' involvement has been limited to the passing of advisory resolutions that boards may (and often do) choose not to follow. We should remove all legal impediments to shareholders' ability to adopt bylaws or even charter amendments. And shareholders should also get to vote on the compensation committee's report, or least get the power to opt into having such a vote.

In the end, executive compensation arrangements reflect the quality of the corporate governance processes that produce them. Problems of executive compensation can thus be fully addressed only by improving these processes. Strengthening shareholder rights would make boards more accountable and attentive to shareholders – and thereby improve corporate performance and enhance shareholder value.

[5] I put forward a detailed proposal for reforming corporate elections in "The Myth of the Shareholder Franchise," available at http://ssrn.com/abstract=829804.

[6] For a detailed explanation why shareholders need the power to adopt governance arrangements and not only the power to replace directors, see Bebchuk, The Case for Increasing Shareholder Power,118 *Harvard Law Review* 833-914 (2005), available at http://ssrn.com/abstract=387940; and Bebchuk, "Letting Shareholders Set the Rules, "Harvard Law Review (2006), available at http://papers.ssrn.com/abstract=891823

BOSTON COLLEGE
LAW REVIEW

VOLUME XXXIV SEPTEMBER 1993 NUMBER 5

EXECUTIVE OVERCOMPENSATION—A BOARD-BASED SOLUTION†

CHARLES M. ELSON*

INTRODUCTION

Envy, for better or worse, is a fundamental part of the human condition. Whether we admit it or not, most of us take a keen interest in the financial status of our neighbors. Few aspects of existence in contemporary society create more anger, resentment and dissension than how much we are compensated for our daily toils in comparison to what our fellow workers earn. It is this simple fact, along with distributive justice concerns, that explain the cause of the extraordinary popular attention and fury directed at the seemingly innocuous issue of executive compensation. Within the last several months, both the popular and financial media have devoted much attention to the charge that the executives of America's largest and most respected public corporations are being grossly overpaid for their services, at the expense of their shareholders, employees and the general public.[1] Comparisons are made with historic U.S. compensation levels and the

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[1] *See, e.g., Debate; Readers and Authors Face Off Over HBR's Last Issue; CEO Pay: How Much is Enough?*, HARV. BUS. REV., July-Aug. 1992, at 130 [hereinafter *Debate*]; Amanda Bennett, *A Little Pain and a Lot to Gain*, WALL ST. J., Apr. 22, 1992, at R1; Amanda Bennett, *Voices of Protest*, WALL ST. J., Apr. 22, 1992, at R6; Tommy Denton, *Where is the Justice in Bloated Executive Bonuses?*, L.A. DAILY J., May 14, 1991, at 6.

amounts executives of foreign competitors receive, particularly in relation to the spread between the salaries of the highest and lowest paid employees.[2] It is argued that U.S. executives are being compensated at an alarmingly high and dramatically escalating rate, despite the fact that domestic corporations may be performing less efficiently and less profitably than similarly situated foreign enterprises.[3] What are the legal ramifications of this executive compensation issue and is there a need for some sort of legal response?

The controversy is not a new one. In the mid-1930s, a similar public debate emerged over what was then considered to be the extraordinarily high compensation levels of certain corporate executives. While acknowledging that a corporate board may be responsible for salaries paid to executives that exceeded compensation for services rendered and thus became actionable "waste" or improper gifts of corporate assets, the courts generally declined to intervene.[4] It was believed that a court was no better at valuing an executive's worth than a properly functioning board, and therefore judicial review would be fruitless.[5] With the judiciary a reluctant venue for compensation reform, Congress attempted to resolve the issue by dramatically raising

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[2] In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. In 1980, the average chief executive earned only 42 times the average factory worker's wage. John A. Byrne, *What, Me Overpaid? CEOs Fight Back*, BUS. WK., May 4, 1992, at 142, 143. *See also* ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 170 (1991) (observing that executive overcompensation has a negative effect on employee morale); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 69–71 (1992); Jonathan Rowe, *CEO Pay Affects Company Morale*, CHRISTIAN SCI. MONITOR, Mar. 12, 1992, at 13.

[3] Roberto Goizueta, Chairman of Coca Cola, recently received over $80,000,000 in restricted stock for his services to the company. Anthony O'Reilly, the retiring chief executive officer of H.J. Heinz, was paid $75,085,000 in compensation for 1991. And for the same year, Leon Hirsch, chairman of U.S. Surgical Corp., received $23,281,000. *See* Byrne, *supra* note 2, at 142. Can any one executive's services be worth that much to the corporation? The tenor of the varied articles discussing the phenomenon suggests not. *See supra* note 1.

[4] *See, e.g.*, Rogers v. Hill, 289 U.S. 582, 591–92 (1933) (ruling that bonus payments to executives which have no relation to the value of services rendered are gifts of corporate property, and remanding to the trial court to determine whether payments constituted a waste of corporate assets); Seitz v. Union Brass & Metal Mfg. Co., 189 N.W. 586, 587–88 (Minn. 1922) (explaining that courts should proceed with caution when determining whether salaries are excessive and unreasonable; courts are not called upon to make a yearly audit and adjust salaries); Gallin v. National City Bank, 281 N.Y.S. 795, 802–03 (Sup. Ct. 1935) (ruling that the magnitude of the total compensation received by officers does not, by itself, entitle plaintiffs to recover, but merely requires an investigation by court as to whether a cause of action exists and leaves the burden of proof on the plaintiffs); Barris, *supra* note 2, at 81–83; Detlev Vagts, *Challenges to Executive Over Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–55 (1983).

[5] Heller v. Boylan, 29 N.Y.S.2d 653, 679–80 (Sup. Ct. 1941) ("Courts are ill-equipped to solve or even to grapple with these entangled economic problems."), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

the income taxation rates imposed on those receiving the greatest compensation.[6] No legal changes, however, in internal corporate governance procedures were enacted. Following this taxation-based response, the issue basically lay dormant until the perceived salary excesses of the late 1980s revived public interest and debate.

Although some may argue that through efficient market function, either few executives are overcompensated or that market-based forces will act to limit salary excesses,[7] there is a compensation problem today that, for various reasons to be discussed below, is not responsive to a market-based solution. The best way to encourage reasonable compensation without discouraging effective executive performance centers on better internal corporate oversight. Such oversight may come only from an unfettered, unbiased, *independent* board of directors. This article proposes two reforms in corporate board structure to encourage such independence of judgment that will result in the proper review of executive compensation procedures. First, the outside directors should be compensated solely in company stock. Second, directors' term lengths should be significantly expanded. These internal structural changes will result in a more effective board-level review of executive compensation and should lead to more reasonable compensation schemes.

Unfortunately, as this article will discuss, most commentators examining the compensation issue have not focused on reform of the internal corporate governance procedures that created the problem. Rather, they have proposed externally-based solutions that will either prove ineffective or hinder effective corporate management. Indeed, the regulatory and legislative communities have been quickest to respond, offering varying responses to the overcompensation problem. The Securities and Exchange Commission, probably seeking to stimu-

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[6] 1 George T. Washington & V. Henry Rothschild, 2nd, Compensating the Corporate Executive 9 & n.32, 10–11 (1951).

[7] *See, e.g.*, Robert Thomas, *Is Corporate Executive Compensation Excessive?*, *in* The Attack on Corporate America 276, 278 (M. Bruce Johnson ed., 1978) ("Competition among corporations . . . sets the level of executive compensation."); Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1263, 1283 (1982) ("[M]arket constraints . . . may be more effective in setting salaries than a committee of uninformed independent directors."); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. Miami L. Rev. 959, 975–78 (1980) ("excessive" compensation is eliminated by market forces, including competition for executive positions); Alisa J. Baker, *Stock Options—A Perk that Built Silicon Valley*, Wall St. J., June 23, 1992, at A20; Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, Harv. Bus. Rev., May-June 1992, at 28 (arguing that executives are paid in line with performance and their pay should not be cut); Kevin J. Murphy, *Top Executives are Worth Every Nickel They Get*, Harv. Bus. Rev., Mar.-Apr. 1986, at 125 (arguing that current compensation policies encourage managers to act in the best interests of company shareholders).

late a shareholder response to the issue, has taken a two-flanked approach. The first, adopted in early 1992 during the height of the proxy season, loosened the restrictions on placing shareholder-initiated proposals on compensation issues on corporate ballots.[8] The second, initially released as proposed amendments to the proxy rules and later adopted with some revisions, expanded the amount of disclosure companies must provide to their shareholders on the amounts their top executives are paid.[9] The Congress, on the recommendation of President Clinton, chose an historic tax-based response to the problem. In the Revenue Reconciliation Act of 1993, Congress mandated that corporations may no longer deduct, as a business expense, any compensation to an executive in excess of $1 million per annum that is not related to performance.[10] Additionally, a new "millionaires" surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year.[11]

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[8] Shareholder Communications Rules, Exchange Act Release No. 34-29562, 56 Fed. Reg. 41,635 (SEC 1991). The SEC revised the proposal in 1992. Regulation of Communications Among Securityholders, Exchange Act Release No. 34-30849, 57 Fed. Reg. 29,564 (SEC 1992).

[9] One of the elements of the SEC proposal, and later adopted in rule form, required companies to compare, in graphic form, the company's performance with the amount of compensation its executives received. Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582 (SEC 1992); Executive Compensation Disclosure, Exchange Act Release No. 6962, 57 Fed. Reg. 48,126 (SEC 1992).

[10] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). This bill prohibits publicly held corporations from deducting executive compensation in excess of one million dollars per annum. *Id.* However, corporations that tie compensation to performance may be able to continue to deduct the entire amount of compensation. In order to qualify for this performance-based compensation exception, corporations must meet five basic requirements: 1) executive compensation must be made according to a previously established performance based goal; 2) the performance goal may not be altered following its establishment; 3) such a plan must be approved by a board committee that is comprised of at least two outside directors; 4) the material terms of the plan must be disclosed to and ratified by stockholders prior to the payment of compensation; and 5) the committee must certify satisfaction of the performance goals prior to the payment of compensation. *Id.* Thus, corporations may avoid the deduction limitation by either following these guidelines, shifting a portion of compensation into stock options, "which are generally considered 'performance based'" or making payments to a qualified retirement plan. Kathryn Jones, *Tax Law Expected to Bring Little Shift in Executive Pay*, N.Y. TIMES, Aug. 24, 1993, at C1, C2. Consequently, some commentators and corporate executives have suggested that these new deduction limitations will in actuality have only a limited impact upon most corporate executive compensation schemes. *Id.*

[11] H.R. 2264. The bill, which both the House and Senate passed by the narrowest of margins, imposes a ten percent surtax upon individuals with taxable income in excess of the applicable threshold of two hundred fifty thousand dollars. *Id. See also* Jackie Calmes, *With Signature, President Will Erase Reagan's Legacy*, WALL ST. J., Aug. 9, 1993, at A4. During the presidential campaign, President Clinton proposed implementing a "millionaires" surtax upon individuals with incomes in excess of one million dollars. *See President-Elect Clinton Foresees Change in Plan for Middle-Class Tax Break*, 10 DAILY TAX REP. (BNA) D-4 (Jan. 15, 1993). However, President Clinton subsequently lowered this ceiling and proposed imposing a ten percent surtax upon

A debate is also occurring within the academic community. Despite the traditional reluctance of courts to involve themselves in compensation disputes, a few commentators have called for increasing judicial activism in reviewing questionable compensation schemes.[12] Given the present interest in both the legal and financial communities in the emerging power of institutional investors, some academics have suggested an institutional investor-based solution to the problem. Should the institutions eschew their traditional passivity and take a greater interest in the management of the companies in which they invest, they may act as a powerful force in preventing executive overcompensation.[13]

Although each of these approaches is not without some merit, this article will argue that they are "solutions" that will either cause more harm than good, or effect little change in the present state of affairs which, given the level of public discontent, cannot be ignored. The problem of executive overcompensation is best dealt with not at the regulatory or even shareholder level, but by focusing on that body traditionally charged with responsibility for corporate oversight—the board of directors. It is the board which must approve all executive compensation. Thus, it is the board which must act to rein in overzealous and overcompensated management. Some commentators have suggested that only by strengthening the power and independence of the board's compensation committee will the issue be successfully resolved.[14] Such tampering, however, is not the solution. In large publicly-traded companies, where the compensation crisis is most manifest, no major shareholder or group of shareholders controls the activities

individuals with incomes in excess of two hundred fifty thousand dollars per annum. Under the new tax code, the effective tax rate for individuals with incomes in excess of two hundred fifty thousand dollars per year has risen to 39.6 percent. H.R. 2264.

[12] Vagts, *supra* note 4, at 275–76; Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 79–83 (1993); Richard L. Shorten, Jr., Note, *An Overview of the Revolt Against Executive Compensation*, 45 RUTGERS L.J. 121, 159–61 (1992).

[13] *See, e.g.*, Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 915–17 (1992) [hereinafter Black, *Empirical Evidence*]; Kevin G. Salwen & Joann S. Lublin, *Activist Holders: Giant Investors Flex Their Muscles More at U.S. Corporations*, WALL ST. J., Apr. 27, 1992, at A1.

[14] *See* Lance Berger, *New Initiatives for the Compensation Committee*, DIRECTORS & BOARDS, Winter 1985, at 33; James W. Fisher, Jr., *Crafting Policy for Performance and Rewards*, DIRECTORS & BOARDS, Winter 1986, at 26. *See also* Alison L. Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at C1 (noting that the leaders of various companies often sit on each others' compensation committees and, as such, set pay for one another). Some large institutional investors are proposing that shareholders be allowed to vote on the selection of compensation consultants used by boards to set executive compensation. Gilbert Fuchsberg, *Investors May Seek Vote on Executive Pay Consultants*, WALL ST. J., Aug. 27, 1992, at B1.

of the enterprise because of the sheer size of the operation and atomistic shareholding patterns. Rather, corporate management controls the business. The board is not representative of any one shareholder or shareholder group, but is picked by and responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.[15] In a captured board, the directors, responsible for oversight, are generally either the officers themselves (inside directors); participants in enterprises retained by management, such as law firms, and investment banks (inside "outside" directors); or social or business acquaintances of the top executives, most likely the top officers of other corporations, on whose boards the chief executive officers may sit ("outside" directors).[16] Although such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Even if the compensation committee (which determines compensation levels) itself is composed exclusively of "outside" directors, both economic and psychological ties to management exist that preclude exercise of truly independent judgment. Theoretically, the threat of legal liability should ensure unencumbered judgment, but, as a matter of practice, the protection afforded by the business judgment rule and concomitant reliance on "captured" outside consultants counters any potential prophylactic effect. A compensation committee is only as effective as its members. If the outside directors comprising it are beholden in any respect to management, whether by economic or psychic ties, the committee will not function as the panacea.

The solution lies in loosening the outside directors' ties to management and recreating a vital and independent board, which will engage in active oversight, not passive agreement. A way must be found to reinvigorate the outside director who traditionally acted in the shareholders' interests by directing management. Some commentators have argued that this may be accomplished by placing representatives of the corporation's major institutional shareholders on the board.[17]

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[15] *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139–48 (1976). *See generally* MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1986).

[16] *See* Avery S. Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, 837 (1977) (classifying directors as "inside directors, non-independent outside directors, and independent outside directors"); *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1619–20 (1978) (describing directors as management and non-management directors); *but see* PRINCIPLES OF CORPORATE GOVERNANCE § 1.29 (A.L.I.) (Tentative Draft No. 11, 1991) (abandoning the use of labels, but defining when a director has a "significant relationship" with a company's senior executives).

[17] *See* Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37 (1990) (arguing that the proxy rules should be modified so that it is easier for shareholders to elect

They reason that because these individuals attained their board positions as a result of their relationship to the shareholding institutions and not to management, they will act in the shareholders' best interests, independent of management.[18] This approach is problematic in one major respect. It assumes that the institutions will bond together to elect their representatives and that the institutions possess sufficient voting power to place enough directors in office to gain control over the board.

There is, however, a much simpler and more effective way to reposition the board to act as a counter-force to management, and resolve the perceived compensation crisis. The outside directors must be made to consider management proposals from the perspective of the equity-holders to whom they are legally responsible, and not from the viewpoint of one engaged by and beholden to management. After all, they were elected to their positions as the representatives of the shareholders, not the officers. The best way to create this perspective may be to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Frequently, however, outside directors do own stock in the corporations on whose boards they sit. Yet, they are still subject to management capture. Why? It is because their equity positions in the companies are insubstantial compared with the monetary and reputational compensation they receive for serving on the board. Financially, it is far better to side with management and not risk failing to be renominated and receiving the compensation and prestige a board seat brings, than to act independently and face removal. If, however, one's personal financial interest in the corporation's stock exceeded the annual compensation and prestige value of board membership, one would be less willing to side automatically with management. Self-interest is obviously tied to board behavior, and if a director's self-interest is aligned with the equity-holders, as opposed to management, then the compensation problem, and maybe even the whole issue of management capture, might be solved. But how do we place significant equity positions in the hands of the outside directors?

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outside directors); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992) [hereinafter Black, *Agents*] (arguing that regulations should be relaxed so that particular institutions may be permitted to own 5-10% of certain companies). *See also* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991) (calling for institutional investors to organize a core of professional directors).

[18] Black, *Agents*, *supra* note 17, at 842-44.

This article proposes that corporations should pay their directors their annual fees in restricted company stock. In a few years, each outside director will have accumulated a reasonably substantial portfolio and, therefore, will possess a powerful financial incentive to act more independently of management. Additionally, directors' term lengths must be significantly expanded both to ensure that their equity positions (or potential positions) will reach the levels necessary to influence their decision-making and to mitigate the chilling effect of a management threat not to renominate that frequent elections create.

Of course, the linchpin to the effectiveness of this approach is the assumption that stock ownership has a salutary impact on individual behavior—that significant stock ownership does make for a director less susceptible to management capture. An empirical examination of the voting behavior of boards comprised of outside directors with substantial stockholdings, compared with boards with outside members who do not, should confirm the validity of the approach. This article undertakes such an examination. In the realm of executive compensation, it appears that companies with boards composed of outside directors with significant shareholdings are less susceptible to the charge of executive overcompensation than companies without such boards. In fact, an apparent relationship exists between the way companies are regarded by the financial community in terms of the fairness of executive compensation, and the levels of outside director stock ownership. Those companies that are viewed as having high levels of executive compensation tend to have fewer outside directors with significant holdings in the business. On the other hand, those businesses with levels of executive pay considered to be in line with services rendered tend to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with management, through the development of substantial equity holdings which results in more effective oversight, would explain this phenomenon. Director stock ownership may not prove the comprehensive cure to the overcompensation controversy and related captured board syndrome—but it may have a strong salutary effect and certainly would be a good beginning.

Part I of this article examines the question of overcompensation. Are U.S. executives overpaid, and, if so, can the market itself act to correct any imbalances? For reasons to be discussed, I think the market cannot. Part II considers the various solutions proffered, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation

committees. These approaches are critiqued as either ineffective or causing more harm than good to ultimate shareholder and national interests. Part III focuses on stock ownership and lengthened board terms as the preferred response to the problem of overcompensation. Finally, this article examines the link between substantial equity holdings and better oversight and proposes that companies create such holdings in their outside directors. This proposal should eventually result in more effective board oversight, reasonable market-based compensation schemes, and healthier, more competitive corporations.

I. The Overcompensation Problem

A. *Is There Overcompensation?*

Before embarking on a quest to determine an appropriate solution to a perceived inequity, it must first be determined that a problem exists which requires an active response. In other words, are U.S. executives overcompensated and, if so, is extraordinary action necessary to remedy the situation? The problem with examining compensation is that the entire inquiry begs the question—for what is the true value of the deployment of human capital? Unlike determining the cost of providing a physical good based upon known variables, there is really no mechanistic process for quantifying the value of human labor. If it were merely the cost of the basic human needs of food, clothing and shelter, we would all be compensated similarly.[19] However, we are not. Although human effort is in one sense easily quantifiable by being limited to the physical capacities of the human being and the time limitations of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain an advanced economy are extraordinarily varied and require vastly different skills. Some skills are seemingly more valuable to society than others and, as a result, are compensated at higher levels. What those levels may be are determined through the routine function of the market.

How much individuals are compensated for their labors is the

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[19] As Karl Marx and Fredrich Engels stated:

> The average price of wage labor is the minimum wage, i.e., that quantum of the means of subsistence which is absolutely requisite to keep the laborer in bare existence as a laborer . . . . We by no means intend to abolish this personal appropriation of the products of labor . . . . All that we want to do away with is the miserable character of this appropriation . . . .

Manifesto of the Communist Party, *in* Marx & Engels, Basic Writings on Politics & Philosophy 22 (Lewis S. Feuer ed., 1959).

result of an implicit or explicit bargaining process. One party has labor to offer and another has a need for the skill. The resulting compensation is the product of the matching of expectations—what one expects to receive and what the other is willing to give. These expectations, created through routine market function, determine compensation levels. What others are giving or receiving for similar tasks produces the expectations that determine particular compensation levels for particular skills. The "value" of a particular skill is not implicit in the skill itself but, rather, is simply the result of this bargaining process. In this regard, there is really no such thing as an implicitly "fair" salary—only one that is acceptable to both parties.

This is the real problem with discussions concerning "overcompensation," for if a salary is the result of an active bargaining process can such compensation ever be considered excessive? Because there is no truly objective standard for valuing human capital other than through the operation of the market driven by active bargaining, the reasonableness of a particular compensation arrangement is objectively indeterminable. Reasonableness is the product of the bargain. For example, who can say that an employee is overcompensated if two willing parties agree that the efforts of one of them are worth one million dollars? If one is voluntarily willing to part with capital to obtain a particular service, that is the value of the service. The compensation is thus reasonable. Compensation becomes unreasonable when it is not the product of balanced bargaining. Where one party to a bargain, due to external pressures, is unable or unwilling to bargain effectively to maximize self-interest, then the resulting agreement may be unreasonable.

In the corporate setting, the executive bargains with the corporation for compensation. The executive possesses managerial skills that the corporation desires. The corporation possesses capital that the executive desires in exchange for services rendered. How much capital will be parted with for these services is the result of bargaining. The resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest. This is the crux of the overcompensation dispute. Executive salary arrangements are the products of negotiation between the executive and the company's board of directors who represent the interests of the company and its owners, the shareholders. If the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it believes itself to be more closely allied with management than the shareholders, then the product of such a "bargain" may be no bargain at all to the corporation and its owners.

Alliances between bargaining parties may result in acquiescence rather than bargained-for agreement. Salary arrangements that result from such a one-sided bargaining process may be susceptible to charges of excess.

Although the popular media focuses simply on the large executive salaries themselves as proof of the existence of an overcompensation problem, the problem actually involves the process by which these salaries were determined and not the dollar amount. A lucrative salary, either standing on its own or in comparison with other salaries paid within the organization, is not in and of itself proof that the recipient has been overcompensated. As long as the compensation was the product of an active, good-faith bargaining process between the board and the executive, the salary cannot be characterized as unreasonable. Negotiation, motivated by self-interest on both sides, assures proper compensation. There is really nothing improper about an executive's compensation if a board determines that the services rendered are highly valuable to the corporation and offering a high salary is the only way to retain that executive.

Compensation amounts do become problematic, however, when a board, beholden to a particular executive, agrees to a salary package upon demand, in the absence of self-interested bargaining. The failure to actively negotiate an executive's compensation request is most likely to occur in corporations where the directors are not obligated to any particular shareholder or shareholder block, but gain and maintain their board seats because of executive largesse. This situation generally exists in companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.[20] In such businesses, the boards of directors generally consist of management and those appointed by management. In these situations, it is unwise for the outside directors to actively challenge the executives who have placed them in office.[21] Such directors have little incentive, other than fiduciary duty (which for reasons to be discussed has proven ineffective

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[20] As of December 31, 1974, management controlled 165 of the 200 largest, publicly-owned, nonfinancial corporations in the United States. EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 58 (1981) (Table 3.2). "[W]ide diffusion [of stock] does not increase the power of holders of small blocks of stock; it enhances the power of whoever controls the proxy machinery." *Id.* at 53. *See also* MACE, *supra* note 15, at 83–84. *See generally* ADOLF A. BERLE, JR., & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 47–118 (1933).

[21] EISENBERG, *supra* note 15, at 147.

> [I]n life as in law the power to hire implies the power to fire. A director who has been brought on the board by a chief executive—as outside directors typically are—is therefore likely to regard himself as serving at the latter's sufferance.

in creating incentive), to bargain actively with management over compensation.

Many of the largest U.S. public corporations have shareholding ownership patterns that dispose them to such potential management capture and attendant compensation problems.[22] It is these companies which have traditionally paid their executives the largest salaries and are currently the target of popular scrutiny.[23] A large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture, may be indicative, because of its size, of a failure by the directors to have bargained effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the U.S. and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.[24]

The difficulty with attempting to measure the adequacy of compensation is the highly subjective nature of the entire matter. This is why the courts have traditionally been reluctant to open their dockets to salary disputes. There are too many ways of measuring compensation and related performance.[25] What by one standard is excessive, may

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Id.; *see also* HERMAN, *supra* note 20, at 30–48; MONKS & MINOW, *supra* note 2, at 73–79; Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 607–39 (1982); Gilson & Kraakman, *supra* note 17, at 873–76 ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management."). This situation may be changing. In October 1992, the outside directors of General Motors fired their CEO in response to the company's lackluster performance. *See* Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14. *See also* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17–31 (1989) (noting that while the CEO still controls the director nomination process, boards are beginning to have greater participation in the process); Thomas A. Stewart, *The King is Dead*, FORTUNE, Jan. 11, 1993, at 34 (discussing recent firings and forced resignations of company CEOs); Stuart Mieher, *Firms Restrict CEOs in Picking Board Members*, WALL ST. J., Mar. 15, 1993, at B1 (reporting survey which indicates that many companies now prohibit corporate insiders from nominating new directors).

[22] *See* HERMAN, *supra* note 20, at 70–85.

[23] *See, e.g.*, MONKS & MINOW, *supra* note 2, at 166 (explaining that in 1989, the average CEO at top 200 companies received $2.8 million in salary and bonuses); Arch Patton, *Those Million-Dollar-a-Year Executives*, *in* EXECUTIVE COMPENSATION : A STRATEGIC GUIDE FOR THE 1990S 43, 44 (Fred K. Foulkes ed., 1991) (noting that executive pay in the 100 largest publicly-owned corporations increased by an average of 13.7% in 1983); *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148–62 (rating executive pay among 500 largest U.S. companies).

[24] *See supra* note 2. *See also* MONKS & MINOW, *supra* note 2, at 166–67 (noting that U.S. executive pay significantly outpaced inflation, wage, and profits rates from 1977 to 1987 and that American CEOs in billion-dollar companies receive two to three times the pay of comparable executives in Europe and Japan).

[25] Statistics describing compensation levels do not give a complete picture of an executive's compensation package. In addition to salary and incentive awards, executive compensation often

be by another perfectly reasonable. This is what accounts for the tremendous division within the financial community over who is being overpaid and who is not.[26] The only way to judge a compensation package objectively is through the same process by which businesses themselves are assigned value—through the operation of routine market forces, characterized by active bargaining. Given the potential for subdued bargaining and coincident overcompensation in the largest corporations, coupled with rapidly accelerating salary scales in the face of a national economic recession, it is not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness, the great potential for abuse mandates the formulation of a prophylactic response.

B. *The Inadequacy of a Market-Based Response*

Some argue that even if an overcompensation problem does exist, no external response need be forthcoming. The ordinary operation of the markets themselves will provide the solution. If the compensation scheme in a particular company is unreasonable, then market forces will punish that enterprise in the form of a lower stock price. The lessened equity value will, in turn, force the board to bargain more effectively for reduced salary levels to avoid revolt and replacement by enraged shareholders. Under this model, a market-induced decline in share values will encourage shareholder rebellion sufficient to compel a traditionally management-allied board to reconsider its compensation bargaining strategy. As a result, no externally-based approach to the compensation problem is necessary. The situation will take care of itself.

This approach may be seriously flawed despite its strong logical appeal. It is based entirely on the problematic assumption that unrea-

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includes executive stock plans with company-arranged financing, use of company aircraft and automobiles, financial, tax, and estate counselling, retirement benefits, life insurance, and intangibles, such as the power to designate firms with which the company does business, that increase the executive's prestige and power. V. HENRY ROTHSCHILD, 2ND & ARTHUR D. SPORN, EXECUTIVE COMPENSATION 1-2 (1984).

Most executive compensation plans attempt to align an executive's rate of compensation with the company's performance in various areas, most predominantly stock prices and profits. *See* Seymour Burchman, *Choosing Appropriate Performance Measures*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 189 (Fred K. Foulkes ed., 1991); Stephen F. O'Byrne, *Linking Management Performance Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91; S. Prakash Sethi & Nobuaki Namiki, *Factoring Innovation Into Top Management's Compensation*, DIRECTORS & BOARDS, Winter 1986, at 21.

[26] *See supra* notes 1 and 7.

sonable executive salary levels will result in lower equity prices. Although high salaries may indicate a lax bargaining environment between the board and the company's top executives regarding compensation practices, the harm to the company itself may appear insignificant in a macro view. To a multibillion dollar corporation, a few million more dollars paid to its top management than may actually be necessary to retain their services has little bearing on that business's overall profitability. In this sense, the alleged overcompensation may be statistically insignificant. To a business earning $250,000,000, a million dollar overpayment to an executive, while a spectacular windfall to that individual, is insignificant in evaluating the company's earnings.[27]

Many techniques are used to value a business. Analysts consider such factors as price/earnings ratios, debt to equity computations, projected earnings streams, resale value, and break-up potential, among others, to determine the going equity value of an enterprise.[28] While an executive's compensation is of major concern to that individual, in a large organization it has little impact on any of the common valuation methods because of its small relative scale. The actual effect of an excessive salary on the company's earnings or even its total asset base is likely to be minimal, if not minuscule.[29] Therefore, even if an executive has been grossly overpaid, the impact on the company's stock price will be negligible because the market places its heaviest emphasis in valuation on "the bottom line," whether that may involve earnings, assets or liabilities.[30] For a "market-based" solution to the compensation

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[27] *But see Debate*, *supra* note 1, at 133 (Michael S. Kesner, National Director on Compensation and Benefits at the accounting firm of Arthur Andersen, states that "[A] $5 million CEO pay package on the bottom line of a $2 billion sales company is clearly not the issue."). As former Illinois Senator Everett M. Dirksen remarked, "A billion here, a billion there, and pretty soon you're talking about real money." RESPECTFULLY QUOTED 155 (Suzy Platt ed., 1989).

[28] Analysts use four main methods to value companies. Discounted cash flow analysis ("DCF") essentially states that the value of a company is reflected in the profits the company will earn over a projected period of time. With the comparable company method, analysts compare the business to be valued with companies possessing similar financial and operational profiles. With the comparable acquisitions method, the value of a business is based on the cost of acquiring similar businesses. Liquidation analysis determines the company's value based on the prices the company's assets could be sold for in an orderly manner. Analysts apply combinations and variations of these methods when valuing a company. ROBERT L. KUHN, INVESTMENT BANKING 97–123 (1990). *See also* Brian H. Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing the strengths and weaknesses of the four methods).

[29] Most valuation analyses do not separately address the executive's compensation. *See supra* note 28.

[30] *See* Brownstein & Panner, *supra* note 7, at 29 ("The question is not 'Are executives paid too much?' The real question is 'Are shareholders getting their money's worth from their executives?'").

problem to be effective, overcompensation must have a reasonably significant impact on the equity value of a company to force a board response.

The market functioning alone will provide no certain remedy, because the problem seems to merit little market attention.[31] Still, a response is warranted. Even if an executive is overpaid only a single dollar, that dollar rightfully belongs to the shareholders, not the executive. In our system of criminal justice, the amount that an individual takes wrongfully is unimportant in adjudging potential criminal responsibility. The mere fact that an unlawful gain occurred is the basis for action. So must a response in the corporate arena be similarly forthcoming? While an unreasonable compensation scheme may, in and of itself, have little impact on overall corporate performance, it may also indicate a much broader problem that should demand an immediate response. An overcompensated executive is indicative of an inattentive board whose neglect may result in far more dire consequences for corporate profitability than a simple excessive salary scheme.[32] Inattention to this problem will ultimately result in a runaway management which may lead to corporate disaster. By the time company profits have decreased to such a level as to warrant a market-based response, the damage to the business and shareholder wealth will have already been done. If the loss to the corporation of its market share and reputation are severe enough, the damage may be irreversibly crippling and perhaps even fatal to the enterprise. An active, non-market-based response is therefore required.

II. A Critique of Currently Proposed Solutions

As the controversy over compensation has grown, proposals to solve the problem have proliferated as well. The governmental and legal communities have offered several dramatically differing solutions. These well-intentioned approaches miss the mark. They appear to

[31] Compensation commentator Graef Crystal concedes that a CEO's pay package does not significantly influence stock values, but argues that investors should consider both the amount of an executive's pay as well as the mechanisms by which he is paid in order to make an intelligent investment decision. Graef S. Crystal, In Search of Excess 253–64 (1991).

[32] The consequences of an inattentive board and the resulting benefits of an activist board are best illustrated by the recent turmoil at General Motors. Throughout its history, the GM board was typically beholden to GM management, with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM board finally took affirmative steps to improve the company's performance, steps which included firing GM's CEO, Robert Stempel. *See* John Greenwald, *What Went Wrong?*, Time, Nov. 9, 1992, at 42, 44.

attack the manifestation of the problem without targeting its root cause—passive bargaining resulting from inactive boards. These proposals will either prove ineffective or may even act to compound the damage to corporate health that overcompensation creates.

A. *Heightened Disclosure*

The Securities and Exchange Commission (the "SEC") has developed a two-tiered approach to the issue. This approach involves a reexamination of the way the proxy rules deal with executive compensation questions and it will have about as much effect on the problem as aspirin provides for the common cold. It may make us feel a bit better, but the offending virus remains. First, the SEC has liberalized its stance on permitting shareholders' resolutions regarding executive compensation onto the annual meeting ballot. Traditionally, such proposals were excluded as a matter of policy. Under Rule 14a-8(C)(7) of the Securities and Exchange Act of 1934, resolutions that dealt "with a matter relating to the conduct of the ordinary business operations of the registrant" were excludable.[33] Resolutions relating to compensation were said to fall within this category. In early 1992, however, the SEC amended its policy and announced that it would no longer permit the wholesale exclusion of such proposals, as long as they targeted top executive compensation and not ordinary managerial compensation policy.[34] At least ten shareholder proposals calling for compensation

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Recently, a number of formerly passive boards have become increasingly active and have removed from office managers who were previously untouchable. For example, Paul E. Lego, the Chairman and CEO of Westinghouse, resigned his post in response to mounting charges of inadequate corporate financial performance and growing concern about management effectiveness amongst the company's directors. Stuart Mieher, *Westinghouse's Paul E. Lego Resigns as Chief*, WALL ST. J., Jan. 28, 1993, at A3, A6. IBM's CEO and Chairman John F. Akers was forced into retirement as the company saw its stock price lose half of its value within a six-month time frame: the corporation was forced to make a 55% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Michael W. Miller & Laurence Hooper, *Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed*, WALL ST. J., Jan. 27, 1993, at A1, A6.

In the past 18 months, 13 Fortune 500 corporate CEOs have either resigned, been fired, or been asked by their directors to prepare for departure. Prominent among Lego's and Aker's colleagues: Nicholas J. Nicholas, Jr., Time Warner; Tom H. Barrett, Goodyear; James D. Robinson III, American Express; Kenneth H. Olsen, Digital Equipment; Joseph R. Canion, Compaq Computer; and James L. Ketelsen, Tenneco. Stewart, *supra* note 21, at 34, 35–36, 40.

[33] 17 C.F.R. § 240.14a-8(c)(7) (1992). Rule 14a-8(c)(7) states:

> (c) The registrant may omit a proposal and any statement in support thereof from its proxy statement and form of proxy under any of the following circumstances:
>
> ....
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> (7) If the proposal deals with a matter relating to the conduct of the ordinary business operations of the registrant.

[34] Kevin G. Salwen, *Shareholder Proposals On Pay Must be Aired, SEC to Tell 10 Firms*, WALL ST. J., Feb. 13, 1992, at A1.

limitations were allowed onto proxy ballots. None, however, was ultimately successful.[35]

The second tier of the SEC's response to the compensation issue involves increased public disclosure of executive salary arrangements. In June, 1992, the SEC proposed sweeping changes in the type and amount of disclosure that must be made to the public by reporting corporations in the executive pay area. The reasoning behind the proposals was ostensibly "to improve shareholders' understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance."[36] Three new disclosure requirements were proposed. First, all compensation paid to certain senior executives was to be reported to the public in the form of a "Summary Compensation Table" which would "show both annual and long-term compensation in a single, comprehensive overview."[37] Second, the board's Compensation Committee would be directed to prepare a report "on the corporate performance factors that it relied on in making specific compensation awards for reporting executives, as well as describe the general policies of the committee in determining senior executive compensation."[38] Third, the reporting corporation would be required to prepare an annual "Performance Graph"[39] to aid in shareholder evaluation of the effectiveness of corporate performance in relationship to compensation practices. This graph would set forth the cumulative total return to shareholders of the registrant over a period of at least the previous five years, together with the comparable return to

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[35] The ten proposals and the percentage of shares voted in favor of each motion are: IBM: improved disclosure of officer pay, 16.7% shares; Baltimore Gas & Electric: cap executive pay at 20x average worker's salary, 12.2% shares; Eastman Kodak: disclose executive severance packages, 15.9% shares; Equimark: tie executive severance pay to company performance, 16.5% shares; Bell Atlantic: end management short-term bonus plan, 10.9% shares; Black Hills Corp.: eliminate director's retirement plan, 36.9% shares; Chrysler: disallow revaluing of stock options, 5.6% shares; Aetna: cut director's pay for failure to attend board meetings, 7.5% shares; Battle Mountain Gold: cut executive pay 30% and end stock options until profit recovers, not on ballot; Reebok: establish compensation committee of independent directors, 19.2% shares. Executive Compensation Disclosure, Exchange Act Release No. 6940, 57 Fed. Reg. 29,582, 29,583 (July 2, 1992); REEBOK INT'L LTD., MAR. 30, 1992, PROXY STATEMENT (1992); *Battle Mountain Gold Sees Possible Loss*, REUTERS, Apr. 21, 1992, *available in* LEXIS, Nexis Library, Reuters File; Salwen, *supra* note 34, at A12. *See also* Judith H. Dobrzynski, *A Ground Swell Builds for 'None of the Above'*, BUS. WK., May 11, 1992, at 34 (observing that many shareholders are withholding proxy votes in an effort to remove directors from company boards).

[36] Executive Compensation Disclosure, Exchange Act Release No. 6962, 57 Fed. Reg. 48,126, 48,126 (Oct. 21, 1992).

[37] *Id.* at 48,126–27.

[38] *Id.* at 48,127.

[39] *Id.*

shareholders for the stocks included in (i) the Standard and Poor's 500 Composite Stock Price Index ("S & P 500"); and (ii) any recognized industry index (e.g., the Dow Jones Transportation Average) or a group of peer companies selected by the registrant.[40] Following substantial public comment and debate,[41] the SEC adopted the proposals with some changes made in the amount of information to be disclosed. A number of the proposed tables were either revised or dropped "to eliminate redundant information and to improve the clarity of information presented."[42] Despite these changes, the increase in the amount and type of information to be reported under the new rules as compared with the material disclosed under the old regime was substantial.

It is clear from these changes that the SEC has settled on a disclosure-based approach to the compensation controversy. In the SEC's view, the solution to overcompensation lies with an informed and empowered shareholdership, informed as to exactly how much the executives are earning and how that figure relates to performance, and empowered to vote both on compensation resolutions and, if thoroughly dissatisfied, on ultimate board replacement. SEC Chairman Richard C. Breeden has summarized the Commission's theory behind its actions by stating that:

> The proposals would give the shareholders more information and then make it reasonably possible for them to do something about that information . . . . The philosophy that underlies the proposals is that the people in the best position, if a company is deteriorating or stagnating, to do something about it are the people who own it. For too long, the Wall Street rule has been that if you don't like what's going on, sell out. That has made it difficult and expensive for shareholders. These proposals make sure the information is out in the open and remove the restraints so shareholders can do something.[43]

This approach, although not without some visceral appeal (for who can argue with a better-informed public), is basically ineffectual. Indeed, in its very premise can be found the source of its primary

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[40] *Id.*

[41] 57 Fed. Reg. at 48127. The SEC received more than 900 letters of comment concerning the proposal. *Id.*

[42] *Id.*

[43] Stephen Labaton, *SEC Will Require Fuller Disclosure of Executive Pay*, N.Y. TIMES, Oct. 15, 1992, at A1, C22.

weakness. The whole concept relies on the idea that an outraged and invigorated shareholding public will provide the solution to the perceived corporate malaise. Shareholder activism will result in more accountable and productive management. The best way to create this necessary activism is through the prodding effect of heightened disclosure. Additionally, the more excessive a salary structure appears, the more likely that full disclosure will embarrass management into correcting the situation.

Although it is certainly true that as the owners of the enterprise, shareholders have the power to engage effective and accountable managers, it is equally clear that this ability does not always translate into results. Indeed, it was the same shareholders who permitted the creation of that management capture that has led to the entire controversy. Shareholder passivity created the problem, and it is unlikely that disclosure will provide the solution. This irksome passivity is not the result of a lack of information, but, rather, a growth in the size of the typical public corporate entity. The larger the corporation became, the more likely its ownership took on an atomistic quality, with no one shareholder or shareholding group exercising control.[44] Moreover, as the size of proportionate shareholding fell, individual shareholders, who no longer held controlling or particularly significant amounts of stock, lacked the incentive to take an active role in the corporation's affairs. Management then filled the vacuum.[45] Increased disclosure will have no effect on this situation. As Professor Bainbridge has observed:

> Basic financial economics tells us that most shareholders prefer to be passive investors. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs. Given the length and complexity of SEC disclosure documents, the opportunity costs are quite high and very apparent. In contrast, the benefits aren't at all clear because most shareholders' holdings are too small to have any significant effect on the vote's outcome. For most shareholders, therefore, the investment of time and effort necessary to make informed voting decisions remains a game not worth playing. . . . What then will shareholders do with the enhanced disclosure required by the commission's present proposals? They will do what they always do

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[44] *See* WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 142–43 (concise 6th ed. 1988).

[45] *Id.* at 141.

with corporate disclosure: ignore it and simply vote for management's director slate and management compensation proposals.[46]

What about the institutional investors whose growing ownership presence in the largest public corporation presents, according to many scholars, so much potential for effecting positive change in corporate governance? Will increased disclosure motivate this group to pursue more reasonable compensation practices? Probably not. First, for reasons to be developed later in this section,[47] it is unlikely that institutional investors, even if awakened from their current economic slumber, will ever achieve the substantial control position in a corporation necessary to direct the affairs of the business. Second, it is unclear that the compensation disclosure now mandated by the SEC will inform institutional investors (or individual investors, for that matter) of anything that they do not already know. As a result of the heightened media attention to the issue, much information on compensation programs in a dizzying variety of corporations (based on past disclosure requirements) has flooded the market-place. Various popular financial publications feature annual performance profiles of numerous public companies detailing compensation practices and how they relate to overall performance.[48] There is no shortage of information available to the individual investor on corporate compensation. Moreover, the performance comparisons the SEC has now required reporting companies to make are well within the analytical capabilities of even the most inexperienced financial analyst and may be available to all investors through periodic brokerage house reports. Indeed, the SEC's new disclosure regime will only serve to create more fodder for potential Rule 10b-5 mis-disclosure actions.[49] The end result may be an

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[46] Stephen M. Bainbridge, *Executive Pay: Who Listens?*, LEGAL TIMES, Aug. 10, 1992, at 23. *See also* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 525 (1992) (observing that shareholders are not effective monitors of a company's board of directors and that prominent features of corporate law actually make it difficult for shareholders to hold the board and managers legally responsible).

[47] *See infra* notes 90–100 and accompanying text.

[48] *See, e.g.*, *The Boss's Pay*, WALL ST. J., Apr. 22, 1992, at R9; *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 149; *What 800 Companies Paid Their Bosses*, FORBES, May 25, 1992, at 182.

[49] *See* Bainbridge, *supra* note 46, at 22 (commenting that disclosure rules only benefit plaintiffs' lawyers who will bring lawsuits and defense lawyers who will defend them). To avoid this potential liability, companies have started to hire a variety of different advisors, including law firms, compensation consultants, public relations firms, accountants, investment banks, computer software makers, and publishers of electronic data. Thus, company shareholders must pay for increased disclosure in the form of fees the company pays to these advisors. Joann S. Lublin &

increase in official information available, but with little corresponding benefit.[50] Increased required disclosure will do little to arrest the traditional cause of shareholder passivity and will have an insignificant impact on overcompensation.

B. *Increased Taxation*

The second major response to the compensation controversy has come from the legislature. In early August, 1993, the Congress, upon the recommendation of the President, enacted legislation that placed a one million dollar limit on the deductibility of executive compensation. Under a provision contained within the Revenue Reconciliation Act of 1993, corporations are no longer able to deduct, as a business expense, compensation payments to executives that exceed one million dollars per annum that are not performance-based.[51] Additionally, a special surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year.[52] The theory seems to be that by removing the deductibility of high salaries, and increasing the taxes due by the recipients of sizeable compensation, corporations and the individual recipients will find it too costly to negotiate excessive compensation packages. The benefits of high compensation to the recipient will be taxed out of existence and the corporation itself will find it twice as expensive to pay such large salaries. Moreover, by setting the taxation tripwire at one million dollars, Congress seems to have concluded that salaries over this level are per se excessive.

Although this approach will certainly "solve" the compensation problem and simultaneously produce heightened revenues for a tax-

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Julie A. Lopez, *Executive-Pay Disclosure Rules Pay Off—For Advisors*, WALL ST. J., Jan. 15, 1993, at B1.

[50] Indeed, the new disclosure requirements may even have the deleterious effect of deluging the investor in "data-overkill." Joann Lublin, *Executives Grumble About SEC Plan to Require More Pay Data*, WALL ST. J., Sept. 21, 1992, at B1. The new disclosure requirements, however, appear to have increased institutional investor scrutiny of the compensation practices of at least one company. The Wisconsin public pension fund is seeking to remove the outside directors of Paramount Communications who approved the company's executive compensation plan. The fund is basing its action on charts, required by the SEC, which show that, although Paramount's stock has underperformed both the Standard & Poors 500 stock index as well as peer group stocks, Paramount executives continued to receive bonuses. Susan Pulliam, *Paramount Is Targeted by Pension Fund Due to Weak Stock Price, Executive Pay*, WALL ST. J., Mar. 4, 1993, at A4.

[51] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). See *supra* note 10 and accompanying text for a discussion of the new limitations placed upon corporate deductions for executive compensation.

[52] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). See *supra* note 11 and accompanying text for an examination of the surtax placed on individual incomes in excess of two hundred fifty thousand dollars.

starved treasury, it will have no favorable impact on corporate health in general. This response is akin to removing a splinter by amputating the limb. The splinter is gone, but at enormous cost. Similarly, this tax-based "cure" may result in more harm to the patient than the initial problem.

First, there is nothing inherently wrong with a salary over one million dollars. An executive who produces substantial increases in corporate profitability that results in large profits for the shareholders, may be worth paying more to retain in the competitive labor market place.[53] The salary is only problematic when it has not been fairly bargained for. Second, a salary not only provides compensation for an individual's efforts, but also acts as an incentive for future activity. Companies compensate both to reward past activities and to encourage greater productivity in the future. The idea emanates from the classic carrot-stick parable. It is not the stick that compels productive labor, but the carrot as incentive. The larger the carrot, the greater incentive to increase productivity.[54] While a large salary may certainly be viewed as a wasteful expenditure of corporate assets if one assumes that wages were simply created to compensate solely for work produced, from a different perspective, heavy compensation may be beneficial to the corporate enterprise as a powerful incentive for heightened management creativity and effort. The larger the proffered salary, the greater effort potentially to be expended. To limit arbitrarily the amount of compensation will effectively eliminate any incentive for the kind of executive productivity necessary to keep our large corporations competitive.

The term compensation itself is a bit of a misnomer, for compensation is not merely a reward for past services, but also acts as an incentive for future efforts. As pointed out earlier, a large salary is not in and of itself pernicious; it is only when it has not been bargained for and is a simple toll paid to the ineffective that it becomes troublesome.[55] To solve the perceived problem of overcompensation by summarily taxing out of existence salaries over one million dollars per year

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[53] *See* CRYSTAL, *supra* note 31, at 159–73 (arguing that high-paid CEOs of Reebok, Walt Disney, and H.J. Heinz are properly compensated due to the risk they take and the returns they generate for their shareholders).

[54] *See* LLOYD G. REYNOLDS ET AL., LABOR ECONOMICS AND LABOR RELATIONS 183–84 (1986). *See also* Burchman, *supra* note 25, at 189–211 (discussing ways to create proper incentives through executive compensation). This "carrot" theory of compensation is evidently in operation as IBM searches for a new CEO. Despite IBM's well-publicized problems, it has had little difficulty finding accomplished candidates for the lucrative position. Michael W. Miller, *IBM's Search for New Leader Appears Ahead of Schedule*, WALL ST. J., Feb. 24, 1993, at B1.

[55] *See infra* notes 113–16 and accompanying text.

would stifle the crucial incentives created by the prospect of high, and perhaps seemingly excessive, salary levels.

C. *Judicial Activism*

While some have sought to curtail compensation through heightened disclosure or tax-based legislative limits, one group of commentators has focused on a judicially-based approach.[56] They maintain that active judicial review of executive compensation structures may serve to limit executive salaries. Professor Vagts has argued that while judicial evaluations of "the excessiveness of compensation are not easy to make, they are not impossible. . . . [C]ourts can and should carefully scrutinize compensation that is substantially out of line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them."[57] This approach to the compensation issue is not without some appeal but it may prove to be as ineffective today as it was when the problem first emerged in the mid-1930s.

Board compensation decisions are generally protected by the business judgment rule.[58] Provided that there has been an informed deci-

[56] *See* Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 252–61. Both authors point out the willingness of several courts to grapple with the overcompensation issue by applying comparative data in judging the appropriateness of compensation in close corporation, tax and partnership cases. Although the authors note that there are salient differences between public corporations and close corporations, and between tax cases and derivative actions, they each conclude that courts should be willing to apply the same type of analysis in the context of public corporation overcompensation cases. Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 252–61. *See also* Bogus, *supra* note 12, at 79–83.

[57] Vagts, *supra* note 4, at 276. *See also* Barris, *supra* note 2, at 87. *But see* Geoffrey S. Rehnert, Comment, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1154 n.38 (1985) (observing that courts have not applied reasoning employed in close corporation and tax cases to public corporation cases).

[58] Compensation decisions are in essence "self dealing" transactions because they may be voted on by those inside directors who have an obvious stake in the decision and theoretically should be reviewed under the rules governing self-interested transactions, which require that such transactions must (1) be fully disclosed to the corporate decision-makers and (2) be fair to the corporation in order to pass muster. Because "compensation differs from other self-interested transactions," these rules are applied somewhat differently. Section 5.03 of the [ALI's] *Principles of Corporate Governance*, following the case law, therefore breaks off compensation transactions for separate treatment by adopting the rule that if full disclosure has been made, and the compensation has been approved by disinterested directors, it will be reviewed only under a business judgment standard. Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1006 (1988). Therefore, provided that an executive who is also a director does not vote on his compensation arrangement, the disinterested directors' decision to approve that arrangement will be protected by the business judgment rule. *See* Barris, *supra* note 2, at 81–83.

In Aronson v. Lewis, 473 A.2d 805 (Del. 1983), the Delaware Supreme Court described the business judgment rule as:

> [A] presumption that in making a business decision the directors of a corporation

sion-making process and no self-dealing, a board's compensation award will be judicially unassailable, with one exception. Where compensation to an executive simply bears no relation to the services that individual has rendered, it will be considered a waste of corporate assets and thus actionable.[59] This standard was initially promulgated by

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> acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest . . . of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted). The American Law Institute—in its *Principles of Corporate Governance* has defined the rule in the following manner:

> (c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:
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> (1) he is not interested . . . in the subject of his business judgment;
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> (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
>
> (3) he rationally believes that his business judgment is in the best interest of the corporation.

PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). *See also* Teren v. Howard, 322 F.2d 949 (9th Cir. 1963); Wall & Beaver Street Corp. v. Munson Line, Inc., 58 F. Supp. 109 (D. Md. 1944); Richardson v. Blue Grass Mining Co., 29 F. Supp. 658 (E.D. Ky. 1939), *aff'd*, 127 F.2d 291 (6th Cir. 1942); Haber v. Bell, 465 A.2d 353 (Del. Ch. 1983).

The Delaware Supreme Court, in *Beard v. Elster*, explained the rationale behind the application of the business judgment rule to compensation decisions:

> We have before us a [stock option] plan which, in the judgment of a disinterested Board, is adequately designed to further the corporate purpose of securing the retention of key employees' services. It is theoretically possible, we suppose, that some businessmen could be found who would hold the opinion that options exercisable at once were improvidently granted, but, on the other hand, there are businessmen who would hold a favorable view, as this board of independent businessmen in fact did. At most, therefore, we find ourselves in the twilight zone where reasonable businessmen, fully informed, might differ. We think, therefore, we are precluded from substituting our uninformed opinion for that of experienced business managers of a corporation who have no personal interest in the outcome, and, whose sole interest is the furtherance of the corporate enterprise.

160 A.2d 731, 738 (Del. 1960), *aff'd sub nom.* Elster v. American Airlines, 167 A.2d 231 (1961).

Section 5.03 of the ALI *Principles of Corporate Governance* provides in part that a court may not invalidate a compensation arrangement if it is "authorized in advance or ratified by disinterested directors . . . in a manner that satisfies the standards of the business judgment rule." PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 5.03(a)(2). Where directors have a personal interest in the fixing of executive compensation, the business judgment rule does not apply and the directors must prove that the transactions were fair to the corporation. Cohen v. Ayers, 596 F.2d 733, 739–40 (7th Cir. 1979) (citing Kerbs v. California Eastern Airways, 90 A.2d 652 (Del. 1952), *reh'g denied*, 90 A.2d 652 (1952); Gottlieb v. Heyden Chemical Corp., 90 A.2d 660 (Del. 1952)).

[59] Even disinterested directors and shareholders cannot ratify waste. Rogers v. Hill, 289 U.S. 582, 591–92 (1933) ("If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority."). Courts usually define "waste" in terms of the adequacy of consideration the corporation receives from the employee in return for the

the Supreme Court in 1933 in *Rogers v. Hill*,[60] which remains the seminal compensation case.[61] Following disclosures made in the 1930s of substantial compensation paid to executives immediately prior to and during the Great Depression, a number of shareholder actions were brought challenging these compensation practices.[62] The *Rogers* decision determined the approach for judicial review of these claims.

While the "waste" standard articulated by the *Rogers* Court was seemingly simple to comprehend, problems arose in its actual application. The difficulty was, of course, in determining when exactly compensation was unrelated to services rendered. The oft-cited language of a New York State Supreme Court Judge in the legendary *Heller v. Boylan*[63] decision highlights the difficulty of determining what constituted actionable waste:

> Assuming arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring-rod? The conscience of equity? Equity is but another name of human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing this

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compensation paid by the corporation. *See, e.g.*, Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984) (holding that stock option plans must contain conditions or surrounding circumstances must be such that the corporation may reasonably expect to receive the contemplated benefit from the grant of options); Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (ruling that the court's examination is limited to discovering whether what the corporation has received from the employee is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation paid). Courts have held that boards have not wasted corporate assets when the boards canceled existing stock option plans and reissued new options to executives at a lower exercise price when the company's stock price declined. *See Cohen*, 596 F.2d at 741–43.

The United States Court of Appeals for the Eighth Circuit, in *International Ins. Co. v. Johns*, ruled that in determining whether a corporation receives "adequate" consideration for payments to an executive, a court must inquire into whether the compensation an executive receives bears a "reasonable relationship" to the services rendered. 874 F.2d 1447 (1989) (citations omitted). The court further stated that to find a reasonable relationship, a court must answer three questions. First, did the corporation benefit from the services rendered? If the corporation received no benefits in exchange for the payments, the compensation plan is waste. Second, was the compensation so disproportionate to the benefits received that a reasonable person would think that the corporation received no quid pro quo? If no quid pro quo resulted, the payments would constitute corporate gifts. Finally, did the services rendered trigger the payments? If some other occurrence triggered the payments, the plan is invalid because it cannot assure performance. *Id.* at 1461–62 (citations omitted).

[60] 289 U.S. 582 (1933).

[61] Barris, *supra* note 2, at 84.

[62] Vagts, *supra* note 4, at 252–53.

[63] Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941), *reh'g denied*, 32 N.Y.S.2d 1011 (1942).

> corporation than its stockholders?
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> Yes, the Court possesses the *power* to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.
>
> If comparisons are to be made, with whose compensation are they to be made—executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province.[64]

For these reasons, courts have been highly reluctant to involve themselves in compensation disputes. A compensation decision is not really capable of mechanistic review. It is essentially a business judgment and the same rationale that mandated the creation of the business judgment rule lies behind judicial reluctance to characterize certain payments as "waste." A court is hardly in a better position than an informed, impartial board to determine an executive's worth.[65] Furthermore, the liability that would result from such judicial second-guessing would seriously compromise a board's effectiveness and its ability to recruit prospective members. Thus, since the *Heller* ruling, there have been few reported cases dealing with the compensation levels of executives of large publicly-traded corporations. In those cases, the courts have reached similar results, "either appl[ying] the business judgment rule and endors[ing] the compensation practice, or simply throw[ing] in the towel and refus[ing] to deal with the problem."[66]

Despite judicial reluctance to decide compensation questions in-

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[64] 29 N.Y.S.2d at 679–80.

[65] Barris, *supra* note 2, at 82. *See also* Vagts, *supra* note 4, at 254–55.

[66] Barris, *supra* note 2, at 82. *See infra* notes 67–69 and accompanying text. *See also* Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 255–57.

volving large, public corporations, the same reticence is not evident in numerous cases regarding compensation disputes in smaller close corporations. Courts regularly pass on salary fairness, or lack thereof, in this area.[67] In addition, in the tax arena, both tax court and U.S. District Court judges frequently review executive compensation packages to determine the appropriateness of specific corporate deductions for "reasonable" compensation expenditures under § 162 of the Internal Revenue Code.[68] Commentators argue that if the courts have no problem determining the reasonableness of compensation in the close corporation and tax settings, they should extend the same "judicial aggressiveness" to the large corporation compensation cases.[69]

This call for judicial activism, in the face of escalating compensation packages, will remain as unheeded by the courts in the future as it was when initially issued by Professor Vagts more than ten years ago. Although courts have indeed manifested a willingness to review compensation in certain limited contexts, Professor Vagts' call to action underestimates the critical differences between compensation disputes in the close corporation or tax cases and those involving large corporations. The close corporation compensation cases are not disputes about compensation at all. Rather, they are grounded in the attempted oppression of minority shareholders by a controlling shareholder or group of shareholders.[70] In actuality, these cases involve attempts by

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[67] *See, e.g.*, Roged, Inc. v. Paglee, 372 A.2d 1059 (Md. 1977); Galler v. Galler, 316 N.E.2d 114 (Ill. 1974), *aff'd*, 336 N.E.2d 886 (1975); Baker v. Cohn, 42 N.Y.S.2d 159 (Sup. Ct. 1942), *modified and aff'd*, 40 N.Y.S.2d 623 (1943), *aff'd as modified*, 54 N.E.2d 689 (1944). *See also* Barris, *supra* note 2, at 87; Vagts, *supra* note 4, at 256.

[68] The Internal Revenue Code states generally that a trade or business deduction shall be allowed for all ordinary and necessary expenses, a provision which includes a "reasonable" allowance for salaries and compensation for services actually rendered. I.R.C. § 162(a)(1) (1988). Factors used by the courts include: the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexity of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable position in comparable concerns; the salary policy of the taxpayer as to all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in recent years. Mayson Mfg. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949). *See generally* WILLIAM E. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 215–20 (2d ed. 1981); David E. Hoffman, *Heeding Significant Factors Improves the Odds for Reasonable Compensation*, 50 J. TAX'N 155 (1979).

[69] Barris, *supra* note 2, at 87; Vagts, *supra* note 4, at 276. *See also* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1896–1906 (1992) (reviewing GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991)) (suggesting that easing the legal standard from "waste" to "reasonable in relation to the corporate benefits expected" will create the possibility of litigation with attendant uncertainty which will result in incentive for restraint by CEOs seeking substantially above-average compensation).

[70] All of the close corporation cases Professor Vagts cites to support his proposition that courts

the controlling shareholders to steer large portions of the corporate profits selfward rather than sharing the fruits of corporate success proportionately with their fellow equity-holders. Instead of dividing the profits evenly through dividends, the controlling individuals enrich only themselves through large compensation packages, leaving fellow shareholders out in the cold, deprived of the benefits of equity ownership.[71]

Whether effected through simple greed or as part of some nefarious "freeze-out" scheme,[72] this manifestly unfair sharing is the type of self-dealing that courts, from an equity standpoint, are eager to remedy. It is not the size of the compensation that provokes a judicial response, but the attempt to divert profits from the minority holders. These shareholders really have no other remedy besides judicial intervention. Because of their minority status, they cannot win a board or shareholder vote on the practice, nor is there any market for their shares. The only potential purchaser is the oppressing majority. In such circumstances, it is a relatively appealing task for a court to intervene and find the compensation unjustified, either forcing a proper sharing of corporate profits with the minority, or a majority buy-out of their shares at an acceptable price. This explains judicial willingness to engage in compensation review in this area. Such judicial involvement is not really about compensation; rather, it involves clear and remedi-

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can determine reasonable compensation involved some kind of self-dealing or bad faith conduct. Vagts, *supra* note 4, at 256 nn.114–15 (citing Ruetz v. Topping, 453 S.W.2d 624, 631 (Mo. Ct. App. 1970) (defendant, president of company, raised his own salary; suit brought by defendant's ex-wife who owned half of the company's stock); Fendelman v. Fenco Handbag Co., 482 S.W.2d 461 (Mo. 1972) (majority shareholder directors forced minority shareholder director who founded company out of office and paid no dividends to non-director shareholders; founder returned to former job of cutting linings for purses); Goldman v. Jameson, 275 So. 2d 108 (Ala. 1973) (directors owning 80% of company stock removed minority shareholder from board and did not pay dividends); Binz v. St. Louis Hide & Tallow Co., 378 S.W.2d 228 (Mo. Ct. App. 1964) (after minority shareholder/director sold stock to son, other directors brought in additional directors in violation of stock agreement and raised their salaries)).

In one study, courts found compensation to be excessive in 23 out of 67 close corporation overcompensation cases. Of these 23 cases, all but one involved self-help or self-dealing on the part of the defendant executive. 2 Washington & Rothschild, *supra* note 6, at 865–67.

Most courts, before they will substitute their judgment for that of the directors, seem to require that unreasonable compensation be coupled with a clear showing of dishonest, oppressive or improvident corporate management that they can label "fraud," "bad faith," "breach of fiduciary duty," "waste," or "spoliation."

1 F. Hodge O'Neal & Robert B. Thompson, O'Neal's Oppression of Minority Shareholders § 3.08, at 59–60 (2d ed. 1991).

[71] *See, e.g.*, Sugarman v. Sugarman, 797 F.2d 3 (1st Cir. 1986); Bessette v. Bessette, 434 N.E.2d 206 (Mass. 1982); Shelstad v. Cook, 253 N.W.2d 517 (Wis. 1977).

[72] *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513–15 (Mass. 1975) (describing various freeze-out techniques). *See generally* O'Neal & Thompson, *supra* note 70, § 3.07.

able self-dealing. Without the protection of the courts, few investors would be willing to accept minority status in a small corporation, and such enterprises would be deprived of necessary investment capital.

This is not the case in the large public corporation setting where excessive executive compensation deprives shareholders of a relatively small portion of profits and is effected by a group without the kind of absolute control possible in the close corporation arena. In small businesses, it is not uncommon for a control group to possess over 50% of the corporation's stock and effectively block any kind of minority response to unwelcome actions.[73] In the large public corporation, management controls a relatively small amount of stock and can always be outvoted by an outraged shareholdership. This is obviously not an easy task but it is not a numerical impossibility, as is often the case in the close corporation setting. Thus, judicial involvement seems less necessary, as the problem appears less drastic and other remedies are available. Concerns about judicial competence to review compensation reemerge and stifle intervention.[74]

Judicial activism in the taxation cases is also easily distinguished from the ordinary compensation dispute. The general object of any kind of tax litigation is not the punishment of some overreaching executive, but the production of additional revenue for a tax-starved federal treasury.[75] The objective is revenue generation and any judicial

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[73] *See Donahue*, 328 N.E.2d at 511 (defining a close corporation as a corporation typified by "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in management"). Holders of a majority of a company's stock have the ability to elect and control a majority of the company's directors and thus have the power to employ a variety of techniques to deprive minority shareholders of the value of their interests in the company. Some examples of these techniques include a refusal to declare dividends, payment of exorbitant salaries to majority shareholder officers, refusal to employ minority shareholders, and sale of corporate assets to majority shareholders at inadequate prices. O'NEAL & THOMPSON, *supra* note 70, § 3.02.

[74] Due to the disparity in size of earnings between a small close corporation and a large public corporation, it is usually easier for a court to determine whether an executive's salary is excessive in the close corporation. For example, a $1 million salary for an executive in a Fortune 500 company is insignificant in relation to the company's bottom line, whereas in a small close corporation, the same salary could constitute a significant percentage of the company's earnings for a given year and thus substantially reduce dividend payments to the company's shareholders. *See* Vagts, *supra* note 4, at 255–56.

[75] The executive compensation cases in this area generally deal with close corporations in which company executives are also controlling shareholders. Section 162 of the Internal Revenue Code is designed to prevent these owner-managers from distributing sums in the guise of salaries (which are deductible by the corporation) that are actually non-deductible dividends and thus subject to corporate-level taxation. *Id.* at 257. Thus, in this area, courts do not focus solely on the reasonableness of an executive's compensation. They are equally, if not more, concerned with a company's dividend policy. *See, e.g.*, McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970) (finding compensation reasonable, yet disallowing deduction because the corporation

concern about second-guessing a board is secondary to the process. With this in mind, courts review compensation in this arena not with the objective of limiting unreasonable salaries, but to determine the legitimacy of income deductions that reduce tax revenues.[76] The business judgment concerns that accompany judicial review of ordinary compensation actions are simply not present in this area and thus do not create the same judicial reluctance to become involved.

The problem of judicial involvement in large corporation compensation disputes, like that raised in *Heller*,[77] is as valid today as it was fifty years ago. Courts neither feel comfortable nor particularly well-qualified to substitute their business judgment for that of an informed board of directors. Nothing has changed in the past five decades to enable courts to determine with any better precision what part of a salary has been earned and what part constitutes "waste." The Judiciary's discomfort and consequent reticence remain and will continue. There simply is no mechanistic procedure available to compute with precision an executive's worth and any judicial resolution of the matter involves a judgment call of the type courts have typically avoided. Unless a plaintiff can introduce some kind of evidence of fraudulent or collusive behavior on the part of a board in its compensation decision-making process, misconduct which would provide for easy judicial resolution, it is highly unlikely that the courts will abandon their traditional passivity in compensation cases. Judicial activism is simply not a realistic solution to the overcompensation dilemma.

D. *Institutional Shareholder Activism*

Another proffered solution to the compensation problem involves institutional shareholder activism. It is argued that institutional inves-

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did not pay dividends the previous five years). *See also* Geoffrey S. Rehnert, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1155 n.38 (1985).

[76] The legal standard in the tax cases is different from the standard in shareholder suits. While shareholders must show that compensation amounts to "waste," the test in the tax cases is merely one of "reasonableness." *See supra* notes 59 and 68.

Professor Vagts observes that very few tax cases involve public corporations. Vagts, *supra* note 4, at 258. This fact is not surprising given that, in most public corporations, compensation is approved by a majority of disinterested directors and has no relation to the company's dividend policy. If a public company does not pay dividends, it usually reinvests the sums into the company for new capital or debt service. *But see* R.J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889, 896–97 (Ct. Cl. 1957) (finding that distributions of profits to employees of a public corporation in proportion to the employees' stockholdings constituted a dividend distribution and not compensation).

[77] Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941).

tors, who increasingly constitute the largest shareholders in many of the largest public corporations,[78] possess tremendous potential to effect positive change in the operation of these businesses by becoming more active "monitors" of corporate management. The size and financial sophistication of institutional investors make them uniquely positioned to take the lead in promoting corporate productivity. Increased institutional investor activism will result in more effective shareholder oversight of both boards and managers and may prove a solution to corporate inefficiency by stimulating more productive and responsive management. Indeed, much scholarly attention has been devoted to the "promise of institutional investor voice."[79]

The positive potential of active monitoring may also carry over to the compensation area. Professor Black has suggested that despite "systemic shortfalls in corporate performance . . . institutional oversight, either directly or through stronger boards of directors, could correct these shortfalls. . . . Institutional investors could add value by . . . establishing a more arm's-length process for setting CEO pay."[80] As a corporation's largest shareholders, institutions may have the clout to force a board to bargain impartially and effectively with senior management to produce reasoned compensation arrangements. Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would

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[78] By the end of 1990, institutions owned 53% of the equity in U.S. companies. In addition, institutions have begun to concentrate their assets in specific companies. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1140 (1991) (observing that the top twenty pension funds plus the ten largest U.S. money managers hold more than 16% of the shares in the 10 largest U.S. corporations) (citing William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70); Black, *Agents*, *supra* note 17, at 827. *See also* Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets*, *in* INSTITUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3–33 (Arnold W. Sametz & James L. Bicksler eds., 1991); Barris, *supra* note 2, at 89.

[79] Black, *Agents*, *supra* note 17. *See also* MONKS & MINOW, *supra* note 2; Barnard, *supra* note 78; Black, *Empirical Evidence*, *supra* note 13; Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (1989); Gilson & Kraakman, *supra* note 17; Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1 (1991); Thomas C. Paefgen, *Institutional Investors* Ante Portas: *A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

[80] Black, *Empirical Evidence*, *supra* note 13, at 899, 915–17.

be strong enough to convince otherwise passive directors to act more effectively.

To encourage this seemingly positive form of monitoring, a number of commentators have proposed various reforms in the legal rules regulating institutional conduct in order to give institutional investors more freedom and incentive to engage in active oversight of corporate activities.[81] In addition, they have formulated numerous techniques for institutional investors to use in their attempts to exercise corporate control.[82] These proposals include: amending various SEC regulations to permit more communication and coordination between institutions;[83] altering regulations governing institutional investment strategy to restrict portfolio diversification to discourage investor "exit" and encourage investor "voice;"[84] creating activist shareholders' advisory committees to make management more aware of institutional concerns;[85] placing representatives of the institutional investors on the corporate boards themselves;[86] or even creating a cadre of professional directors who would serve on corporate boards to demand effective management.[87]

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[81] *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (describing the complex web of legal rules and cultural factors that prevent institutional shareholders from becoming more active monitors); Coffee, *supra* note 79 (suggesting that an incentive for institutional monitoring be created by restricting portfolio diversification, requiring fund managers to price investment and monitoring services separately, and authorizing incentive compensation for fund managers); Conard, *supra* note 79, at 176–78 (calling for, among other things, greater access to company proxy statements and the removal of the threat of "controlling person" liability); Dent, *supra* note 79, at 907 (proposing that a committee of a firm's 10 or 20 largest shareholders be given authority to use corporate funds to solicit proxies). *Cf.* Rosenbaum, *supra* note 79 (contending that changes in the proxy rules are unnecessary). *See also* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (observing that U.S. financial institutions cannot reach their full potential as monitors due to a variety of legal prohibitions designed to prevent them from gaining too much power).

[82] See Black, *Agents*, *supra* note 17, at 830–49, for a discussion of the variety of methods institutional investors could employ to affect corporate performance.

[83] *See* Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1991) [hereinafter Black, *Disclosure*]; Conard, *supra* note 79, at 161–62, 177–78; Dent, *supra* note 79, at 907–23.

[84] Coffee, *supra* note 79, at 1351–66.

[85] Participation in a "shareholders' advisory committee" is the most commonly proposed role for the institutional investor. In general, these committees would be composed of representatives of a company's largest shareholders and would be appointed by the board of directors for one-year terms. The committee would advise the board on matters of concern to the company's shareholders and submit proposals from time to time. *See* Barnard, *supra* note 79; Rock, *supra* note 79, at 49. Professor Barnard argues that shareholders' advisory committees will be ineffective monitors of corporate performance and suggests that institutions should place representatives on the board itself, rather than on some "shadow committee." Barnard, *supra* note 79, at 1168–73.

[86] *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209–10 (1988); Barnard, *supra* note 79, at 1168–73; Dent, *supra* note 79, at 907.

[87] Gilson & Kraakman, *supra* note 17, at 883–92.

It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active agitators for change in corporate policy and personnel. Most recently, a number of the large institutions have played a major role in forcing changes in management and policy at such prominent corporations as IBM, Sears Roebuck, American Express, and even General Motors.[88] Despite this activity, it is unclear whether these groups will either be able, or even desire to be a primary force in effecting change in executive compensation practices.[89] There are a number of reasons why sole reliance on institutions to resolve the compensation controversy would be a mistake.

The first set of problems with institutional action is general in nature. There are several fundamental reasons why institutional investors, as currently constituted, may never be able to monitor corporate activities in the manner envisioned by their supporters. The first concern has to do with investment strategy. Professor Coffee has argued that there is an inherent preference among many institutions to structure their investment portfolios in such a manner as to provide maximum liquidity. Investments are arranged by type and size to provide for quick and easy disposition in the event that conditions warrant. Thus, investments that are not readily saleable are avoided. Such liquidity, the ability to easily exit an investment, effectively eliminates

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[88] As its financial outlook has deteriorated, IBM has faced increased shareholder agitation from groups such as the United Shareholders Association (USA). USA plans to press at IBM's annual meeting for the passage of four proxy proposals which deal with management performance, oversight, and compensation. Catherine Arnst & Joseph Weber, *IBM After Akers*, Bus. Wk., Feb. 8, 1993, at 22. Sears Roebuck's Edward Brennan relinquished several leadership roles and the company agreed to divest itself of certain business lines in the face of growing shareholder threats. Stewart, *supra* note 21, at 35. Despite the fact that American Express Chairman James C. Robinson III initially persuaded his board to keep him in power in the face of disappointing results, institutional shareholder agitation eventually led to his resignation. J. P. Morgan, joined by Alliance Capital and Putnam Management, was highly influential in forcing Robinson's removal. Leslie Wayne, *Shareholders Exercise New Power with Nation's Biggest Companies*, N.Y. Times, Feb. 1, 1993, at A1. It was institutional shareholder pressure that was instrumental in convincing the board of General Motors to demand the resignation of its chief executive, Robert C. Stempel. *Id.* See Stewart, *supra* note 21, for a list of companies that have responded to investor pressure by changing leadership. *See also* Black, *Agents*, *supra* note 17, at 828–29.

In addition, investors such as the Council of Institutional Investors, USA, and several state employee pension funds have all gained the attention of corporate management by creating publicized "hit lists" of poorly-performing corporations. Kevin G. Salwen, *Institutions Are Poised to Increase Clout in Boardroom*, Wall St. J., Sept. 21, 1992, at B1. A prime example is ITT Corp. which held several meetings with shareholders and agreed to demands that certain management policies be changed, in order to be removed from USA's "hit list." Salwen & Lublin, *supra* note 13.

[89] *See infra* note 100.

any incentive to exercise a meaningful voice in corporate affairs. The institutions

> have considerable reason to remain 'rationally apathetic' about corporate governance and little reason to become active participants. Why? [A] tradeoff exists and must be recognized between liquidity and control. Investors that want liquidity may hesitate to accept control . . . . [A] preference for liquidity chills the willingness of institutional investors to participate in the control of major corporations . . . .[90]

Coffee suggests several structural reforms to lessen the bias towards "exit" and encourage the exercise of "voice"—such as "a restricted diversification strategy which would discourage institutional investors from diversifying beyond the limits of their monitoring capacity."[91] Unless such reforms are implemented, however, the continued predilection towards liquidity lessens the incentive to monitor, which suggests a continuing passivity among the institutions.

The second concern involves size and communication. Although institutional holdings are substantial, particularly in dollar terms, each institution's ownership interest in the various corporations in which it invests is likely to be proportionately quite small.[92] This reflects a preference for liquidity and portfolio diversification as well as legal restraints.[93] As a result, even if a company's stock is held primarily by institutions, these holders, individually, control very little of that company's overall equity. To exercise "control," therefore, a number of institutions would have to agree to form a coalition. This may be problematic. First, each institution may have varying goals regarding its investment in a particular company and its own general investment strategy. No two institutions are precisely alike insofar as participant composition and investment goals are concerned.[94] Consequently, each

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[90] Coffee, *supra* note 79, at 1281.

[91] *Id.* at 1338.

[92] For example, even the nation's largest state employee pension fund, Calpers (California Public Employees' Retirement System), only owns .6% of Westinghouse's outstanding shares. Mieher, *supra* note 32, at A3, A6. Indeed, despite its stock portfolio totalling $25 billion, Calpers has limited its holdings to just under a 1% ownership interest in more than 1,000 large U.S. corporations. George Anders, *Restless Natives: While Head of Calpers Lectures Other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at A1, A9.

[93] *See* Coffee, *supra* note 79. *See supra* notes 90–92 and accompanying text.

[94] *See* Brancato, *supra* note 78, at 7–13 ("Institutional investors are not a 'monolithic' group and have widely divergent investment and risk objectives, as well as varying attitudes on their appropriate role in corporate governance."). One commentator argues that public pension funds, which have the greatest power to influence management, are not well-equipped to do so effec-

would likely respond to varying control issues with differing levels of concern. Where interests diverge, coalitions and consequent power may disappear. Second, as some commentators have observed, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations, including the proxy rules, however, such communication may be restricted.[95] Although changes have been suggested and some, in fact, promulgated,[96] it remains to be seen how easily institutional investors may be able to solicit each other's votes or consent so as to act as a group without running afoul of various SEC requirements.

While these problems generally act to restrict institutional activity, another set of difficulties exists that may also limit institutional investor effectiveness in the compensation area. The first concern involves the benefits to be achieved by active compensation review. As discussed earlier, the actual impact on corporate earnings that an excessive salary represents is not likely to be particularly significant.[97] Given the costs in terms of reputational capital expended in a compensation challenge[98] and time required for organization of opposition among the

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tively because of their politically-minded leadership. In contrast, private institutions, such as mutual funds, are run by individuals with greater financial expertise, but who have little inclination to influence management. Taylor, *supra* note 78, at 72. *See infra* notes 98–99 and accompanying text. *See also* Anders, *supra* note 92, at A1 (reporting that the head of Calpers is facing pressure from his board, which is composed mostly of state officials, to limit his efforts in influencing poorly performing companies and to concentrate instead on the management of the pension fund itself).

[95] SEC regulations define "proxy" and "solicitation" very broadly so that virtually any statement of opinion to security holders is subject to costly and time-consuming filing requirements. Rules 14a-1(f), 14a-1(l), 14a-6, 17 C.F.R. §§ 240.14a-1(f), 240.14a-1(l), 240.14a-3(a), 240.14a-6 (1992). In addition, all solicitations are subject to antifraud rules which may chill communications in a hotly-contested proxy fight. Rule 14a-9a, 17 C.F.R. § 240.14a-9(a) (1992). Black, *Disclosure, supra* note 83, at 53–57. See *infra* note 96 for a discussion of recent changes to these rules. *See also* Black, *Agents, supra* note 17, at 820 n.9; Coffee, *supra* note 79, at 1342–45; Conard, *supra* note 79, at 161–62.

[96] The SEC recently eased the rules governing communications among shareholders. The changes include: An exemption from the proxy rules for communications with shareholders where the person soliciting is not seeking proxy authority and does not have a substantial interest in the subject matter of the vote. 17 C.F.R. § 240.14a-2(b) (1992) (amendment to Rule 14a-2(b)). The definition of "solicitation" has been changed so that shareholders can publicly announce how they intend to vote and provide reasons for that decision without having to comply with the proxy rules. 17 C.F.R. § 240.14a-1(l) (1992) (amendment to Rule 14a-1). Solicitations conveyed through the public media are not subject to the proxy rules so long as a definitive proxy statement is filed with the SEC. 17 C.F.R. § 240.14a-3(f) (1992) (amendment to Rule 14a-3). In certain transactions, companies must furnish shareholders with lists of all company shareholders. 17 C.F.R. § 240.14a-7 (1992) (amendment to Rule 14a-7). Regulation of Communications Among Shareholders, Exchange Act Release No. 31326, 57 Fed. Reg. 48,275, 48,276 (Oct. 22, 1992).

[97] *See supra* notes 27–30 and accompanying text.

[98] *See* Yablon, *supra* note 69, at 1893.

various stockholders, it may be that the potential benefit of slightly increased earnings due to lower compensation costs, particularly when diluted among many holders, may not appear worth the effort. Indeed, it would seem more expedient to expend one's energies challenging management on the issues that have a more substantial and fundamental impact on the company's business prospects, such as expansion, asset disposition or even general labor policy, than championing an issue with limited impact on the company's "bottom line."

The second concern involves the interests of those managing the large institutions. As Professor Yablon has pointed out:

> Financial institutions are also run by corporate executives who may be receiving, or be interested in receiving, compensation at levels or in forms not very different from those that are under attack from the various shareholder groups. Such executives are unlikely to mount or join challenges to executive compensation plans because they may feel . . . that the compensation offered to their fellow executives is perfectly appropriate.[99]

Thus, the management structure of some of the institutional investors, may itself serve to limit active compensation oversight.

There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. For the various reasons discussed, however, they may never prove as effective in providing either compensation oversight or even a more general monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this "voice" may not bring as much positive change as earlier envisioned, particularly in the compensation arena.[100]

E. *Strengthened Compensation Committees*

A final approach that has been offered to resolve the compensation controversy involves a change in the internal functioning of the corporation's board of directors. It has been suggested that there be a reformation of the way in which the board's compensation committee,

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[99] *Id.*

[100] Recently, the head of Calpers, Dale Hansen, has received pressure from his board to limit his shareholder activism and direct more of his energy to the pension fund's day-to-day operations. Hansen is viewed as the leader of the shareholder rights movement and his retreat could create uncertainty as to the future activism of other large institutional investors. Anders, *supra* note 92, at A1.

appointed to "review, analyze, and approve or revise compensation proposals,"[101] operates to assure independent and effective oversight. If this committee could be strengthened and made more independent of management, then excessive compensation programs could be defeated before they even reach the full board for consideration. This approach is laudable but ultimately unworkable. The problem lies not in the functioning of this committee, but in the composition of the board itself.

Compensation decisions by a board are generally protected by the business judgment rule.[102] As noted earlier, such decisions are immune from attack if made by disinterested directors following an "informed" decision-making process.[103] As one way of satisfying this requirement, most publicly-held corporations have formed compensation committees, traditionally comprised of several outside directors (those who are not employees of the business) to examine and consider proposals for executive compensation.[104] These committees theoretically evaluate the performance of senior management and make recommendations on compensation formulas to the full board. Frequently, a company's management engages compensation consultants to study the subject company's executive salary scheme and to advise its committee on its appropriateness. These outside advisors examine compensation scales at companies of similar size, similar profitability and in similar industries to determine the reasonableness of each proposed plan.[105] The

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[101] Barris, *supra* note 2, at 75. *See also* CRYSTAL, *supra* note 31, at 242–45 (arguing that compensation committees hire their own independent compensation consultants and establish more formal procedures for determining compensation); James W. Fisher, Jr., *The Role of the Compensation Committee*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 366, 369–71 (Fred K. Foulkes ed., 1991) (suggesting that compensation committees should, among other things, establish a charter which clearly designates the committee's responsibilities and its relationship to management); Lance Berger, *New Initiatives for the Compensation Committee*, DIRECTORS & BOARDS, Winter 1985, at 33 (detailing how compensation committees can become more proactive and link payment strategy and performance of the company). *Cf.* Frederick W. Cook, *Executive Pay and the Board*, DIRECTORS & BOARDS, Spring 1992, at 43 (arguing that compensation committees should not hire their own consultants).

[102] *See supra* notes 58–62 and accompanying text.

[103] *Id.*

[104] Recent studies indicate that between 84 and 99 percent of large publicly-held corporations have compensation committees. *See* Fisher, *supra* note 101, at 366 (citing J.E. Richard, *Compensation Committee Issues, 1989*, DIRECTOR'S MONTHLY, June 1989, at 3); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, at § 3A.05. Compensation committees should be composed entirely of outside directors. *Id.*

[105] The American Law Institute recommends that large publicly-held corporations establish compensation committees to provide oversight on compensation issues. The committees should actively review existing compensation programs and recommend methods that ensure that payments are reasonably related to executive performance. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 3A.05. Traditionally, however, compensation committees have been relatively

presence of only outside directors on such committees and the abstention of interested officers from compensation voting removes any self-dealing taint from such decisions and eliminates any challenge on self-dealing grounds. Moreover, the retention of independent consultants to advise the compensation committee and the committee's recommendations to the full board following extensive discussion with the consultants assure that the informed decision-making process required by the business judgment rule has been met and that the board's compensation decisions will thus be protected.

If compensation committees functioned in the truly independent fashion envisioned in their origination, then there would be little controversy over excessive compensation. The outside directors comprising the committees, bolstered by the efforts of independent compensation consultants, would bargain effectively with management to produce compensation packages that were the result of serious negotiation and not simple acquiescence on demand. Unfortunately, for reasons inherent in present board composition and structure, this is unlikely to occur. As noted earlier, many larger public corporations, due to atomistic shareholding patterns and ineffective communication among shareholders, are subject to management capture.[106] No one

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passive. Critics argue that most compensation committees simply rubber-stamp compensation plans submitted to them by consultants hired by management. CRYSTAL, *supra* note 31, at 42–50; Berger, *supra* note 101, at 33–34; Joann S. Lublin, *Compensation Panels Get More Assertive, Hiring Consultants and Sparking Clashes*, WALL ST. J., July 15, 1992, at B1. This passivity may be changing. Twenty percent of major corporations' compensation committees have hired their own compensation consultants to get a second opinion on executive pay plans. *Id.*

According to Professor Crystal, a former compensation consultant, executives use such consultants to justify their salaries to the compensation committee. The compensation consultant has a variety of techniques at his disposal to accomplish this task. First, the consultant will compare the executive's compensation plan with the plans at similar companies to determine whether the executive is being paid competitively. The executive and the consultant can manipulate this process by including in the survey companies which are not obviously similar to the subject company, but which have executives which are paid excessively. In addition, the executive may ask the compensation consultant to limit his company comparisons to certain categories of pay. For example, if the executive has a substantial salary, but does not receive options, he can ask the consultant to survey the option grants of similar companies and not their salary policies, explaining that he will hire the consultant to do a salary comparison next year. Inevitably, the comparisons will reveal that the executive must be given more stock options, even if the executive's base salary dwarfs the salaries of executives in comparable companies. Not only must the executive's pay be competitive, but it must provide the proper incentives. Thus, after determining a competitive level of pay based on comparisons with other companies, the consultant will structure an incentive payment package based on a variety of market and qualitative measures so that the executive will be paid additional amounts for any improvements in the company's performance. CRYSTAL, *supra* note 31, at 42–60. *See also* Burchman, *supra* note 25, at 189; Yablon, *supra* note 69, at 1877–81.

[106] *See supra* note 20 and accompanying text.

shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership.[107] The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management.

Serving on such boards are the officers themselves, individuals performing various professional services for the corporation, such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.[108] The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group (from which the membership of the compensation committee is recruited) will rarely challenge management prerogative either, although there have been recent exceptions.[109] Such board members are usually selected either by the chairman or other senior management and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.[110] These directors are often officers of other public corporations[111] and frequently ask their counterparts, whom they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.[112]

There are three problems with such arrangements that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult

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[107] *See id.*

[108] See *supra* notes 15–16 and accompanying text for a discussion of the distinction between "inside" and "outside" directors.

[109] *See supra* notes 21 and 32.

[110] *See supra* note 21 and accompanying text. *See also* CRYSTAL, *supra* note 31, at 224–30; Gilson & Kraakman, *supra* note 17, at 884. *But see* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 247 (arguing that directors need not have an adversarial relationship with management to be effective).

[111] Barris, *supra* note 2, at 76.

[112] *Id.* at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the boards' compensation committees. Cowan, *supra* note 14, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. *Id.*

to engage in necessary confrontation. It is always tough to challenge a friend—particularly where the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, where one owes one's board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which, given the large fees paid to directors[113] and great reputational advantage to board membership, may function as an effective club to stifle dissension. Such realities hinder effective oversight by a corporation's outside directors. Because the compensation committees are peopled by such outside directors, it is highly questionable whether, on compensation matters, these individuals possess the kind of independence from management necessary to function as effective bargainers for the corporate interest.[114]

Indeed, because of these relational realities, compensation matters are particularly susceptible to management influence. The single most sensitive issue to an employee relating to his employment is compensation. Few issues cause as much excitement or resentment as how much one is to be paid. A confrontation with a manager over compensation has the potential to breed more ill-will towards a complaining director than any other kind of policy dispute. Given the outside director's personal ties to management and the lucrative nature of a board seat, there is very little incentive to engage in a dispute with an executive over salary. Such a confrontation will breed tremendous resentment and may result in that director's failure to be renominated at the next board election.[115] Furthermore, considering that

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[113] For example, non-employee directors receive annual compensation in the amount of $35,000 at Exxon, $55,000 at IBM, $48,000 at American Express, and $35,000 at General Electric. Moreover, these non-employee directors usually receive a fee of between $1,000 and $2,000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between $3,000 and $5,000 per annum. AMERICAN EXPRESS CO., Mar. 14, 1991 PROXY STATEMENT, at 7 (1991); EXXON CORP., Mar. 6, 1992 PROXY STATEMENT, at 5 (1992); INTERNATIONAL BUSINESS MACHINES CORP., Mar. 16, 1992 PROXY STATEMENT, at 10 (1992); GENERAL ELECTRIC CO., Mar. 3, 1992 PROXY STATEMENT, at 13 (1992). *See also* Barris, *supra* note 2, at 78 n.114, 79.

[114] In addition, most compensation committee members do not have the expertise to evaluate compensation packages proposed by consultants properly.

> They are, for the most part, not very adept at statistics and corporate finance, and they may not be able to follow the consultant's sophisticated reasoning. Further, they have no counsel of their own to tell them that what the consultant is saying is or is not true. So they may either fall asleep or look repeatedly at their watches in such a way that the consultant will not fail to notice. CRYSTAL, *supra* note 31, at 50.

[115] *Id.* at 226–27; Barris, *supra* note 2, at 79.

executive compensation has little bearing on a large company's overall profits, why would an individual risk a lucrative board seat on an issue sure to inflame passions but also certain to have minimal impact on corporate performance? Finally, because many outside directors are also officers of other large corporations, it is not in their own self-interest to object too strenuously to generous compensation, for the higher their peers' compensation tends to be, the richer their own packages may become.[116]

This reality makes it extraordinarily difficult for an outside director in a management-dominated enterprise to engage in the sort of active bargaining with executives over compensation that will result in reasonable salary arrangements. Despite the existence of a compensation committee theoretically comprised of "independent" outsiders to monitor compensation, the very composition of most boards in the large public corporation setting limits the effectiveness of that supposedly independent body. A compensation committee is only as independent as its members, and in the typical management-captured corporation, given the predilections of most outside directors, that independence is likely to be minimal.

Despite these problems that may lead to the ineffectiveness of a compensation committee and the full board for that matter, in issues relating to executive compensation, each director is still subject to legal requirements as to conduct that should theoretically compel effective action. Unfortunately, the threat of legal liability has little impact on director behavior or effectiveness. Ideally, a director should carry out his or her responsibilities "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[117] This would seem to compel circumspect and diligent conduct in executive salary negotiations. Under the business judgment rule, however, a director may be found to have met this duty of care, if in making a specific business decision, he or she has acted without self-interest, in an informed manner and with a rational belief that the decision is in the best interests of the corpora-

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[116] Barris, *supra* note 2, at 78. *See also* CRYSTAL, *supra* note 31, at 227–28 (observing that a CEO can ensure high compensation by placing other company CEOs with pay packages rivaling his own on the compensation committee).

[117] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(a). Approximately 37 states have adopted statutory duty of care provisions; the rest have a common law duty of care. *Id.* at 200. Most states have adopted a reasonable care standard. *Id.* at n.15. *See also* 2 MODEL BUSINESS CORP. ACT ANN. 3d § 8.30, at 934 (1990); CAL. CORP. CODE § 309(a) (West 1990); N.Y. BUS. CORP. LAW § 717 (McKinney 1986); Graham v. Allis Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *but see, e.g.*, KY. REV. STAT. ANN. § 271B.8–300(1) (Baldwin 1989) ("A director shall discharge his duties . . . [i]n a manner he honestly believes to be in the best interests of the corporation.").

tion.[118] A director who so acts in reaching a business decision is then protected from any legal liability to his or her shareholders.

This standard of care is not very difficult to satisfy, particularly in the compensation area. Provided that the directors are to receive none of the compensation they are voting on and the decision is not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements have been met.[119] Most challenges to a particular board decision involve the third requirement, that an *informed* decision was made. How exactly does one demonstrate that a decision was informed? The Delaware Supreme Court's landmark ruling in *Smith v. Van Gorkom*[120] created a number of important guideposts to informed decisionmaking. In addition to requiring that a board spend a proper amount of time making a particular decision,[121] the court also suggested that the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement.[122] Consequently, a compensation committee's decisions may be labeled "informed" and, thus, protected, upon a showing that the committee has no actual interest in the salary recommendations it is considering, has spent a significant amount of time discussing compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a particular salary package. And, in due course, the full board itself is entitled to rely upon the recommendation of its compensation committee when approving a salary proposal in order to meet its own obligations under the business judgment rule and, thus, reduce any threat of shareholder liability.[123]

The retention of an independent compensation consultant insu-

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[118] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(c). Where a director has not made a business decision, such as in cases of omission, the business judgment rule does not apply and the director should be judged under the reasonable care standard. *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

[119] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(c) cmt. f.

[120] 488 A.2d 858 (Del. 1985).

[121] *Id.* at 874 (holding that the board of directors was grossly negligent when it approved the sale of the company with only two hours of deliberation).

[122] *Id.* at 876–88. *See generally* Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L. REV. 951 (1992).

[123] *See, e.g.*, International Ins. Co. v. Johns, 874 F.2d 1447, 1460 (11th Cir. 1989) ("[W]hen a board's enactment of a course of action merely effectuates the plans of a disinterested directors' committee, the board's action is *prima facie* subject to the protections of the business judgment rule."). *See supra* notes 58–59 and accompanying text. When a compensation plan is not approved by a majority of disinterested directors, the burden of proof shifts from the shareholder challenging the plan to the directors, who must prove that the plan was fair to the corporation. Cohen v. Ayers, 596 F.2d 733, 739–40 (7th Cir. 1979).

lates both the compensation committee and the full board from liability. Theoretically, the use of a third-party advisor would help to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant/corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation.[124] Thus, there is a powerful disincentive for recommending a salary structure that management would consider inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lie in the offing.[125]

Second, compensation structuring is not a precise art or science. It is based on comparisons with what other business are paying. There is tremendous subjectivity involved in deciding with what businesses the client's compensation structure will be compared. The consultant may look at companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture—the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is also completely up to the advisor.[126] The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above, have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporation that has retained them.[127] As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence neces-

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[124] For example, Towers Perrin, the largest compensation consulting firm also designs employee pension and health plans for companies. CRYSTAL, *supra* note 31, at 219–20.

[125] *Id.* at 218–19.

[126] *Id.* at 42–50. *See supra* note 105.

[127] *See, e.g.*, Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (1989); William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523 (1992); Elson, *supra* note 122. *See supra* notes 120–23 and accompanying text.

See also Suein L. Hwang, *Ties That Bind, Fired Tambrands CEO Was Unusually Close to a Consulting Firm*, WALL ST. J., Aug 23, 1993, at A1. Immediately following the ouster of Tambrands Chairman and Chief Executive Martin C. Emmett, the corporation terminated all contracts with Personnel Corporation of America (PCA). PCA, a corporation with which Emmett had close personal ties, is a human resources firm that had been retained to advise the board of directors concerning, among other matters, executive compensation. As a result of PCA's efforts, Emmett received a lucrative benefit package and options to purchase close to 600,000 Tambrands shares. Judith Fischer, publisher of Executive Compensation Reports, says that "it is, or can be, an

sary to assure a compensation package reasonably related to an executive's professional contributions. This compensation consultant "for hire" phenomenon, particularly when combined with compensation committees comprised of outside directors who may be unwilling to challenge management results in compensation arrangements that are acquiesced to and not bargained for, and, thus, are potentially unreasonable.[128] Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, administered by a judiciary reluctant to involve itself in compensation disputes.[129]

Although a board's use of a compensation committee comprised exclusively of outside directors has the theoretical potential to create reasoned compensation schemes, this solution is entirely predicated on finding outside directors who are unwilling to compromise their objectivity in the face of management capture. This potential may never be realized given the current state of the outside directorship in the typical large public corporation and the ready availability of possibly corruptible outside compensation consultants. How, then, can a compensation committee be made more effective? The solution does not lie in making the consultants more independent of management—their desire for future retention and the subjectivity inherent in the analytic process have rendered this a most difficult goal. Rather, an approach must be found to promote independent and responsible behavior on the part of the outside directors. Simply mandating that compensation decisions be made exclusively by outside directors will accomplish little; only if these directors are truly independent in motivation, will the dispassionate bargaining requisite to reasonable compensation ever occur.[130] Strengthening the compensation committees will have negligible impact, unless those who comprise these bodies are given sufficient motivation to act effectively. This seems unlikely to occur under the current scheme of director appointment and retention.

F. *Summary*

The various proposals for attacking the problem of executive overcompensation, whether involving heightened disclosure, tax-based

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incestuous relationship," when a chief hires a compensation consultant to advise the board concerning executive compensation. *Id.*

[128] *See* CRYSTAL, *supra* note 31, at 214–40; *but see* Cook, *supra* note 101, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).

[129] *See supra* notes 58–66 and accompanying text.

[130] CRYSTAL, *supra* note 31, at 224–28; Barris, *supra* note 2, at 77–78. *See supra* notes 112–16 and accompanying text.

remedies, judicial involvement, institutional shareholder activism or strengthened board compensation committees will ultimately prove ineffective and, worse still, may even jeopardize corporate well-being. Although they may attack the problem from various angles, these proposals fail to strike at the heart of the issue. The real solution to overcompensation lies with stimulating effective board oversight. This must take place from within the boardroom itself. Solutions that attempt to change board behavior through external pressure may effect some positive results, but they do not tackle the problem that created the overcompensation issue in the first place. The board must act as its own motivational force. External pressure will have an impact only so long as it continues to be applied. Once the pressure is reduced due to public apathy, the problem will resurface. The only long-term solution is to create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force both as to compensation and general corporate affairs for which it was originally created.

III. The Equity-Based Approach

The overcompensation controversy is the result of unchecked self-interest on the part of management and passive indifference by the corporation's board of directors. Because personal greed created the problem, a similar appeal to individual interest may resolve it. Externally-based pressure on a board to bargain effectively with management overcompensation, as noted earlier, is an ineffective approach. There is a much simpler and efficacious method to reposition the board as a counter-force to management in the compensation area.

A. *Stock Ownership*

The outside directors must be made to consider executive compensation proposals from the viewpoint of the company's stockholders to whom they are legally obligated instead of from the perspective of ones beholden to management. It is the stockholders who stand to lose the most from unreasonable compensation arrangements. Thus, it is crucial that the company's outside directors re-align their interests and thinking with those of the shareholders. The most effective way of creating such perspective is to appeal directly to these directors' personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director's personal capital is potentially affected by an excessive compensation package, that director is much less likely to acquiesce to such a proposal. It is easy to spend other people's money

freely; it is always much more difficult to be inattentively lavish with what one considers to be one's own funds.

By becoming equity-holders, the outside directors would assume a personal stake in the success or failure of the enterprise.[131] Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with distant legal requirements, or vaguely understood pressures from outside institutions, but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably. In addition to the consideration that the active monitoring of management may lead to eventual replacement, an outside director must also consider that the failure to exercise effective oversight may also result in the diminution of that individual's personal wealth. Under such an arrangement, it would not be quite so easy to simply acquiesce to the demands of management.

Nowhere would the positive effect of a personally-motivated outside directorship be more evident than in the area of executive compensation. Overcompensation is the result of ineffective bargaining.

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[131] The benefits of outside director stock ownership have been well-documented. *See, e.g.*, MACE, *supra* note 15, at 61–65 (outside directors who own substantial amounts of stock in their company are more likely to ask discerning questions than non-stockholding outside directors); Louis Fernandez, *Tax Deferral, Capital Gains*, DIRECTORS & BOARDS, Spring 1985, at 51 (discussing tax advantages of stock payments); James J. Fitzsimmons, *A Better Approach to Director Pay*, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (directors paid in stock are more closely aligned with shareholders and are in a better position to ensure that top management is paid based on its performance); Edmund W. Littlefield, *A Stake with Restricted Stock*, DIRECTORS & BOARDS, Spring 1985, at 51, 52 ("Paying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders."). *See also* Pearl Meyer, *The Rise of the Outside Director As an Equity Owner*, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned large amounts of stock and that companies may be returning to this compensation strategy).

Brown Brothers Harriman's Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly one million dollars, described that group as a "board that pays attention, . . . I've never seen pocket calculators come out so quickly in my life." *Finance*, INVESTOR'S BUSINESS DAILY, July 7, 1993 at 4.

People without great incentive to press for position rarely do. Equity ownership would align the position of the outside director with that of the group most disadvantaged by unreasonable compensation, the shareholders. It would provide an incentive to bargain not out of a sense of duty to some indistinguishable mass of stockholders, but duty to one's own interest. Given the fundamental fact of human nature that all are susceptible to the vice of envy, no one delights in providing a financial windfall to another, most especially when it comes out of one's own pocket. It is galling enough to see someone overpaid for their efforts; it is all the more galling to be the vehicle for such overpayment, particularly when the ill-gotten gain results in the perceived diminution of one's own wealth. This dynamic would set an appropriate tone for compensation negotiations between management and equity-holding outside directors, and, in turn, create the sort of active bargaining that would lead to more reasoned compensation.

B. *Lengthened Director Terms*

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors' stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock.[132]

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[132]For example, the holdings of a few noted outside directors at several larger public corporations are as follows:

	Director	Shares
Bank of Boston	Donald Monan	0
	Thomas B. Wheeler	236
	Alfred M. Zeien	500
IBM	Harold Brown	321
	Nannerl Keohane	321
	Richard Munro	421
Mobil	Donald Fites	200
Disney	Robert Stern	0
	Stanley Gold	250
	Samuel Williams	480
	Gary Wilson	0
Philip Morris	Rupert Murdoch	400
	Richard Parsons	500
Sears Roebuck	Mandell de Windt	450
	Norma Pace	400
	Nancy C. Reynolds	454
Ralston Purina	David Banks	200
	Francis Ferguson	556

Bank of Boston Corp., February 26, 1992 PROXY STATEMENT, at 6 (1992); INTERNATIONAL BUSINESS MACHINE CORP., Mar. 16, 1992 PROXY STATEMENT, at 11 (1992); MOBIL CORP., Mar. 18, 1991 PROXY STATEMENT, at 7, 10 (1991); PHILIP MORRIS COMPANIES INC., Mar. 7, 1991 PROXY

Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position involving the attendance of only a few meetings a year.[133] In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered in the business community, leading to other opportunities for financial benefit.[134] Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.[135]

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and benefits of the contemplated strategy. When an outside director makes a decision that challenges management prerogative, that director, in a management-controlled enterprise, risks retribution from the dominant executives that might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director

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STATEMENT, at 12 (1991); RALSTON PURINA CO., December 10, 1991 PROXY STATEMENT, at 8–9 (1991); SEARS ROEBUCK & CO., Mar. 21, 1991 PROXY STATEMENT, at 6 (1991); WALT DISNEY CORP., Dec. 27, 1991 PROXY STATEMENT, at 2 (1991).

[133] Remuneration for non-employee directors often exceeds $40,000 including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. *See supra* note 113. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each non-employee director at Eastman Kodak is covered by group term life insurance in the amount of $100,000. Non-employee directors at American Express, who have served at least five years, are eligible to receive $30,000 per annum upon their retirement from the board. These payments continue for a number of years equal to the time served on the board or until death. Similarly, General Electric's non-employee directors, who have served at least five years, are over 65 years of age, and retire directly from the board, are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. AMERICAN EXPRESS, Mar. 14, 1991 PROXY STATEMENT, at 7 (1991); EASTMAN KODAK CO., Mar. 18, 1991 PROXY STATEMENT, at 8 (1991); GENERAL ELECTRIC CO., Mar. 3, 1992 PROXY STATEMENT, at 13 (1992). *See* Bruce Overton, *Remuneration of Outside Directors*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990S 383 (Fred K. Foulkes ed., 1991).

[134] *See* MACE, *supra* note 15, at 87–91; Overton, *supra* note 133, at 383.

[135] *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE 97–98 (Harper Perennial 1991). At the time of the LBO, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, *supra* note 133, at 388.

will, consciously or not, weigh the various benefits such a decision entails, with any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that a director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership but *substantial* ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decision-making process. An outside director's shareholding position must be large enough that, in deciding a particular course of action, concern about how that decision will positively affect equity value will subsume traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decision-making process than fee maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fee in company common stock. As compensation for the exercise of oversight as a board member, it seems only natural that each director should be rewarded with an interest in the business itself. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.[136]

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[136] To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.

Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. As noted earlier, to have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director's yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director's term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve for five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an immediate equity stake and, without yearly re-election concerns, the promise of a fixed number of future stock grants. Five years' worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.[137] Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, have recently advocated such a change in board structure, along with a host of other major governance reforms.[138] They suggest that the creation of a five-year fixed term of office will create a corporate "long-term view" highly beneficial to corporate "vitality."[139] The main goal of their proposal, however, involves the creation of a corporate governance model "that will lead managers and stockholders to work cooperatively towards the corporation's long-term business suc-

[137] For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

[138] Lipton & Rosenblum, *supra* note 110, at 187. The quinquennial election of directors is one part of Lipton and Rosenblum's proposal for comprehensive reform of the present corporate governance system. Their proposal would also bar nonconsensual changes in control between elections; provide major shareholders with access to corporate proxy materials relating to elections of directors; require a detailed five-year report on the company's performance and a prospective five-year plan; and tie management compensation awards and penalties to the corporation's performance against the plan. *Id.* at 190.

[139] *Id.* at 216.

cess."[140] Their arguments advocating term expansion focus primarily on creating a management/shareholder "long term" cooperation relationship, rather than corporate productivity through active director oversight.[141] Despite this goal, their call for a longer range perspective on company affairs, an obvious by-product of five-year director terms, is a laudable and desirable result. Who can really argue with management and boards of directors making decisions with the long-term health of the enterprise in mind? Some of Lipton's and Rosenblum's other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. They should not detract, however, from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity-holders in the executive compensation area.

There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish, and second, they could lead to the possible entrenchment of ineffective or even disloyal directors. These problems are not as dramatic as they would appear at initial glance. First, shareholders always have the right to remove a director for cause,[142] a power which should resolve the problem of the disloyal or inattentive director. Second, provision could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear so necessary to compel effective management. Moreover, the "long view" perspective such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in its favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong returns over the long term, even though they may have a negative impact on profitability in the short-run. The five-year term has, thus, great potential.

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[140] *Id.* at 189.

[141] *Id.* at 224–52.

[142] *See, e.g.*, Campbell v. Loew's Inc., 134 A.2d 852 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954). Some state statutes have modified the common law rule and allow shareholders to remove directors without cause. *See, e.g.*, CAL. CORP. CODE § 303(a) (West 1990); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); N.Y. BUS. CORP. LAW § 706 (McKinney 1986). *See also* CARY & EISENBERG, *supra* note 44, at 153–54.

C. *Potential Costs*

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact an equity-based approach may entail. One difficulty that increased equity-ownership may create involves the possible chilling of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individual's personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize, because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear. It assumes that the commitment of a large portion of one's assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk and their stockholdings encouraged still greater risk because of the potential to share in the larger returns such risk brings. What about those in business who are not entrepreneurial in spirit, but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking, rather

than position preservation.[143] Creating equity positions in outside directors may have the same impact.

Although some individuals are risk-averse by nature (and, indeed, the presence on a board of such persons may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors' fees in cash encourages risk-positive behavior. As noted earlier, in the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be the exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity (these individuals could easily convert their cash payments into company stock). This argument misses the point. It was the payment of fees in cash that, in the management-captured enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.[144] Of course, a director is not giving up the right to

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[143] *See, e.g.*, Michael C. Jenson & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 141 ("By controlling a meaningful percentage of total corporate equity, senior managers experience a direct and powerful 'feedback effect' from changes in market value."); Stephen F. O'Byrne, *Linking Management Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91, 97; Alisa J. Baker, *Stock Options—A Perk That Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20; Gilbert Fuchsberg, *Former Critic of Big Stock Plans For CEOs Now Supports Them*, WALL ST. J., Dec. 16, 1992, at B1; *but see* Amanda Bennett, *Taking Stock: Big Firms Rely More on Options but Fail to End Pay Criticism*, WALL ST. J., Mar. 11, 1992, at A1.

[144] One commentator states that he will not serve on public company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial

compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a non-cash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders they were elected to serve by taking an equity position in the enterprise is a corporation's best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity. And reasoned executive compensation will be a beneficial by-product of this approach.

D. *The Empirical Evidence*

Central, of course, to the effectiveness of an equity-based solution to the compensation dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to succeed, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the executive compensation voting behavior of boards composed of outside directors with substantial stockholdings, compared with boards whose outside members do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

Business Week magazine, in conjunction with Standard & Poor's Compustat Services, Inc., conducts an annual survey of 500 of the nation's largest publicly-traded corporations in an attempt "to measure how closely" executive compensation by those companies "matches performance."[145] The study uses two separate approaches to rate performance. The first compares an executive's compensation package with the business's total return to shareholders in stock appreciation and dividends over a three-year period. The second measures compensation against corporate profitability for the same time period. The survey is conducted by assigning each company examined to one of nine industry groups. A comparison is made among those companies in each group based on how their individual compensation programs compared with shareholder return and company profit. A "performance rating" is then assigned to each company surveyed for each of the two categories examined. Each business is thus rated on a scale of 1 (indicating the best performance) to 5 (indicating the poorest). "The

return as well as decreases the chance of lawsuits from other shareholders. William A. Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., May-June 1990, at 28.

[145] Byrne, *supra* note 2, at 148.

top 15% of the sample receives a 1, 25% a 2, 30% a 3, 20% a 4, and 10% a 5."[146]

Assuming that this survey, conducted by two independent organizations, possesses even minimal validity in its assessment of the relationship between pay and performance, it provides an excellent starting point for an empirical examination of the link, if any, between "reasoned" compensation and outside director stock ownership. Of the 500 companies examined in the *Business Week* study, approximately 158[147] were selected that possessed, in either one of the two categories examined, either the poorest possible rating ("5") for compensation in relation to performance, or the best ("1"). The proxy statements of

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[146] *Id.*

[147] Allied Signal, Inc.; Alltel Corp.; Amerada Hess Corp.; American Express Co.; American Home Products Corp.; American International Group, Inc.; Amgen, Inc.; AMP, Inc.; Apple Computer, Inc.; Arco Chemical Co., Atlantic Richfield Co., Automatic Data Processing, Inc.; Avon Products, Inc.; Baker Hughes, Inc.; Baltimore Gas & Electric Co; Banc One Corp.; Bear Stearns Companies, Inc.; Beckton Dickinson & Co.; Berkshire Hathaway, Inc.; Betz Laboratories, Inc.; Biomet, Inc.; Bristol-Myers Squibb Co.; Burlington Northern, Inc.; Burlington Resources, Inc.; Capital Cities/ABC, Inc.; Carolina Power & Light Co.; Caterpillar, Inc.; CBS, Inc.; Centerior Energy Corp.; Central & South West Corp.; Chase Manhattan Corp.; Chemical Banking Corp.; Chrysler Corp.; Citicorp; Coca-Cola Enterprises, Inc.; Commonwealth Edison Co.; Compaq Computer Corp.; Consolidated Rail Corp.; Cooper Tire & Rubber Co.; Costco Wholesale Corporation; CPC International, Inc.; CSX Corp.; Deluxe Corporation; Detroit Edison Co.; Digital Equipment Corp.; Dominion Resources, Inc.; Dow Chemical Co.; Duke Power Co.; Eastman Kodak Co.; Ethyl Corp.; Exxon Corp.; Federal Express Corp.; Fifth Third Bancorp, First Chicago Corp.; First Interstate Bancorp, Fleet/Norstar Financial Group,Inc.; Ford Motor Co.; FPL Group, Inc.; Franklin Resources, Inc.; Freeport-McMoran, Inc.; General Electric Co.; General Motors Corp.; Genuine Parts Co.; Golden West Financial Corp.; Great Lakes Chemical Corp.; Hewlett-Packard Co.; Hillenbrand Industries, Inc.; H.J. Heinz Co.; Home Depot, Inc.; Honeywell, Inc.; H & R Block, Inc.; Intel Corp.; International Business Machines Corp.; International Flavors & Fragrances, Inc.; ITT Corp.; Keycorp; Kimberly Clark Corp.; Liz Claiborne, Inc.; Long Island Lighting Co.; Lyondell Petrochemical Co.; Maytag Corp.; MBIA, Inc.; McCormick & Co., Inc.; MCI Communications Corp.; Mead Corp.; Medco Containment Services, Inc.; Mellon Bank Corp.; Merrill Lynch & Co., Inc.; Microsoft Corp.; Mobil Corp.; Molex, Inc.; Morgan Stanley Group, Inc.; Nalco Chemical Co.; National Medical Enterprises, Inc.; Newmont Gold Co.; New York Times Co.; Nike, Inc.; Novell, Inc.; Nucor Corp.; Nynex Corp.; Occidental Petroleum Corp.; Oracle Systems Corp.; Pacificorp; Pall Corp.; Paramount Communications, Inc.; Pennsylvania Power & Light Co.; Pennzoil Co.; Phelps Dodge Corp.; Philip Morris Companies, Inc.; Pioneer Hi-Bred International, Inc.; Premier Industrial Corp.; Primerica Corp.; Ralston Purina Co.; Reebok International, Ltd.; Roadway Services, Inc.; Rubbermaid, Inc.; Safeco Corp.; Salomon, Inc.; San Diego Gas & Electric Co.; Schlumberger, Ltd.; Scott Paper Co.; Sears Roebuck & Co.; Southern Co.; Southern New England Telecommunications; Stanley Works; St. Jude Medical, Inc.; Stone Container Corp.; Stryker Corp.; Suntrust Banks, Inc.; Syntex Corp.; Tambrands, Inc.; TECO Energy, Inc.; Telecommunications, Inc.; Tribune Co.; Tenneco, Inc.; Texaco, Inc.; Texas Instruments, Inc.; Texas Utilities Co.; Torchmark Corp.; TRW, Inc.; T2 Medical Incorporated; Tyco Laboratories, Inc.; Union Camp Corp.; Union Carbide Corp.; Union Pacific Corp.; UAL Corporation; United Technologies Corp.; Unocal Corp.; Upjohn Co.; U.S. Bancorp; Walt Disney; Waste Management, Inc.; Wells Fargo & Co.; Westinghouse Electric Corp.; Willamette Industries, Inc.; Winn-Dixie Stores, Inc.; Wisconsin Energy Corp.; Wm. Wrigley Jr. Co.

each of these selected corporations were then reviewed to ascertain how much company stock was held by each of the companies' outside directors. This study then compared the stockholdings of outside directors serving on the boards with the worst ratings (indicating overpaid executives) with the holdings of outside directors on the boards of companies with the best ratings (indicating reasonably paid executives). This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that pay their executives in a "reasoned" manner are more likely to have substantial equity holdings in those companies than outside directors on the boards of companies with "overpaid" executives. It was then determined how many companies in the two groups were run by boards in which outside directors with individual holdings valued in excess of $10,000[148] constituted a majority of the full board and thus theoretically controlled that institution. This procedure was repeated for holdings valued in excess of $25,000, $50,000, $100,000, $125,000, $150,000 and $200,000.

The results, presented in Table I, tend to confirm the initial hypothesis on the relationship between equity holdings and effective compensation oversight. The greater the value of outside director holdings, the more likely it was that the corporation surveyed would be managed by "reasonably" compensated executives. In the group of companies with overcompensated executives, as the value of the stockholdings of the outside directors increased, the number of companies with directors holding such equity positions decreased dramatically. At the $10,000 level, 83.1% of the companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped substantially to 42.2%, and at the $100,000 level, the percentage fell to 18.2%. Finally, in the $200,000 category, the highest level surveyed, only 6.5% of the companies in the overcompensation grouping had outside director equity holdings at that value level.

The results for those companies in the "reasonable" compensation category differed significantly. To be sure, there was, as the dollar criteria grew, a decline in the numbers of companies meeting the standards at each level. The decline, however, was not nearly as steep or dramatic as in the overcompensation model and bottomed out at a significantly higher base percentage. At the $10,000 level, 75.3% of the

[148] The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of July 9, 1992. WALL ST. J., July 9, 1992, at C3–5.

TABLE I

Total Number of Companies in Survey: 158
Number of Companies with overcompensated executives: 77
Number of Companies with reasonably compensated executives: 81

Number of Boards controlled by directors who own substantial amounts of company stock:

	Overcompensated	Percentage of total companies in overcompensated grouping	Reasonably compensated	Percentage of total companies in reasonably compensated grouping	Deviation Factor
>$10,000	64	83.1%	61	75.3%	.906
>$25,000	50	64.9%	45	55.6%	.857
>$50,000	33	42.9%	39	48.1%	1.121
>$100,000	14	18.2%	26	32.1%	1.764
>$125,000	11	14.3%	22	27.2%	1.902
>$150,000	9	11.7%	19	23.5%	2.009
>$200,000	5	6.5%	15	18.5%	2.846

companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped to 48.1%, and at the $100,000 level, the percentage stood at 32.1%. Finally, in the $200,000 category, 18.5% of the companies in the "reasonable" compensation grouping had outside director equity holdings at that value level.

While at the lower levels of stockholdings, $10,000-$50,000, the results in both groups were rather similar, it was when the base holdings reached the $100,000 level that the two groups diverged significantly and the effect of equity ownership on compensation patterns appeared to have the greatest impact. At the $100,000 level, only 18.2% of the companies in the overcompensation grouping met the equity-holding criteria; at $150,000, only 11.7%, and at $200,000, just 6.5%. This differed significantly from those companies in the "reasonable" compensation grouping where, at the $100,000 level, 32.1% met the criteria, at the $150,000, 23.5%, and at the $200,000 level, 18.5%. As the stockholding levels grew, the spread between the two groups increased significantly. At the $100,000 level, there were almost twice as many companies with "reasoned" compensation schemes than those overcompensating their executives. And at the highest level, the spread between the two grew to almost three times in number.

What, then, do these numbers demonstrate and how do they relate to an equity-based solution to the overcompensation problem? The results of this survey suggest that at lower levels of outside director equity ownership—that is, less than $50,000—the impact of equity ownership on director behavior seems inconsequential. But as the value of director holdings increases, the two groups experience substantial divergence in result. Substantially fewer of the corporations that are overpaying their executives, at least by the standards of the *Business Week* study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses—that is, greater than $100,000 per director. Many more of the companies that are reasonably compensating their directors have boards numerically controlled by outside directors with large stockholding positions. At the $200,000 level, there are almost three times as many companies that "reasonably" compensate their executives as those in the overcompensation category. Although this is obviously not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity-ownership and more effective compensation oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to reasoned compensation. This

fact gives support to the theory that the creation of substantial equity positions in the outside directors may lead to more effective compensation oversight.

Missing, of course, from an interpretation of the results of the study, is any indication of the effect of a five-year board term on director behavior. None of the 158 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact not simply of stock ownership, but of substantial stock ownership. The key to more effective compensation monitoring, then, is to create in each outside director a substantial equity position in the business itself. The payment of director fees in stock, in combination with five-year terms of office, will create such holdings. As noted earlier,[149] implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit appears to begin.

The empirical evidence yielded by this study, does suggest that in the realm of executive compensation, companies with boards composed of outside directors with significant shareholdings, are less susceptible to the charge of executive overcompensation than those companies that do not. Fewer of those companies that are believed to overcompensate their executives, have outside directors with significant holdings in the business than those enterprises with levels of executive pay that are viewed as proportionate to services delivered. An alignment of the directors' interests with those of the shareholders, rather than with management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based approach to the compensation controversy seems potentially helpful and warranted.

IV. Conclusion

Executive overcompensation is a serious problem that weakens the corporate enterprise and undermines public confidence in the management of our largest institutions. It is primarily the result of ineffective monitoring and bargaining on the part of corporate boards of directors. Unlike a number of governance issues, it is not susceptible to effective solution through the normal operation of market forces. Overcompensation is not merely a problem in and of itself. Rather, it is symptomatic of a more serious problem within the corporation—that

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[149] *See supra* note 137 and accompanying text.

of a management unresponsive to shareholder welfare because it is unchecked by appropriate monitoring and oversight by an active and involved board. Such self-interested management, motivated primarily by personal gain, may create the kind of ineffective corporate enterprise that will result both in diminished shareholder profit and lessened overall societal wealth. Eventually, when corporate productivity declines sufficiently to provoke a market-based response to the situation—the wholesale replacement of management—the problem of overcompensation will be remedied. But by the time this occurs, the damage to the enterprise that ineffective management brings will already have taken place and, in the highly competitive world market, may prove fatal to the enterprise. Thus, in practice, a market-based solution may come along too late to save the enterprise, and is an ineffective remedy to the problem.

This destructive result need not occur. The key is to prevent the problem from ever developing, not to "solve" it once it has manifested itself and lessened shareholder value. A number of solutions to executive overcompensation have been proffered including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation committees. Several of these approaches attempt to eliminate the problem without attacking the root causes, thus creating the potential for its eventual reemergence. All, unfortunately, will ultimately prove ineffective, and some even potentially harmful to corporate well-being.

The most effective solution lies in stimulating effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The only real long-term solution to the compensation controversy is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity-ownership on the part of the outside directors. To create the sizeable shareholdings that may achieve such positive monitoring, directors should be paid their annual fee in company stock. To ensure that the holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove the comprehensive cure to the overcompensation problem, but the costs of this approach are minimal and it is a good beginning. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.

CORPORATE LAW SYMPOSIUM

THE DUTY OF CARE, COMPENSATION, AND STOCK OWNERSHIP*

*Charles M. Elson***

In the United States today, many corporate executives are paid much more than their performance seems to justify.[1] The public fury generated by the popular perception of this fact has increasingly dominated the nation's legislative, political, and financial agendas.[2] In light

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1. The following Article draws from and expands upon an earlier work that examines the executive compensation controversy in substantial detail. *See* Charles M. Elson, *Executive Overcompensation — A Board-Based Solution*, 34 B.C. L. REV. 937 (1993). The prior article explored the history of the compensation problem and critiqued as either ineffective or harmful to corporate well-being the solutions offered by other commentators, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, strengthened board compensation committees, and a market-based approach. It suggested that the solution to the controversy rested in substantial stock ownership on the part of corporate outside directors and presented an empirical study to support its conclusion.

2. The recent legislative and political attention that has been directed toward the executive compensation issue is best evidenced by the 1993 tax bill proposed by President Clinton and approved by Congress. Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). The legislation imposed a 10% surtax on any annual salary in excess of $250,000 and prohibited publicly held corporations from deducting executive compensation in excess of $1 million per annum unrelated to performance. *Id.*; *see also The FOB Loophole*, WALL ST. J., Oct. 14, 1993, at A16 (questioning the disparate impact of the tax bill on Hollywood celebrities and chief executives). Promoting passage of the legislation, President Clinton stated that "the tax code should no longer subsidize excessive pay of chief executives and other high executives." David E. Rosenbaum, *Business Leaders Urged by Clinton to Back Tax Plan*, N.Y. TIMES, Feb. 12, 1993, at A1; *see also* Charles M. Elson, *A Board-Based Solution to Overpaid CEOs*, WALL ST. J., Sept. 27, 1993, at A22 (suggesting that stock ownership by directors is a key in the overcompensation controversy) [hereinafter Elson, *A Board-Based Solution*]. However, attacks on excessive executive compensation have not come exclusively from the President and members of his political party. As a political cause, the excessiveness of executive salaries has cut across party lines. During the 1992 campaign season, Republican Vice-President Dan Quayle joined then-presidential candidate Bill Clinton in criticizing the high salaries received by some of the nation's corporate executives. Jeffrey H. Birnbaum, *From Quayle to Clinton, Politicians Are Pouncing on the Hot Issue of Top Executives' Hefty Salaries*, WALL ST. J., Jan. 15, 1992, at A14.

The Securities and Exchange Commission (SEC) has also directed its attention toward the public outcry over excessive executive compensation by implementing regulations requiring heightened disclosure of corporate executive compensation practices. Executive Disclosure, Ex-

of this problem, we must consider whether some sort of legal response is necessary and, if so, what form it should take. Unfortunately, the problem of executive overcompensation is not an isolated and particularized corporate malady, but is merely one manifestation of a much larger, more generalized problem affecting our entire system of corporate governance. The solution requires a fundamental reexamination of the way in which our law regulates corporate conduct—more specifically, the present legal structure of the corporate director's fiduciary duty of care.

In many of America's leading corporations, management is supervised by a board of directors largely appointed by management.[3] This

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change Act Release No. 33-6962, 57 Fed. Reg. 48,126 (1992) (codified at 17 C.F.R. §§ 228, 229, 240, 249); Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582 (1992) (codified at 17 C.F.R. §§ 229, 240). Under these regulations, among other information to be disclosed, corporations must compare overall financial performance with the amount of compensation paid to top executives. Executive Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48,126; Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582.

Additionally, over the course of the past few years, executive compensation has increasingly become a regular topic in the popular and financial media. The large salaries collected by the nation's top executives have provided the basis for numerous articles, editorials, and compensation surveys. *See, e.g.*, Amanda Bennett, *A Little Pain and a Lot to Gain*, WALL ST. J., Apr. 22, 1992, at R1; Derek Bok, *It's Time to Trim Hefty Paychecks*, N.Y. TIMES, Dec. 5, 1993, at F13; John A. Byrne, *What, Me Overpaid? CEOs Fight Back*, BUS. WK., May 4, 1992, at 142; *CEO Pay: How Much Is Enough?*, HARV. BUS. REV., July–Aug. 1992, at 130 (a collection of editorial columns by various authors); Geoffrey Colvin, *How to Pay the CEO Right*, FORTUNE, Apr. 6, 1992, at 60; Tommy Denton, *Where Is the Justice in Bloated Executive Bonuses?*, L.A. DAILY J., May 14, 1991, at 6; *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148 (surveying executive compensation at the 500 largest companies); Elson, *A Board-Based Solution*, *supra*; Charles M. Elson, *Director-Owners Can Lower High Pay*, N.Y. TIMES, July 18, 1993, at F15 [hereinafter Elson, *Director-Owners*]; John E. Robson, *With Executive Pay, Keep Exploring Options*, WALL ST. J., Oct. 5, 1992, at A12; *The Boss's Pay*, WALL ST. J., Apr. 21, 1993, at R13 (examining executive compensation at 350 of the nation's largest companies).

Executive compensation has also provided the basis for numerous texts and law review articles. *See, e.g.*, DEREK BOK, THE COST OF TALENT 95–118, 223–48 (1993); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991); IRA KAY, VALUE AT THE TOP: SOLUTIONS TO THE EXECUTIVE COMPENSATION CRISIS (1992); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59 (1992); Carl T. Bogus, *Excessive Executive Compensation and the Europe of Corporate Democracy*, 41 BUFF. L. REV. 1 (1993); Douglas C. Michael, *The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation*, 17 J. CORP. L. 785 (1992); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231 (1983); Geoffrey S. Rehnert, Comment, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147 (1985); Richard L. Shorten, Jr., Note, *An Overview of the Revolt Against Executive Compensation*, 45 RUTGERS L.J. 121 (1992).

3. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 184, 193 (1994). Although director candidates are recommended to the board by the nominating committee, "the CEO plays an important, even dominant role in the selection of director candidates." *Id.* at 193. Furthermore, Monks and Minow noted that a 1991 study found that 82% of board

situation, in which board members owe their positions to executive largesse, creates an environment in which corporate directors have little incentive to monitor management, but great reason to acquiesce to any management initiative. This problem, more commonly referred to as "management capture,"[4] is the real cause of the overcompensation problem. Excessive compensation results when passive boards beholden to management agree to salary packages on demand in the absence of spirited negotiation. Thus, any solution to the executive overcompensation controversy must first address the problem of the passive board.

How can we motivate a board, compositionally suited to passivity, to become an active monitor of management? Traditionally, we have attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. The Delaware Supreme Court attempted to bolster compliance with this duty in its landmark *Smith v. Van Gorkom*[5] decision, which resulted in the creation of certain guidelines to decisionmaking that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. As will be discussed, this decision has not lessened, but has in some respects created a costlier form of, board passivity. It was a triumph of form over function. The solution to the problem of the passive board lies not in using the threat of legal liability to force compliance with some theoretical standard of care, but in creating an environment where a board finds it in its own self-interest to engage in active oversight.

Some reform in board structure is warranted to create better board-level review of executive compensation and to promote more effective management monitoring. The outside directors must be made to consider management initiatives, not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stock-

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vacancies were filled as a result of recommendations by the CEO. *Id.*

4. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139–48 (1976). "[I]n life as in the law the power to hire implies the power to fire. A director who has been brought on board by a chief executive—as outside directors typically are—is therefore likely to regard himself as the latter's sufferance." *Id.* at 147; *see also* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 72–73 (1986) (discussing the powers of control in a corporation); ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 73–79 (1991) (opining that directors are often captive because "they are selected by management, paid by management, and . . . informed by management").

5. 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the Delaware Supreme Court held that the directors of Trans Union Corporation breached their fiduciary duty of care when they approved a merger without making an "informed" decision on the fairness of the offered price. *Id.* at 874. For a detailed examination of *Van Gorkom* and a discussion of the director's duty of care, see *infra* notes 48–84 and accompanying text.

holders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management proposal in the best interests of the stockholders, we must make them stockholders as well. Corporations should pay their directors' annual fees in company stock that is restricted as to resale during the directors' terms in office. In a few years, each director will have accumulated a reasonably substantial portfolio and will, therefore, possess a powerful financial incentive to act more independently of management.[6] Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decisionmaking; by stretching out the time between elections, the chilling effect of a management threat not to renominate the director to the board is mitigated.[7]

For an equity-based approach to the problem of board passivity to be effective, it must first be demonstrated that equity ownership has a salutary effect on outside director behavior—that board members who own substantial amounts of company stock are, in fact, more effective monitors of corporate performance. Recently, two independent business

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6. The salutary effects of directors' ownership of a substantial amount of stock have been well documented. *See, e.g.*, MACE, *supra* note 4, at 61–65 (noting that outside directors who own substantial amounts of stock in their companies are more likely to ask discerning questions than their nonstockholding counterparts); Charles M. Elson, *Board Pay Affects Executive Pay*, CORP. BOARD, Mar.-Apr. 1994, at 7–11 (stating that directors with substantial equity in companies are more inclined to keep pay tied to performance); James J. Fitzsimmons, *A Better Approach to Director Pay*, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (concluding that directors paid in stock are more closely aligned with shareholders and in a better position to ensure that management is paid based upon performance); Edmund W. Littlefield, *A Stake with Restricted Stock*, DIRECTORS & BOARDS, Spring 1985, at 51, 52 (stating that "[p]aying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders"); Joann S. Lublin, *Director's Cut*, WALL ST. J., Apr. 13, 1994, at R5 (stating that companies are increasingly turning to stock options as compensation for outside directors); David J. McLaughlin, *The Director's Stake in the Enterprise*, DIRECTORS & BOARDS, Winter 1994, at 53–59 (studying the relationship between outside director stock ownership and corporate performance); Pearl Meyer, *The Rise of the Outside Director as an Equity Owner*, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned a large amount of stock and that they may be returning to this compensation scheme); Robert Stobaugh, *Director Compensation: A Lever to Improve Corporate Governance*, DIRECTOR'S MONTHLY, Aug. 1993, at 1–4 (comparing the performance of companies with a high degree of stock ownership by its directors with companies whose directors' stockholdings are relatively small). *See generally* Elson, *supra* note 1, at 981–96 (stating that the key to independent and dutiful outside directors is not simply stock ownership, but substantial stock ownership).

7. For instance, some commentators have called for fixed five-year terms that would help to establish a corporate "long-term view" and benefit corporate "vitality." Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 216 (1991); *see also* Elson, *supra* note 1, at 983–87 (discussing the benefits of combining quinquennial elections and an increase in directors' stockholdings).

researchers conducted empirical studies of the relationship between outside director stock ownership and corporate performance. They found that companies with substantial outside director equity ownership tended to outperform companies whose directors had insubstantial holdings.[8] Expanding on this research, I conducted a broader study that yielded similar results. I found that companies with boards composed of outside directors with significant shareholdings tend to be considered better managed and to outperform those companies without such equity-holding boards. Those companies that are viewed as being poorly managed had fewer outside directors with significant holdings in the business. On the other hand, those businesses viewed as being well-managed tended to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of substantial equity holdings that result in more effective management oversight would explain this phenomenon. Despite vigorous judicial enforcement of the duty of care exemplified by the *Van Gorkom* ruling, the passive, management-captured board has flourished, bringing in its wake executive overcompensation and poor overall corporate performance. Because of this apparent link between effective oversight and equity ownership, an equity-based approach to the problem of the passive board appears to be highly desirable and, as this Article argues, is the most effective

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8. The first of these studies was conducted by Professor Robert Stobaugh of the Harvard Business School. *See* Stobaugh, *supra* note 6, at 1–4. Stobaugh found that compensating directors in stock resulted in improved corporate performance. *Id.* at 4. The study examined and compared investors' returns from two groups of corporations. The first group was comprised of nine companies that "were corporate governance 'targets' of at least three shareholder groups," and the second group consisted of the nine highest ranked companies on the *Fortune* list of "most admired companies." *Id.* at 2. Professor Stobaugh discovered that the average stockholding of directors at the "most admired" companies was much greater than that of the directors at the poorly performing companies. *Id.* As a result of his study, Stobaugh concluded that there was an apparent correlation between corporate performance and stockholding by members of the board of directors. *Id.* at 2–3. Consequently, he recommended paying half of a director's annual compensation in company stock until "stock ownership by corporate directors . . . increased to a level at which the value of the director's stock ownership is perhaps ten times the director's annual compensation." *Id.* at 4.

David J. McLaughlin, the president of a Connecticut management consulting firm, conducted the second of these studies. *See* McLaughlin, *supra* note 6, at 53–59. McLaughlin's study examined the stock holdings of outside directors at 70 companies, comparing the performance of companies with a high degree of director stock ownership to those with a low degree of director stock ownership. *Id.* at 54. The study found that the companies with the highest degree of director stock ownership "delivered a return of 174% to their shareholders over five years from 1988 to 1992, while those with the lowest delivered only a 73% return." *Id.* For further discussion of the Stobaugh and McLaughlin studies, see *infra* notes 105–14 and accompanying text.

solution.

Part I of this Article considers the problem of executive overcompensation and its root cause—inadequate bargaining resulting from passive boards. Part II examines the corporate director's fiduciary duty of care, which has been the traditional route the law has taken to counteract board inactivity and its consequent dilatorious effect on corporate well-being. Subsequent judicial application of this duty—most notably the Delaware court's decision in *Smith v. Van Gorkom*[9]—although seeking to compel active board monitoring, instead has had the opposite effect and has compounded the passivity problem. The duty-of-care standard need not be abandoned, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and should be reconsidered. Part III focuses on stock ownership and lengthened board terms as an alternative and preferred approach to preventing board passivity and encouraging active oversight. This Section examines the link between substantial equity holdings by directors and more effective corporate performance and argues that companies should create such holdings in their outside directors. In this light, the facts of *Van Gorkom*, most notably the stockholdings of the outside members of the defendant Trans Union Board, are reexamined to lend support to this equity-based proposal. A director equity-ownership program should create more reasonable executive compensation practices and, of greater importance, a more effective and competitive corporation.

I. The Overcompensation Crisis and Its Cause

Excessive compensation results when individuals are paid more for their labor than is warranted in return for services rendered. To determine what part of one's pay is deserved and what part is not, we must first determine the precise value of one's services. Unfortunately, this is not an easy task; for what is the true value of the deployment of human capital? Although human effort is in one sense easily quantifiable, limited to the physical capacity of the worker and the time limitation of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain a complex economy are incredibly varied and require vastly different skills. Some skills are valued more highly by society and are compensated at higher levels. What those levels may be is determined through the routine function of the market.

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9. 488 A.2d 858 (Del. 1985). It is interesting to note that the defendant Trans Union directors held little equity in the company. For a detailed examination of this point and its implications for the duty of care, see *infra* notes 128—30 and accompanying text.

How much individuals are compensated for their labor is the result of an implicit or explicit bargaining process. One party has labor to offer, and another has a need for the skill. The resulting compensation is the product of the matching of expectations—what one expects to receive and what the other is willing to give. These expectations, created through ordinary market function, determine compensation levels. What others are giving or receiving for similar tasks produces the expectations that determine particular compensation levels for particular skills. The value of a particular skill is not implicit in the skill itself, but is simply the result of this bargaining process. In this regard, there is really no such thing as an implicitly "fair" salary, only one that is acceptable to both parties.

Reasonableness is the product of the bargain. If one is voluntarily willing to part with a large amount of capital, say one million dollars, to obtain a particular service, then one million dollars is the value of that service. The compensation is thus reasonable. Compensation becomes unreasonable when it is not the product of balanced bargaining. Excessive compensation results when one party to a bargain, due to external pressures, is unable or unwilling to bargain effectively to maximize self-interest. This is the crux of the overcompensation controversy.

In the corporate setting, executive overcompensation results when there is a failure in bargaining between the executive and the corporation. The executive possesses managerial skills that the corporation desires. The corporation possesses capital that the executive desires in exchange for services rendered. How much capital will be given for these services is the result of bargaining. The resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest. An executive salary arrangement is the product of negotiation between the executive and the company's board of directors, which represents the interests of the company and its owners, the shareholders. If the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it finds itself more closely aligned with management than with the shareholders, then the product of such a "bargain" may be no bargain at all to the corporation and its owners. Alliances between bargaining parties may result in acquiescence rather than a bargained-for agreement. A salary arrangement resulting from such one-sided, passive bargaining is potentially excessive.

Although today many focus simply on large executive salaries as proof in and of themselves of an overcompensation problem, the real problem involves the process by which those salaries were determined,

not the dollar amount.[10] A high salary does not, on its own, necessarily suggest that the recipient has been overcompensated. As long as the salary was the result of an active, good-faith bargaining process between the board and the executive in question, the compensation cannot be labeled unreasonable. Spirited negotiation by both parties assures proper compensation. That is the very nature of a market-based economy at work.

Compensation amounts do become problematic, however, when a board beholden to a particular executive agrees to a salary package upon demand, in the absence of self-interested bargaining. But under what circumstances would this phenomenon occur? Why would an independent board elected by the shareholders find itself blindly and passively responsive to management in compensation negotiations? The failure to negotiate an executive's compensation request is most likely to occur in those corporations where the outside directors find themselves obligated to no particular shareholder or shareholder block, but gain and maintain their board positions because of executive favor. This situation most commonly exists in large, publicly traded companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.[11]

In such businesses, no one shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership.[12] The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management. The board is thus not representative of any one shareholder or shareholder

10. Elson, *supra* note 1, at 947. "Excessive CEO pay is symptomatic of inattentive boards and uninformed shareholders." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 130, 138 (comments of Nell Minow).

11. As of December 31, 1974, management controlled 165 of the 200 largest publicly owned nonfinancial corporations in the United States. EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 58 (1981). "[W]ide diffusion [of stock] does not increase the power of holders of small blocks of stock; it enhances the power of whoever controls the proxy machinery." *Id.* at 53. "[E]xecutive leadership is becoming more indispensable than ever. Only the executive can mediate among the multitude of constituencies vying to influence every corporation." Thomas A. Stewart, *The King Is Dead*, FORTUNE, Jan. 11, 1993, at 35, *quoted in* MONKS & MINOW, *supra* note 3, at 193; *see also* MACE, *supra* note 4, at 83–84.

12. In testimony before a United States House subcommittee, Dale Hanson, CEO of California's Public Employee Retirement System, stated that "[n]ominating committees all too often are sham, pure and simple." MONKS & MINOW, *supra* note 3, at 193. Monks and Minow note that a 1991 study showed that 82% of board vacancies were filled pursuant to recommendations from the chairman, who in the vast majority of instances also serves as the CEO. *Id.*

group, but is instead responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.[13] The directors on a captured board, responsible for oversight, are generally the officers themselves, individuals performing various professional services for the corporation such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.[14] The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group will rarely challenge management prerogative either, although there have been recent exceptions.[15] Such board members are usually se-

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13. *See* EISENBERG, *supra* note 4, at 139–48; *see also* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058, 1058 n.127 (1993) (examining the shirking of the duty to monitor management by "independent" directors who, because of composition and constraints on time and information, simply "rubberstamp" management decisions); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873–76 (1991) ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management.").

14. The first two groups of directors—the corporate officers and those who perform services for the corporation—are respectively known as "inside" directors and inside "outside" directors. Alternatively, those directors with no connection to the corporation other than board membership are known as "outside" directors. *See* Avery S. Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, 837 (1977) (classifying directors as "inside directors," "non-independent outside directors," and "independent outside directors"); *see also* WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 156–57 (concise 6th ed. 1988) (noting that inside directors and outside directors who perform services for the corporation are unable to exercise independent oversight because they have strong professional and economic ties to the corporation and are therefore likely to acquiesce to the decisions of the chief executive); Bainbridge, *supra* note 13, at 1059 (questioning the independence of outside directors); *CEO Pay: How Much Is Enough?*, *supra* note 2, at 130, 131 (comments of Ralph V. Whitworth, proposing that if one wants truly independent directors then the question should be how they obtained their position on the board and not whether they worked for the corporation). *But see* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.34 (1994) [hereinafter ALI] (abandoning the use of labels, but stating that a director has a "significant relationship" with a corporation's senior executives when, among other things, he is employed by the corporation, a member of the immediate family of an officer, or affiliated in a professional capacity with a law firm that is the primary legal advisor to the corporation).

15. Recently, outside directors have become emboldened and have challenged management in several notable cases. For example, in October 1992, the outside directors of General Motors ousted their CEO, Robert Stempel, in response to the company's lackluster performance. *See* Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14. Similarly, James D. Robinson, III, was removed from his position as chief executive of American Express in a move orchestrated by outside directors in January 1993. Chief executives at Westinghouse and IBM met similar fates as a result of director revolts led by outside directors, many of whom were former CEOs. *See* Julie Amparano Lopez, *CEOs Find That Closest Chums on Board Are the Ones Most Likely to Plot a Revolt*, WALL ST. J., Mar. 26, 1993, at B1; *see also* Eben Shapiro, *Philip Morris CEO Resigns Under Pressure*, WALL ST. J., June 20, 1994, at A3

lected either by the chairman or other senior management, and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.[16] These directors are often officers of other public corporations[17] and frequently ask their counter-

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(examining the resignation of Philip Morris CEO Michael A. Miles in the wake of the company's loss of more than $30 billion in stock market value in two years and mounting criticism of his leadership from the board and institutional investors); Stewart, *supra* note 11, at 34 (discussing the recent firings and forced resignations of CEOs at several of the nation's largest corporations).

While these cases demonstrate a board's ability to dispose of an ineffective chief executive, some commentators argue that such board action occurs too infrequently and often only after serious damage to the corporation.

> Cases like RJR-Nabisco, General Motors, and American Express, among others, show us that if the situation gets bad enough, directors will do the right thing. However, they also show us that current board structures impose substantial obstacles to doing it sooner and more consistently. For example, the financial press heralded the board of IBM for pushing out CEO John Akers in January 1993. Yet this action took place after the company had lost over $80 billion in market value in just a couple of years. Where was the board during that period?

Nell Minow & Kit Bingham, *The Ideal Board*, CORP. BOARD, July-Aug. 1993, at 11; *see also* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 59 (1992) ("Directors eventually may act . . . but their actions often are late, after the shareholders have lost value, employees jobs, and the corporation its competitive market position.").

16. *See supra* note 4; *see also* BOK, *supra* note 2, at 98 (arguing that the selection of new directors is frequently dominated by senior executives); CARY & EISENBERG, *supra* note 14, at 157; CRYSTAL, *supra* note 2, at 224–30 (discussing factors that lead to ineffective compensation committees); HERMAN, *supra* note 11, at 31 (discussing the "transitory" and "guestlike" nature of an outside directorship); MONKS & MINOW, *supra* note 4, at 77–79 (stating that many directors are picked, not for their business acumen, but for their "business or personal relationship[s]" with management); Gilson & Kraakman, *supra* note 13, at 884 (noting that the way in which outside directors are selected leads to lack of incentive for corporate governance); Minow & Bingham, *supra* note 15, at 12 (comparing shareholder elections of directors to elections held by the communist party of North Korea in that management selects the candidates and counts the votes).

17. The most common selection for an outside director is the chief executive of another corporation. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITIES OF AMERICA'S CORPORATE BOARDS 18 (1989) (noting that "63% of all board members are CEOs of other corporations"); J. Spencer Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505, 1515 (1980). "For a CEO, the most highly coveted boardmembers are CEOs of other companies. A startling two-thirds of all corporate directors are CEOs." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 132 (comments of Ralph V. Whitworth). "One wonders, however, if the person among all who is most likely to be generally supportive of the chief executive isn't another chief executive." Letts, *supra*, at 1515; *see also* Barris, *supra* note 2, at 76 (discussing the lack of impartiality of outside directors). Such directors are deemed to be "outside" directors despite their close personal and professional ties to the executives of the company on whose board they sit. For a definition of "outside directors," see *supra* note 14. However, Martin Lipton and Jay Lorsch would "not view as independent an executive of another company on the board of which an executive of the company serves." Lipton & Lorsch, *supra* note 15, at 67-68. Lipton and Lorsch propose that the exclusion of these otherwise "outside" directors would lead to a more independent and active board. *See id.* at 68 n.32 (citing Kenneth A. Macke, *The Board and Management: A New Partnership*, DIRECTORSHIP, July-

parts, whom they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.[18] While such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Board passivity in regard to management monitoring is the result of this compositional structure.[19] Consequently, the outside directors have little incentive other than fiduciary duty (which, for reasons to be discussed, has proven ineffective in creating incentive) to bargain effectively with management over compensation. Passive boards, created by management capture, are ineffective compensation negotiators.

Aug. 1992, at 8 ("The composition of the board is critical to how well it functions. We like to make sure that everything is geared toward making the board as independent and active as possible.")).

18. Barris, *supra* note 2, at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the board's compensation committees. Alison L. Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. *Id.* In order to be truly independent, The Blue Ribbon Commission on Executive Compensation recommends that compensation committees exclude "any interlocking directorates, particularly among CEOs." Joann S. Lublin, *Panel Adopts a Tough Line on CEO Pay*, WALL ST. J., Feb. 10, 1993, at B1; *see also* HERMAN, *supra* note 11, at 43 (suggesting that the cross-directorships are the result of the directors' trusting each other to be truly "outside" directors).

19. *See* James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 977 (1992). Discussing executive compensation in light of board composition, Professor Repetti stated:

> Since 63% of all outside directors on the boards of America's 1000 largest companies are chief executives of other firms, the abdication of the board of directors should be expected. Chief executives who serve as directors for companies other than their own are generous in establishing the salaries of management of those companies because the high salaries can then be used to justify large salaries from their own companies.

Id.

Similarly, Graef Crystal observed that most compensation committees are comprised of directors who serve as chief executives of other companies. CRYSTAL, *supra* note 2, at 227. Consequently, these executives bring an attendant bias with them to their services on the board that prohibits true arms-length bargaining over compensation. *Id.* Interestingly, Crystal has noted that a correlation exists between the compensation of chief executives and the compensation of director-CEOs serving on compensation committees. "[T]he higher the pay of the CEOs who sit on the compensation committee, the higher will be the pay of the CEO whose pay the committee regulates." *Id.*

Ralph V. Whitworth, President of the United Shareholders Association, characterizes the relationship between the CEO and his hand-picked directors as one where "[y]ou dance with who brought you." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 131 (comments of Ralph V. Whitworth). Therefore, it is not surprising that "this crowd rarely argues when it comes to approving a CEO's pay." *Id.* at 132.

Many of the largest American public corporations have shareholding patterns that dispose them to such potential management capture and attendant compensation problems.[20] It is these companies that have traditionally paid their executives the largest salaries and that are currently the target of popular attention.[21] As noted earlier, a large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture may be indicative, because of its size, of a failure by the directors to bargain effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the United States and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.[22] It is

20. *See supra* note 11. As public corporations developed and grew during the 20th century, ownership was spread "among tens of thousands of individual shareholders, none of whom could cast a meaningful vote in governance of their companies." Stewart, *supra* note 11, at 35 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933)). According to Berle and Means, the result of this wide diffusion of ownership was the birth of a class of professional managers who controlled the corporation while owning a de minimis amount of the company's stock. *Id.*; *see also* BERLE & MEANS, *supra*, at 6 (discussing the results of separating ownership from management); Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.—Apr. 1990, at 46, 46 (stating that capitalism evolved from a "market society dominated by corporations . . . with absentee owners and professional managers"). "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear." *Id.*

21. *See generally* MONKS & MINOW, *supra* note 4, at 166 (explaining that in 1989, the average CEO at the nation's top 200 companies received $2.8 million in salary and bonuses); Arch Patton, *Those Million Dollar-A-Year Executives*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s, at 43, 44 (Fred K. Foulkes ed., 1991) [hereinafter A STRATEGIC GUIDE] (noting that executive pay in the 100 largest publicly owned corporations increased by an average of 13.7% in 1983); Byrne, *supra* note 2, at 142 (discussing the outcry over executive compensation); *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148—62 (rating executive compensation among the 500 largest American companies); Carol J. Loomis, *King John Wears an Uneasy Crown*, FORTUNE, Jan. 11, 1993, at 44 (discussing IBM's difficulties and the potential removal of CEO John Akers); Joann S. Lublin, *Higher Profits Fatten CEO Bonuses*, WALL ST. J., Apr. 21, 1993, at R1 (discussing executive compensation at America's larger corporations); Joann S. Lublin, *Looking Good*, WALL ST. J., Apr. 13, 1994, at R1 (examining executive compensation at America's largest corporations); Kevin Maney & Michelle Osborn, *Megabucks Amid Layoffs Stoke Outrage*, USA TODAY, Mar. 27, 1992, at 1B (examining executive compensation packages in light of continued corporate failures); Stuart Mieher, *Westinghouse's Paul E. Lego Resigns as Chief*, WALL ST. J., Jan. 28, 1993, at A3 (discussing Lego's resignation in "the midst of financial troubles and pressure from directors and shareholders"); Stewart, *supra* note 11, at 34 (examining the removal or resignation of 13 Fortune 500 CEOs in 18 months, including chief executives at General Motors, American Express, and Time Warner).

22. In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. Byrne, *supra* note 4, at 142. In 1980, the average

therefore not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness (for how do we know with any precision what one's services are worth?),[23] given the great potential for ineffective, passive bargaining that the captured board presents, we cannot downplay the significance of the overcompensation controversy. Some sort of reasoned response must be developed.

But what sort of response should be forthcoming? How can we prevent corporations from overpaying their executives? The problem is not high salaries, but excessive salaries. Such is the result of ineffective negotiation between boards and executives. This lack of effective bargaining comes about through board passivity, which is the result of management capture. Passive boards do not negotiate effectively. Eliminate the board passivity created by management capture, and you will solve the compensation crisis. The solution lies not in addressing the malady's results, overpaid executives, but in facing its root cause, board passivity. The captured, passive boards—not excessive salaries—are the real evil that must be addressed. Executive overcompensation is but a symptom, not the illness.[24]

The core malady afflicting all too many large United States corporations today, board-based passivity, in addition to being problematic in

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chief executive earned only 42 times the average factory worker's wage. *Id.* at 143; *see also* MONKS & MINOW, *supra* note 4, at 166–67 (observing that United States executive pay significantly outpaced inflation, wage, and profit rates from 1977 to 1987 and that American CEOs in billion-dollar companies receive two to three times the pay of comparable executives in Europe and Japan). A 1991 study of 282 large and medium sized corporations by the Hay Group found that CEOs earned an average of $1.7 million a year in total compensation and that CEOs at the 30 largest corporations earned an average of $3.2 million. Colvin, *supra* note 2, at 60.

23. It is impossible to determine the excessiveness of an executive's compensation in a vacuum; such a determination requires the use of some type of quantitative measure. For instance, an executive who produces an increase in corporate profitability that results in larger returns for shareholders may be worth paying more to retain in a competitive labor market. *See* CRYSTAL, *supra* note 2, at 159–73 (arguing that the high-paid CEOs of Reebok, Walt Disney, and H.J. Heinz are properly compensated given the risks that they take and the profits that they generate for their shareholders). Consequently, most executive compensation plans attempt to align executive compensation with the company's performance in various areas, most notably, stock prices and profits. *See* Seymour Burchman, *Choosing Appropriate Performance Measures*, *in* A STRATEGIC GUIDE, *supra* note 21, at 189; Stephen F. O'Byrne, *Linking Management Performance Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91; S. Prakash Sethi & Nobvaki Namiki, *Factoring Innovation into Top Management's Compensation*, DIRECTORS & BOARDS, Winter 1986, at 21.

24. As *Forbes* editor James W. Michaels put it, "[T]he sin against society is not in the size of the paycheck, it's in the dereliction by boards that don't police the reward system." James W. Michaels, *Should Anyone Earn $25,000 a Day?*, FORBES, May 25, 1992, at 10.

the compensation area, is extraordinarily detrimental to the well-being of the entire corporate enterprise. It robs the corporation and its owners, the shareholders, of the necessary independent oversight, guidance, and reasoned control vital to the health of the entity. Theoretically, under the traditional legal model, the board is responsible for the overall direction of the enterprise. It should manage the corporation's business and set general business policy.[25] Management is engaged to carry out that policy and operate the company on a day-to-day basis. The board is expected continually to monitor corporate performance and management effectiveness in maintaining optimal business operation and carrying out board policy.[26] If management performs sub-

25. *See* CARY & EISENBERG, *supra* note 14, at 154–57. The American Law Institute has established general duties for boards of directors:

> (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
> (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
> (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;
> (4) Review and, where appropriate, approve major changes in, the determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements; [and]
> (5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

ALI, *supra* note 14, at § 3.02(a); *see also* LORSCH & MACIVER, *supra* note 17, at 8–12 (examining the historical concept of the burden of proof); MONKS & MINOW, *supra* note 3, at 182-84 (examining the board of directors' duties).

However, in reality, the traditional legal model of the corporation serves only as a starting point for the study of corporate structure and governance. "It has become increasingly clear that in practice the board rarely performs either the management or policymaking functions." CARY & EISENBERG, *supra* note 14, at 155. Consequently, most of the power supposedly vested in the board is actually held and exercised by management. *Id.* at 156.

Discussing this current view of the board's role, Chancellor William Allen of the Delaware Court of Chancery stated:

> The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis.

Chancellor William T. Allen, Address at the Ray Garret, Jr., Corporate & Securities Law Institute, Northwestern University, Chicago (Apr. 1992), *in* Lipton & Lorsch, *supra* note 15, at 62.

26. *See* CAREY & EISENBERG, *supra* note 14, at 154–57. "[T]he board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders." SEC Chairman Richard Breeden, Address at the Town Hall of California (June 1992), *in* Lipton & Lorsch, *supra* note 15, at 62. Actively monitoring corporate performance and management in an informed manner is foremost among the responsibilities of the board of directors.

> Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of

standardly, the board as an effective monitor must either provide executives with new direction or replace them.

The active monitoring role of the board of directors is not only central to the traditional legal model of the corporation, but critical to ensuring the success of the enterprise. Management operates, boards monitor. When the monitoring function of the board becomes compromised for any reason, the corporation may be destined for disaster.[27]

> the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve these goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.

Allen, *supra* note 25.

27. The effects of a derelict board of directors are evidenced by the recent fortunes of corporations such as American Express, General Motors, and IBM. For instance, the recent turmoil at General Motors demonstrates the consequences of an inattentive board and the resulting benefits of more activist directors. Throughout its history, the GM Board was typically beholden to GM management, with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM Board finally took affirmative steps to improve the company's performance, steps that included firing GM CEO Robert Stempel. *See* John Greenwald, *What Went Wrong?*, TIME, Nov. 9, 1992, at 42, 44; *see also* Kathleen Day, *GM's Move Symbolizes Wider Fight*, WASH. POST, Oct. 27, 1992, at A1 (noting that "boards typically have been captive to the wishes of the company chairmen," but that pressure has been mounting on boards to assume a more proactive stance in the fulfillment of their duties).

In January 1993, IBM CEO John Akers was forced to resign amid sagging profits and lost market share. IBM saw its worldwide market share drop from 30% in 1985 to 19% in 1991, witnessed its stock price lose half its value over a six-month period, was forced to make a 55% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Loomis, *supra* note 21, at 45, 48; Michael W. Miller & Laurence Hooper, *Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed*, WALL ST. J., Jan. 27, 1993, at A1.

Similarly, American Express Board members, dissatisfied with the company's recent financial performance and public relations gaffes, deposed CEO James D. Robinson, III. Bill Saporito, *The Toppling of King James III*, FORTUNE, Jan. 11, 1993, at 42–43. Robinson, who served as CEO for 16 years, developed American Express into a "financial services supermarket." *Id.* However, the number of American Express cardholders was down worldwide, earnings were lackluster as the result of a $112 million charge at Optima, and the stock price remained depressed. *Id.* at 43.

The recent allegations of nefarious activity by Orange & Rockland Utilities CEO James F. Smith, however, present perhaps the most egregious example of executive largesse at the hands of an indulgent and derelict board. Joann S. Lublin, *Less-Than-Watchful Eyes Didn't Oversee Expenses of Utility Chairman*, WALL ST. J., June 15, 1994, at B1. Smith allegedly appropriated nearly $326,000 of company money for his personal use during his 14 years as chief executive. *Id.* The Orange & Rockland Board was "handpicked" by Smith and contained some personal friends and several directors who owned little stock. *Id.*; *see also* ORANGE & ROCKLAND UTILITIES INC., APR. 6, 1994 PROXY STATEMENT 3–5, 9 (1994) (The proxy statement listed board members' stockholdings, including those of directors with relatively few shares: Linda C. Taliferro, Audit Committee, 53 shares; Frank A. McDermott, Jr., Compensation Committee Chairman and Executive Committee, 697 shares; James F. O'Grady, Jr., Compensation and Executive Committees, 600 shares; Michael J. Del Giudice, Audit Committee, 0 shares.). In the words of Kenneth Gribetz, the district attorney prosecuting Smith, the Orange & Rockland

The benefits to be achieved by effective board supervision of management are obvious. Thoughtful, judicious management is encouraged; unnecessarily risky or imprudent behavior is discouraged. The potentially dilatorious impact of the unproductive, foolish, or felonious is lessened by a vigilant board.[28] On the other hand, the pernicious impact of the absence of active board oversight is equally obvious. Without effective board monitoring, the corporation becomes, in effect, a runaway stagecoach likely to do great damage to those within and to its owners who watch in horror from the sidelines.

The primary consequence of board passivity created by management capture is decreased management monitoring. But why does management control over board appointments necessarily create board passivity? Why would nonmanagement, outside directors on such captured

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Board "was one big, happy family." Lublin, *supra*, at B1.

28. The board's preeminent duty is to monitor management and "*prevent* crisis." Minow & Bingham, *supra* note 15, at 15. "The board's most important function is to ask tough questions, listen to responses from management, and work together to find the right answers." *Id.* at 11. If directors perform their monitoring function, "they may prevent a significant portion of the long-term erosion of corporate performance that has plagued many once successful U.S. corporations." Lipton & Lorsch, *supra* note 15, at 62.

In order to fulfill this monitoring obligation, boards must be comprised of individuals with "the financial and strategic expertise and time to do the job." Robert A.G. Monks, *To Change the Company, Change the Board*, WALL ST. J., Apr. 27, 1993, at A20. In short, the keystone of a vital public corporation must be a "reformed and revitalized [board] of directors willing to monitor management and capable of mustering the courage and will to conduct themselves with a fiduciary conscience." Johnson, *supra* note 20, at 55. In order to effectuate the establishment of independent boards of directors, Elmer Johnson, a former General Motors Board member, has suggested removing retired CEOs from the boards of their former companies, limiting the size of boards to as few as seven directors, requiring directors to own a "significant" number of the company's shares, and compensating management with shares of the corporation's stock. *Id.* at 54-55. As Johnson puts it, "Patient capital is the foundation on which long-lived, wealth-creating institutions rest. But since patient capital is helpless capital unless it has a voice, its prerequisite is a properly functioning board of directors." *Id.* at 46; *see also* Lipton & Lorsch, *supra* note 15, at 62 (quoting Chancellor Allen, who stated that the board's "most basic responsibility [is] the duty to monitor the performance of senior management in an informed way"); The Working Group on Corporate Governance, *A New Compact for Owners and Directors*, HARV. BUS. REV., July–Aug. 1991, at 141, 142 (suggesting that "outside" directors should evaluate the performance of the chief executive annually).

Professor Cox notes that empirical evidence demonstrates that outside directors may "help to shield the corporation from managers' self-dealing or overreaching conduct." James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1234, 1242 (1993). Examining the relationship between board composition and the termination of poorly performing management, Cox points to data that show that the "likelihood that a board will terminate an underperforming executive increases as the board's overall size increases" and continues to increase with the proportion of outside directors. *Id.* at 1241 (citing Donald L. Helmich, *Organizational Growth and Success Patterns*, 17 ACAD. MGMT. J. 771, 774 (1974)); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988); Joann S. Lublin, *More Chief Executives are Being Forced Out by Tougher Boards*, WALL ST. J., June 6, 1991, at A1.

boards be unwilling to challenge management prerogative and engage in active oversight? There are three problems with a management-appointed board that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult to engage in necessary confrontation. It is always tough to challenge a friend, particularly when the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, when one owes one's board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which—given the large fees paid to directors[29] and the great reputational advantage to board membership—may function as an effective club to stifle dissension. Such realities hinder effective oversight by a corporation's outside directors.

It appears, therefore, that board passivity may be a problem structurally inherent in the management-appointed board. This passivity chills effective oversight of management activity, including the presently controversial area of executive compensation. If management domination of the board appointment process leads to board passivity, why not simply forbid management involvement in that process? Would such a prohibition eliminate the passive board?[30] Although this sort of rule might create a group of directors more independent of management, in the realities of the large, modern corporation, it is both ill-advised and completely unworkable.

First, simply because management proposes an individual for board membership does not automatically make that individual unworthy of service. Management, with its knowledge of the company and its in-

29. For example, nonemployee directors receive annual compensation in the amount of $35,000 at General Electric, $35,000 at Exxon, $55,000 at IBM, and $48,000 at American Express. Moreover, these nonemployee directors usually receive a fee of between $1000 and $2000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between $3000 and $5000 per year. AMERICAN EXPRESS CO., MAR. 14, 1991 PROXY STATEMENT 5 (1991) [hereinafter AMEX PROXY]; INTERNATIONAL BUSINESS MACHINES CORP., MAR. 16, 1992 PROXY STATEMENT 10 (1992) [hereinafter IBM PROXY]; GENERAL ELECTRIC CO., MAR. 3, 1992 PROXY STATEMENT 13 (1992) [hereinafter GE PROXY]; *see* Barris, *supra* note 2, at 78-79, 78 n.114.

30. In fact, many corporations, presumably in an effort to create a more independent board, have begun to limit management participation in the selection of new directors. Stuart Mieher, *Firms Restrict CEOs in Picking Board Members*, WALL ST. J., Mar. 15, 1993, at B1. Proposals to limit the role of CEOs in director selection have been made by a number of commentators, including Jay Lorsch and Elizabeth MacIver. *See* LORSCH & MACIVER, *supra* note 17, at 173–76.

dustry and its contacts in the general business community, may be well-suited for finding those whose experience and skill would make them productive board members. To rule out management involvement in the recruitment process might eliminate a whole pool of individuals whose board service could be highly valuable to the business. And, while friendship with management should not be the reason for one's appointment to a board, neither should it act as an automatic disqualifier.

Second, such a prohibition would be unworkable in a very practical sense. Management domination of the board appointment process occurs when a company, due to atomistic shareholding patterns and ineffective communication among shareholders, has no dominant shareholder or shareholding group. Management simply fills the void. If management is forbidden from dominating the process, who will? Prohibiting management involvement will not necessarily create a shareholder's utopia. It was small shareholdings that created the vacuum; there was no economic incentive for a small holder to become actively involved in the process.[31] Removing management from the process will not change this reality and will only lead to chaotic board

31. Because of their relatively small stockholdings, shareholders will become actively involved in running the corporation "only if the expected benefits of doing so outweigh its costs." Bainbridge, *supra* note 13, at 1055 (citing ROBERT C. CLARK, CORPORATE LAW 390-92 (1986)). Professor Bainbridge notes that the average shareholder is presented with opportunity costs that far outweigh the concomitant benefits of becoming involved. *Id.* Furthermore, because of atomistic shareholding patterns and divergent interests, it is extremely difficult for shareholders to organize and act as a cohesive unit to produce significant change. EISENBERG, *supra* note 4, at 159-60, 167; Bainbridge, *supra* note 13, at 1054-55; Cox, *supra* note 28, at 1236. "Shareholders are thus rationally apathetic." Bainbridge, *supra* note 13, at 1055; *see* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 66-67 (1987). Management, with its access to information, is able to fill the vacuum left by shareholder apathy to provide uniform and coherent leadership. *See* CARY & EISENBERG, *supra* note 14, at 141 (noting that shareholders who own a relatively insignificant amount of the corporation's stock "will normally not want to spend a significant amount of time on the corporation's affairs, and management fills the vacuum"); MACE, *supra* note 4, at 191 (observing that management controls large public corporations in the absence "of control or influence by the [unorganized] owners of the enterprise"); MONKS & MINOW, *supra* note 3, at 98-103 (examining the separation between ownership and control of the corporation). *But see* Bainbridge, *supra* note 13, at 1054 n.108 (discussing those commentators who believe that institutional investors can provide an active voice in corporate governance); Cox, *supra* note 28, at 1258-59 (discussing the role that institutional investors may play in monitoring); *infra*, note 86 (discussing the role that institutional investors may play in corporate governance). *See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (arguing that institutional passivity is a result of insufficient incentives to monitor the corporation rather than a result of overregulation); Gilson & Kraakman, *supra* note 13, at 863 (proposing a strategy for increased corporate governance by institutional investors).

elections.[32] This approach would promote corporate uncertainty and instability, certainly no blessing.

If prohibiting management involvement in the board appointment process is not a workable or desirable solution to the passivity problem, what is? How can we stimulate a board, compositionally suited to passivity, to become an active monitor of management? The answer to this question will not only solve the executive overcompensation dilemma, which is but one result of the passivity problem, but will also create much more effective corporate performance. The real problem confronting United States corporate law today is not excessive executive compensation, but the passivity of the management-captured board.

II. Board Passivity and the Duty of Care

If board passivity is the real problem hindering the effective operation of the large public corporation, what then is the appropriate legal response? What can be done to motivate a board, which is compositionally passive, to become an active management monitor? The problem of board supervisory laxity is not at all new. In fact, it probably dates back to the development of the modern board-managed corporation with its severance of ownership and control. Corporate law traditionally has been highly responsive to this issue. In part to counteract the potentially dilatorious effect of director inattentiveness and inactivity, the law created the corporate director's fiduciary duty of care, which was formulated to compel effective oversight. A standard of conduct was developed, violation of which led to personal liability on the part of the offending board member.[33] The duty of care was an effort

32. Bainbridge, *supra* note 13, at 1054.

33. Most commentators have suggested that the duty of care developed from the law of fiduciaries and originated in equity. *See* Duties and Responsibilities of Outside Directors 20 (Avery S. Cohen & Ronald M. Loeb eds., 1978) ("The classic definition of the duty of care of directors arose from the law of fiduciaries, and it was only through an evolutionary process that there began to be differentiation in form and substance between the duties of corporate directors and the duties of other fiduciaries, such as trustees."); Howard H. Spellman, A Treatise on the Principles of Law Governing Corporate Directors 14-15 (1931) ("Numerous decisions iterate the proposition that the directors bear a fiduciary relationship toward the corporation, its stockholders and creditors."); 2 Seymour D. Thompson & Joseph W. Thompson, Commentaries on the Law of Corporations § 1320 (3d ed. 1927) ("The rule is thoroughly embedded in the general jurisprudence of both America and England that the status of directors is such that they occupy a fiduciary relation toward the corporation and its stockholders, and are treated by courts of equity as trustees."); *see also* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880 ("As a legal principle, the [fiduciary] obligation originated in Equity. . . . The term 'fiduciary' itself was adopted to apply to situations falling short of 'trusts,' but in which one person was nonetheless obligated to act *like* a trustee."). *But see* E. Norman Veasey & William E. Man-

to force desired behavior through a threat of legal liability for noncompliance. It proved to be ineffective, however, as passive boards flourished. In response, the Delaware Supreme Court created a new legal stricture designed to strengthen board adherence to the duty in its landmark *Van Gorkom* ruling.[34] Unfortunately, as will be discussed, like most economic regulations designed to create desired behavior through a mandate rather than an incentive, this approach has not proven to be particularly effective. In fact, it has bolstered rather than discouraged board passivity.

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ning, *Codified Standard-Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 925 (1980) (citing MODEL BUSINESS CORP. ACT ANN. § 35 cmt. at 256 (2d ed. Supp. 1977), for the proposition that the American Bar Association Committee, which is responsible for the Model Business Corporation Act, omitted any reference to the term fiduciary in its formulation of the duty of care).

The fiduciary duty of care developed as a means to compel oversight by an independent board, which, according to the traditional view, possessed broad power over corporate affairs. Howard Spellman, in a 1931 treatise on corporate directors, described the development of this duty in the following manner:

> [T]he legal situation in which a director finds himself is the product of judicial precaution, motivated by the necessity of safeguarding the interests of the corporation, of its stockholders, and of those who deal with it from overreaching by the members of its managing body for their own advantage. The reason for holding corporate directors to a high degree of accountability is a result of their dominant position, growing out of the complete control accorded to the board in the management of corporate affairs. . . . The courts have consistently upheld the board's independence. But it is a proper corollary of the grant of extensive powers that their misuse be prevented and their abuse punished. Accordingly, equity subjects the directors of a corporation to the same liability for negligence or misconduct as it does trustees.

SPELLMAN, *supra*, at 15–16; *see also* HENRY W. BALLANTINE, BALLANTINE'S MANUAL OF CORPORATION LAW AND PRACTICE § 114, at 359 (1930) (stating that the duty of care requires directors "to exercise an active and vigilant supervision over the officers of the company . . . to be familiar with the requirement of the by-laws of the corporation and enforce them . . . [and] to take the usual methods to inform themselves of the true condition of the affairs of the company"); 4 WILLIAM M. FLETCHER, OF THE LAW OF PRIVATE CORPORATIONS § 2261, at 3510 (1918) (stating that directors occupy a fiduciary relationship with stockholders because they are "agents intrusted with the management of the corporation"); 2 HOWARD L. OLECK, MODERN CORPORATION LAW § 959, at 730 (1959) (arguing that directors act as fiduciaries to shareholders because they are "the central power of management").

Recent commentators have similarly suggested that the duty of care was developed to compel active oversight of the modern board-managed corporation. *See* Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983) (arguing that the duty of care developed in response to "the freeing of management . . . from effective discipline by stockholders" and the consequent "separation of ownership and control in the modern publicly-held corporation"); *see also* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1353 (1989) (noting that "over the last century," the duty of care imposed "a set of standards—a regime—for judicial review of corporate decisionmaking").

34. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). For a complete discussion of the standards that the court in *Van Gorkom* created to bolster director adherence to the duty of care, see *infra* notes 52–58 and accompanying text.

Under the traditional duty of care, a director was expected to carry out his or her responsibilities "with the care that an ordinary prudent person in a like position would exercise under similar circumstances."[35] Failure to meet this standard would result in the imposition of liability upon the slothful director. This would theoretically compel circumspect and diligent conduct in carrying out the various responsibilities of board membership, including executive salary negotiations. Under the business judgment rule, however, a director would be found to have met this duty of care if in making a specific business decision he or she acted without self-interest, in an informed manner, and with a rational belief that the decision was in the best interests of the corporation.[36] A director who so acted in reaching a business decision was

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35. MODEL BUSINESS CORP. ACT § 8.30 (rev. ed. 1991). The Model Business Corporation Act states the director's duty of care as follows:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

Id.

The American Law Institute has defined the duty of care in a similar fashion:

> (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

ALI, *supra* note 14, § 4.01(a).

Approximately 37 states have adopted statutory duty-of-care provisions; the rest have a common-law duty of care. *Id.* at 200. Most states have adopted a reasonable care standard. *Id.*; *see* CAL. CORP. CODE § 309(a) (West 1990 & Supp. 1994); N.Y. BUS. CORP. LAW § 717 (McKinney 1994); Graham v. Allis-Chalmers Mfg., 188 A.2d 125, 130 (Del. 1963); 2 MODEL BUSINESS CORP. ACT ANN. § 8.30, at 934 (3d ed. 1990). *See generally* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 593 n.7 (1983) (discussing the evolution of a common-law duty of care and the later statutory duties of care); Veasey & Manning, *supra* note 33, at 919 (comparing the standard of care in the Model Business Corporation Act section 35 with that of Delaware case law). *But see* KY. REV. STAT. ANN. § 271B.8-300(1) (Baldwin 1994) ("A director shall discharge his duties. . . [i]n a manner he honestly believes to be in the best interests of the corporation.").

36. In Aronson v. Lewis, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court described the business judgment rule as follows:

> [A] presumption that in making a business decision the directors of a corporation acted on a informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company . . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted).

The American Law Institute has defined the rule in the following manner:

then protected from any legal liability to his or her shareholders. Over the years, this standard of care proved not to be very difficult to satisfy, and it was quite unusual for a board to be found to have violated this duty.[37] Questions then began to arise as to its effectiveness in assuring

> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:
> (1) is not interested in the subject of the business judgment;
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> (3) rationally believes that the business judgment is in the best interest of the corporation.

ALI, *supra* note 14, § 4.01(c); *see* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Teren v. Howard, 322 F.2d 949, 952-53 (9th Cir. 1963); Richardson v. Blue Grass Mining Co., 29 F. Supp. 658, 665 (E.D. Ky. 1939), *aff'd*, 127 F.2d 291 (6th Cir. 1942); Wall & Beaver Street Corp. v. Munson Line, Inc., 58 F. Supp. 109, 115-16 (D. Md. 1944); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); Citron v. Fairchild Camera & Instrument Corp. 569 A.2d 53, 64 (Del. 1989); Haber v. Bell, 465 A.2d 353, 357 (Del. Ch. 1983).

Where a director has not made a business decision, such as in the case of an omission, the business judgment rule does not apply, and the director should not be judged under the reasonable care standard. *Aronson*, 473 A.2d at 812–13.

For a complete discussion of the differences between the ALI's formulation of the business judgment rule and that of the Delaware Supreme Court in *Aronson v. Lewis*, see Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992).

37. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). After extensive research, Professor Bishop discovered only four cases in which a court found that a director violated the duty of care, absent an allegation of self-dealing. *Id.* at 1099–1100; *see* New York Credit Men's Adjustment Bureau v. Weiss, 110 N.E.2d 397 (N.Y. 1953); Syracuse Television, Inc. v. Channel 9, Syracuse, 273 N.Y.S.2d 16 (Sup. Ct. 1966); Clayton v. Farish, 73 N.Y.S.2d 727 (Sup. Ct. 1947); Selheimer v. Manganese Corp. of Am., 224 A.2d 634 (Pa. 1966). Even though all of these decisions resulted in director liability, Bishop stated that "none of these cases carries real conviction." Bishop, *supra*, at 1100.

Several more recent commentators have also taken the view that the duty of care was an easily satisfied standard for directors. They argued that in the few cases where the courts found a breach of the duty of care, elements of director self-interest were present. *See* William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 992 n.126 (1993) ("I am aware of only five cases in the history of American corporate law that have held directors liable for breaches of the duty of care, four of which seem tainted by conflicts of interest."); Cohn, *supra* note 35, at 591 n.1 ("Research reveals only seven successful shareholder cases not dominated by elements of fraud or self-dealing."); Palmiter, *supra* note 33, at 1360 ("During their century-long tenure, [care] standards have produced remarkably few cases holding directors liable for unreasonable or careless decisions."); Scott, *supra* note 33, at 933 ("[V]ery few cases have imposed liability solely on the basis of a violation of the duty of care."). Professor Scott also noted that "[m]any of the 'negligence' cases are tainted by the presence of some elements of conflict of interest or personal gain." *Id.* at 933 n.23 (citing Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981)); *see also* Dooley, *supra* note 36, at 482 (indicating that the lack of decisions holding directors liable for violating the duty of care signifies that "American judges have followed an authority model [designed to preclude judicial review] and have therefore intended that their articulation of the duty of care be mostly hortatory").

diligent board behavior.[38]

The American Law Institute (ALI), in connection with its landmark Corporate Governance Project in the early 1980s, consequently decided to reexamine the entire duty-of-care concept and its continuing viability.[39] This reexamination sparked a great deal of controversy among

38. Professor Bishop was one of the first to question the effectiveness of the duty of care in assuring diligent board behavior. Bishop, *supra* note 37, at 1078-81. A number of other commentators were similarly critical of the duty's efficacy. *See, e.g.*, Carney, *supra* note 37, at 923 ("Although courts frequently stated that directors owed their corporations and shareholders a duty of care, courts' failure to enforce that duty in cases of erroneous decisions meant that for practical purposes, the law played no role in enforcing diligence of directors."); George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. L. REV. 623, 654 (1981) ("[T]he duty of care has hitherto been an ineffective tool for requiring directors to perform a meaningful function within the corporation."); Scott, *supra* note 33, at 932−33 (using a two-fold approach to explain why the duty of care is ineffective).

According to Professor Dent, the duty was ineffective because of judicial reluctance ever to find that a board was in violation of the duty. Dent, *supra*, at 646−54. Among other reasons for this judicial reticence, Dent explores what are considered the three traditional explanations. First, courts do not feel "that they are competent to review business decisions," as they "possess no special expertise in business affairs." *Id.* at 648. Second, rigorous enforcement "would pose such a substantial threat of personal liability that the best qualified persons would decline to serve as directors." *Id.* at 649. Finally, a stringent review "would force directors to become unduly cautious in order to avoid risky ventures that might result in losses to the corporation." *Id.* at 650.

39. The American Law Institute initiated its Corporate Governance Project in 1978. Roswell B. Perkins, President of the ALI, in discussing the project's origins, may have had the controversy concerning the duty of care in mind when he stated that "[a] commitment to the health and vigor of the free enterprise system requires that the law as to governance of business associations be fully as efficient and effective as, for example, the law of contracts and the law relating to commercial transactions." Melvin A. Eisenberg, *An Introduction to the American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495, 495 (1984) (quoting Roswell B. Perkins, *The President's Letter*, 4 A.L.I. REP. 1 (1982)). Perkins further commented that "there has been a degree of uncertainty and inconsistency in the law which cries out for rational, dispassionate analysis and the development of guiding principles." *Id.* at 496.

For further commentary concerning the origins and methodology of the Corporate Governance Project, see Eisenberg, *supra*, at 498-500; Melvin A. Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271 (1993); Elliot Goldstein, *The Relationship Between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations*, 52 GEO. WASH. L. REV. 501 (1984); Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325 (1987). Professor Seligman suggested, among other things, that the following governance problems led to the ALI's reconsideration of American corporate governance:

> Directors did not establish the basic objectives, corporate strategies, and broad policies in most large and medium-sized companies. . . . Nor did the board select the corporation's chief executive officer. . . . Outside directors were not expected to play an adversarial role . . . . Moreover, few boards met frequently enough to perform a useful role.

Id. at 330−32.

For an alternative perspective on the origins of the Corporate Governance Project, see Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L.

corporate law commentators. A fierce debate ensued,[40] with Professor Scott arguing for the complete abolition of the duty because he believed it to be of minor importance. He suggested:

> [V]ery little if any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit. Other incentives for an appropriate degree of care in corporate decision-making would remain, and mechanisms would exist outside the courtroom to correct shortcomings.
>
> What would be gained by such an abolition? . . . There would be savings in litigation expense, insurance premiums, unnecessary record building, and risk-averse decisionmaking by the board. More important, abolishing duty of care liability could enormously clarify and

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REV. 1212, 1214 (1993) ("[T]he ALI was motivated to embark on its reform effort by internal bureaucratic incentives rather than by external public policy concerns. . . . [Moreover], [t]he ALI's initial interest in the Project is best characterized as little more than a bureaucratic exercise in turf-grabbing.").

40. Three different viewpoints emerged in the debate over the duty of care. The first, most notably propounded by Professor Scott, called for the abolition of the duty. Scott, *supra* note 33, at 936–37. A number of other commentators subscribed to this view. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 7, 28–32 (1990) (stating that corporations are contractual in nature and that fiduciary duties should be governed by contract); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 174 (advocating the contract theory of corporate governance and suggesting that parties affected by corporate changes are better served by private contracting than by regulatory intervention); Palmiter, *supra* note 33, at 1436–64 (suggesting the creation of a director's duty of independence); David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 704 (1984) (stating that the ALI's current approach to the duty of care will "undermine the utility of corporate doctrine to tackle managerial self-enrichment"); Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 987–98 (1993) (suggesting that corporate governance should arise from contract rather than mandatory rules).

The second approach, typified by arguments by Professor Cox, called for application of a stronger, more rigorous duty of care. James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984). Other commentators suggested a similar approach. *See, e.g.*, Cohn, *supra* note 35, at 595, 607–27 (proposing a standard of reasonable care so that "the business judgment rule would resume its historical basis as a protection against hindsight evaluation of erroneous decisions, but would shed its protective role as a shield for all director action in the absence of fraud or other illicit behavior").

The third viewpoint on the controversy called for maintenance of the duty of care as it was then currently structured. *See* John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 828 (1984); *see also* Victor Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223 (1983) (defending the ALI's formulation of the duty of care); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1747 (1989) (exploring arguments for and against the duty of care and offering a model provision "in the style of the ALI's Corporate Governance Project"); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1525 (1989) (defending the use of mandatory rules in corporate governance and fiduciary duties).

simplify the legal system in this field.[41]

Responding to this attack on the duty of care, a number of commentators rushed to its defense, some even calling for a stronger, invigorated, more easily enforceable duty.[42] Professor Cox argued:

> [T]he law should find violations of the duty of care and impose remedies to compensate shareholders for their losses because of egregious decisionmaking by managers . . . . Derivative suit procedures should be drafted so that violations of the duty of care can be vindicated as efficiently as violations of the duty of loyalty.[43]

In response, taking what he termed a middle course between the Scott and Cox position—"Steering Between Scylla and Charybdis"[44]—Professor Coffee also called for the duty's retention, although he was critical of an "invigorated" duty as one having the potential to "chill the movement towards independent directors or produce excessive risk aversion."[45] Coffee suggested that the duty still had value because of "its socializing and exhortative impact" and that it should be left intact because of its "aspirational" potential.[46]

In the end, despite the attacks on its viability, the traditional duty of care was more or less retained by the ALI and continued to function as corporate law's response to the problem of the inattentive board.[47]

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41. Scott, *supra* note 33, at 937. Professor Scott believed that pressures and incentives in the free market would compel active board oversight. *Id.* at 935-36. For instance, "proxy contents, negotiated takeovers, and hostile tender offers" existed to provide protection of shareholder interests without the necessity of due care litigation. *Id.* at 935. Further, performance-based compensation packages, competition in the market place, and "managerial labor market[s]" also provided incentive for effective board management. *Id.* Lastly, Professor Scott suggested that board members' personal reputations and stock portfolios would facilitate active board monitoring. *Id.* at 936.

42. For those commentators calling for a stronger, more invigorated duty of care, see *supra* note 40.

43. Cox, *supra* note 40, at 788.

44. Coffee, *supra* note 40, at 789.

45. *Id.* at 799.

46. *Id.* at 798.

47. For the ALI's statement of the duty of care, see ALI, *supra* note 14, § 4.01(a).

Beginning in 1982 and throughout the drafting of § 4.01(a) as part of its Corporate Governance Project—including the final draft adopted in 1992—the ALI continually represented that its formulation of the duty of care did not represent a radical departure from traditional doctrine. *See* ALI, *supra* note 14, § 4.01(a) cmt. a; AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 11, 1991); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 4, 1985); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 3, 1984); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 1, 1982); *see also* Brudney, *supra* note 40, at 225 (noting that the duty of care under the ALI is largely "a description of existing legal

Then in mid-1985, the Delaware Supreme Court shocked the corporate and legal communities by dramatically changing the nature of the duty-of-care action through its ruling in *Smith v. Van Gorkom*.[48]

As discussed earlier, traditionally it was very rare for a court to rule that a board had violated its duty of care. The courts were very liberal in their application of the protective business judgment rule to challenged board actions. Provided that the directors had no financial interest in the decision they had made, and the decision was not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements had been met.[49] The final element, that an informed decision be made, was never really an issue, because the courts seemed to give boards great latitude in their decisionmaking process.[50] It was highly unusual for a court to characterize a board

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doctrine"). *But see* William J. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U. L.Q. 239, 240 (1988) (stating that "section 4.01 represents a change in the 'real law' governing directors").

Despite the ALI's actions, the issue was far from settled among some commentators. Professor Ribstein attacked the ALI's "regulatory" approach and suggested that the duty of care be imposed contractually rather than by operation of law. Ribstein, *supra* note 40, at 987—88. Professor Ribstein further noted that "[t]he contract theory of the corporation holds that legal rules should effectuate the parties' contracts through interpretation, enforcement, and standard form rules, rather than by supplanting existing contracts or restricting the contracts the parties can make." *Id.* at 989. For more discussion on the contract theory of corporate governance, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1—39 (1991); Butler & Ribstein, *supra* note 40, at 7, 28-32. *See also* Armen A. Alchian & Harold Demsetz, *Production, Information Cost, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); Steven N.S. Cheung, *The Contract Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* R.H. COASE, THE FIRM[,] THE MARKET AND THE LAW 33 (1988); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

48. 488 A.2d 858 (Del. 1985). For a complete discussion on the *Van Gorkom* decision, see *infra* notes 52—84 and accompanying text. The ALI's approach to the duty of care was initially formulated in 1982, prior to *Van Gorkom*. However, in the final version of its *Principles of Corporate Governance*, adopted by its membership in 1992, the ALI cited *Van Gorkom* with seeming approval in its discussion of § 4.01(a). ALI, *supra* note 14, § 4.01(a) reporter's note 15; *see also* Macey, *supra* note 39, at 1220 (noting the ALI's seeming approval of *Van Gorkom*).

49. ALI, *supra* note 14, § 4.01(c) cmt. f.

50. To receive business-judgment-rule protection from liability, directors must inform themselves of all reasonably available material prior to making a business decision. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see* Lutz v. Boas, 171 A.2d 381, 395—96 (Del. Ch. 1961) (holding outside directors liable based on their uninvolved and uninformed posture during their tenure as directors); Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933) ("[There was] no justification in the evidence for concluding that the defendant's directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."); *see also* Cohn, *supra* note 35, at 615 (stating that to meet a reasonable

judgment as uninformed and, therefore, undeserving of the business judgment rule shield. This is why the duty of care was never considered to be a particularly difficult standard to meet and why it was

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care standard, the following question must be answered affirmatively: "Have the directors sought adequate information?"); Joseph Hinsey, IV, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 610 (1984) (describing the elements of the business judgment rule and stating its common-law presence in corporate governance law); E. Norman Veasey and Julie M. S. Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1485 (1985) (discussing the origins of the common-law definition of the business judgment rule); *cf.* Palmiter, *supra* note 33, at 1382–83. Professor Palmiter has described "uninformed" director conduct in the following manner: " 'uninformed' has been understood to mean that directors were grossly negligent or that they engaged in a 'sustained pattern of inattention.' " *Id.* (citations omitted).

Courts, however, have generally given broad discretion to a director's decisionmaking process and thus rarely question whether an informed decision was made. *See* Warsaw v. Calhoun, 221 A.2d 487, 492–93 (Del. 1966) ("In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts."); Auerbach v. Bennet, 393 N.E.2d 994, 1000 (N.Y. 1979) ("It appears to us that the business judgment doctrine . . . is grounded in the prudent recognition that courts are ill equipped . . . to evaluate what are and must be essentially business judgments."); Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (N.Y. App. Div. 1976). The court in *Kamin* stated:

> The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others presents no basis for the superimposition of judicial judgment.

Id.; *see also* Cohn, *supra* note 35, at 594 (stating that the business judgment rule "has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality"); Dent, *supra* note 38, at 648 (suggesting that courts give broad latitude to director's judgment because "[c]ourts sometimes deny that they are competent to review business decisions"); Hinsey, *supra*, at 612 ("As long ago as 1917, Justice Louis Brandeis recognized the principle that courts leave matters of internal management to the directors' discretion and courts will seldom interfere with this discretion absent misconduct or a breach of the duty of loyalty." (citing United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917))); Scott, *supra* note 33, at 933 ("In recognition of the fact that risk taking and uncertainties about future developments characterize most business decisions, courts will not second-guess corporate decisionmakers unless the mistakes in judgment are extreme."); *see also* Palmiter, *supra* note 33, at 1361–62. Professor Palmiter has stated that "the business judgment rule shield[s] board decisions from judicial second-guessing and directors from liability unless a challenger shows that the corporate decision either was tainted by interest . . . was uninformed . . . or lacked a rational business purpose." *Id.* at 1361. Referring to the latitude that courts give directors under the business judgment rule, Palmiter further argued that "courts accord near-complete deference to corporate decisions untainted by interest." *Id.* at 1361–62. *See generally* S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) (discussing the different versions of the business judgment rule and concluding that the business judgment rule is essentially embodied in § 35 of the Model Business Corporation Act); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1994) (advocating the abolition of the business judgment rule).

For a discussion of judicial reluctance to overturn a board decision concerning executive compensation, see Elson, *supra* note 1, at 959–63.

considered to be somewhat ineffective in combating the problem of board laxity.[51]

However, the Delaware court in *Smith v. Van Gorkom*, in a startling change of approach, stiffened substantially the standards that a board must meet to demonstrate that its decisionmaking process was "informed" and therefore merited the protection of the business judgment rule. In that case, after describing in great detail the decisionmaking process by which the defendant Trans Union Corporation Board (Board) had approved the sale of its company, the court ruled that the Board's decision was uninformed. Although many in the financial community firmly believed that the Board's actions in reaching its decision were perfectly reasonable in the context of events and in no way demonstrated an uninformed judgment (an opinion apparently shared by the court's two dissenting justices),[52] the majority's detailed

51. *See supra* notes 37–38.

52. It has been vigorously argued that the facts in *Van Gorkom* did not warrant the court's finding of director liability. Critics of *Van Gorkom* have pointed out, among other facts, the following:

> 1) There was no indication that the Trans Union directors acted out of self-interest or impropriety, and the directors all possessed substantial business expertise, experience and in-depth knowledge of the affairs of the company;
>
> 2) The offered price was substantially above the market value of the company's stock;
>
> 3) The directors were aware that previous attempts to sell the firm were unsuccessful; and
>
> 4) Trans Union possessed extensive tax credits which could be utilized only through a merger.

Carney, *supra* note 47, at 283-85; Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1438 (1985) ("[T]he Delaware Supreme Court erred in holding that the actions of Trans Union's directors were not protected by the business judgment rule."); Macey, *supra* note 39, at 1221 ("From a business perspective, the directors [of Trans Union] probably thought they had all the information they needed."); Paul H. Zalecki, *The Corporate Governance Roles of the Inside and the Outside Directors*, 24 U. TOL. L. REV. 831, 838 (1993) ("The opinion [in *Van Gorkom*] surprised many, particularly because Van Gorkom was a large stockholder and was satisfied with the price.").

Consequently, observers in the financial and legal communities felt that the Board's decision was reasonable and informed. In commenting on the *Van Gorkom* decision, Professor Carney made the following observation:

> The result [of *Van Gorkom*] was that the court upset a decision made by a disinterested board, charged with no fraud or illegality, on the recommendation of a CEO with a substantial ownership interest, because the court did not believe these directors had sufficient information to protect their decision under the business judgment rule. As one dissenting justice pointed out, the five inside directors had 68 years of combined experience, while the five outside directors had 53 years cumulative experience as directors of this company. One outside director was an economist, formerly a Professor of Economics at Yale, Dean of the Graduate School of Business of the University of Chicago, and presently Chancellor of the University of Rochester. The other four were chief executives of major business corporations.

description of that decisionmaking process and the problems that they felt were implicit in the defendant Board's actions served to create a number of new and important guideposts to "informed" decisionmaking.[53]

By detailing where the Trans Union Board's decision was in contravention with what it felt was acceptable behavior, the court created new standards for defining what was and what was seemingly not appropriate conduct for availing oneself of the protection of the business judgment rule. While it never actually mandated any specific requirements in the opinion, the court created its new guidelines for effective decisionmaking by negative implication through its critique of the Trans Union Board's actions. The defendant Board's actions became, in effect, a model for improper conduct, against which other boards' actions would be measured. By criticizing the short amount of time the Board spent deliberating its decision, among other things, the court seemed now to require that a board demonstrate that it had spent some substantial amount of time making a particular judgment in order to demonstrate informed decisionmaking.[54] However, the most significant new requirement to emerge from *Van Gorkom* involved the use of third-party advisors. Although the court's attack on the Trans Union Board's decisionmaking process explicitly stated that investment-bank-rendered fairness opinions were not "required as a matter of law,"[55] the fact that the court imposed liability on a board that failed to obtain such an opinion, and indicated that the procurement of such an opinion would have insulated the directors from liability, suggested the imposition of an informal requirement.[56] It seemed apparent that, as a

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Carney, *supra* note 47, at 285. For further discussion of the *Van Gorkom* decision and its implications, see Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 36–74 (1989); Leo Herzel & Leo Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Carey Kirk, *The Duty of Care and Duty of Loyalty in the Aftermath of Trans Union*, 5 COOLEY L. REV. 1 (1988); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127 (1988); William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985).

The two dissenting justices in *Van Gorkom* apparently felt similarly. Justices McNeilly and Christie both argued that the Trans Union directors exercised sound business judgment with full knowledge of the pertinent facts when they approved the merger. *Van Gorkom*, 488 A.2d at 893–99.

53. *See* Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 103–9 (1989); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 8–14 (1985); *see also* Carney, *supra* note 47, at 283–88.

54. *Van Gorkom*, 488 A.2d at 874 (stating that the Board was grossly negligent when it approved the sale of the company after only two hours of deliberation).

55. *Id.* at 876.

56. *Id.* at 876–78; *see* Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How*

general proposition, the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement. This was to have tremendous impact on the way boards made decisions in all kinds of circumstances. Prudent corporate counsel now mandate the use of independent third-party counsel in various situations to enable a board to demonstrate that it has made an informed judgment.[57] In corporate control transactions, the acquisition of an investment-bank-rendered fairness opinion has become a virtual necessity.[58]

If few felt that what the Trans Union directors had done was improper, and the court's actions signaled a break with precedent, what then was the reasoning behind this result? Why liability?[59] Perhaps the court felt that, despite common practice and acceptance, the Board's actions were lax and inimical to the interests of the shareholders. By seemingly acquiescing to a management-initiated plan to sell

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Fair Are They and What Can Be Done About It?, 1989 DUKE L.J. 27, 28 (1989); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 958 (1992); Robert J. Giuffra, Jr., *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 119–20 (1986); Dennis J. Block & Jonathan M. Hoff, *Investment Banker Opinions and Directors' Right to Rely*, N.Y. L.J., Nov. 17, 1988, at 5; *see also* Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (finding that the board's reliance on the advice of an investment banker fulfilled its duty of good faith and reasonable investigation); Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 512 (Del. Ch. 1990) (holding that the board's reliance on the advice of an investment banker satisfied its fiduciary duty).

57. *See* Branson, *supra* note 53, at 103 (stating that to avoid due care violations after *Van Gorkom*, directors should "make use of independent, outside experts, at least when the transaction is large enough to justify their use"); Fischel, *supra* note 52, at 1453 ("The most immediate effect of Trans Union will be that no firm considering a fundamental corporate change will do so without obtaining . . . documentation from outside consultants.").

58. *See* Branson, *supra* note 53, at 104; Elson, *supra* note 56, at 958–59; Giuffra, *supra* note 56, at 119–20; Macey, *supra* note 39, at 1221; Macey & Miller, *supra* note 52, at 139. Professor Fischel, commenting on the *Van Gorkom* ruling shortly after its announcement, wryly noted that the "outside consultants are the biggest winners after [*Van Gorkom*]. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost." Fischel, *supra* note 52, at 1453.

59. Commentators have offered varying explanations as to why the Delaware court found the Trans Union directors liable. Professor Carney cited *Van Gorkom* for the proposition that "Delaware courts have shifted from an assumption of adequate process to an examination of the actual processes." *See* Carney, *supra* note 37, at 924. He added that "these cases begin with a presumption of director ignorance and place the burden on directors of demonstrating that sufficient 'evidence' was introduced at the meeting at which the final decision was made, rather than respecting the accumulated experience and knowledge of the directors." *Id.*; *see also* Fischel, *supra* note 52, at 1445, 1447 ("The court in Trans Union was extremely critical of the procedures followed by Van Gorkom and the other directors. . . . Another aspect of the transaction that troubled the court was the failure of Trans Union's directors to conduct an auction."); Macey, *supra* note 39, at 1220 ("The *Van Gorkom* court based its opinion on its conclusion that the board of directors making the underlying decision was grossly negligent for recommending the merger to the company's shareholders without having constructed an 'appropriate procedural framework for the decisional process.' " (citing Jonathan R. Macey, *Civic Education and Interest Group Formation in the American Law School*, 45 STAN. L. REV. 1937 (1993))).

the business without great argument or inquiry,[60] the Board had abdicated its traditional supervisory role and had consequently diminished shareholder value by getting less for the company than might have been received had it taken a more active role in the sale process. By imposing liability on the Trans Union directors, the court was making an example of the group to the rest of the corporate community. This harsh result thus would act both to create guideposts for effective decisionmaking and to compel better behavior through the threat of individual director liability. If boards simply followed the guidelines for good decisionmaking created by implication in the Trans Union Board's transgressions, the result would be better oversight and enhanced shareholder wealth.

Whatever the motivation of the *Van Gorkom* court, the result was clear. Through its decision, the Delaware court had signaled that the duty of care, rather than being simply "aspirational,"[61] had now been fitted with a new, sharp set of teeth that would compel effective board behavior. The court's attempt to force compliance with the duty resulted in the creation of certain procedures that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. Avoid the pratfalls of the Trans Union Board, and liability will thus be averted. The Delaware court's response to board passivity was to enhance the duty of care by making it more difficult for a board to avoid its violation by claiming business-judgment-rule protection. Unless it followed certain implied rules of procedure, a board's actions would be subject to judicial review and potential liability.

Van Gorkom had a profound impact on corporate behavior. In an attempt to avoid liability for loss-producing decisions, corporate boards developed various procedures, based on the missteps of the Trans Union Board, to ensure that their decisions would be labeled informed

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60. The court noted that the Trans Union Board approved the merger recommended by Van Gorkom without extensive questioning. *Van Gorkom*, 488 A.2d at 875, 877. The court stated:

> [T]he directors were duty bound to make reasonable inquiry of Van Gorkom and [Chief Financial Officer] Romans, and if they had done so, the inadequacy of that upon with they now claim to have relied would have been apparent. . . . No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. . . . [T]he Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the company—a subject that the Board had never previously considered.

Id. at 875, 877.

61. Coffee, *supra* note 40, at 799.

and therefore subject to the protection of the business judgment rule. Detailed, lengthy discussions regarding the decisions at issue were held, records were made of these debates, numerous documents were presented to each director, and most importantly, third-party "independent" advisors were retained to advise the board on the issues to be resolved.[62] All of these steps were designed to meet the criticism that the Delaware court leveled at the Trans Union directors. Each new step was responsive to some problem with the Trans Union Board's decisionmaking process as identified by the court. By following the guidelines implicitly laid out in *Van Gorkom*, it was thought, a board could avoid the disastrous consequence of personal liability.[63]

62. For a listing of steps that directors should take to ensure a judicial finding of "informed" decisionmaking, see Branson, *supra* note 53, at 103-09; Manning, *supra* note 53, at 8–14. *See also* Carney, *supra* note 47, at 283–88 (discussing the judicial determination of a properly informed business decision); Macey, *supra* note 39, at 1219–21 (discussing the steps that directors should take, pursuant to the ALI).

63. Branson, *supra* note 53, at 103–09 (listing 15 specific guidelines that, if followed, insulate directors from duty-of-care violations); Manning, *supra* note 53, at 8–14 (listing factors implicit in the *Van Gorkom* decision that enable directors to avoid liability).

In response to the *Van Gorkom* decision, a number of state legislatures took action to reduce a director's risk of personal liability for actions taken while a board member. Delaware was the first state to enact a statute that allowed the placement into a corporation's certificate of incorporation by shareholder vote of a clause limiting or eliminating director liability for a breach of the duty of care. Dennis J. Block & Jonathan M. Hoff, *Protecting Outside Directors: D & O Insurance*, N.Y. L.J., Oct. 12, 1989, at 5, 7. The Delaware statute provides that a certificate of incorporation may contain the following:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such a provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law; (iii) under § 174 of the title; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). "Within two years" following enactment of the Delaware statute, some 41 states similarly amended their corporations statutes to limit director liability. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) [hereinafter Romano, *Aftermath of the Insurance Crisis*]. Most of these statutes tracked the Delaware approach, but there were some variations. Some states increased the level of culpability necessary to find personal liability. *See, e.g.*, IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1994) (requiring "willful misconduct or recklessness"); OHIO REV. CODE ANN. § 1701.59(D) (Anderson 1992) (requiring "deliberate intent" or "reckless disregard"); WIS. STAT. ANN. § 180.0828 (West 1993) (requiring "willful failure to deal fairly," "violation of criminal law," "improper personal profit," or "wilful misconduct"). At least one state simply limited the amount of damages for which a director may be liable. *See* VA. CODE ANN. § 13.1-692.1 (Michie 1994) (capping the liability at $100,000 or the amount of compensation received from the corporation within the last 12 months). For further discussion on the different approaches state legislatures used to limit director liability, see JOSEPH W. BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS INDEMNIFICATION AND INSURANCE §§ 6.36-.86 (1994); Block & Hoff, *supra*, at 5, 7; Deborah A. DeMott, *Limiting Directors'*

Almost ten years have passed since the ruling in *Van Gorkom* was handed down. Despite numerous attacks on its viability and logic,[64] the decision still stands. In fact, recently the Delaware court explicitly reaffirmed *Van Gorkom* in *Cede & Co. v. Technicolor.*[65] In that case, which among other things involved an alleged board duty-of-care violation, the court approvingly cited and applied *Van Gorkom* to determine whether the defendant Technicolor Board had made an "informed" decision in approving the sale of the company.[66] It found that they had not. And in the most recent Delaware takeover decision, *Par-*

Liability, 66 WASH. U. L.Q. 295 (1988); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988); Romano, *Aftermath of the Insurance Crisis, supra*, at 1160–68.

These statutes, however, have not necessarily eliminated the potential for, or director's fear of, personal liability. *See* Leo Herzel et al., *Next-to-Last Word on Endangered Directors*, HARV. BUS. REV. Jan.-Feb. 1987, at 38, 43 (stating that courts can circumvent the new Delaware statute because "[w]ith only a little effort, courts could find directors liable for disloyalty where before they would have found them liable for negligence"); Romano, *Aftermath of the Insurance Crisis, supra*, at 1161 (questioning the effectiveness of the legislative response to director liability because "the statutes in most states do not exempt from liability claims for breach of the duty of loyalty, violation of federal securities laws, and breach of the duty of care by directors who are also officers"); Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 32 (1989) (stating that limited liability statutes are ineffective because "plaintiffs will, in all likelihood, be able to redraft their complaints to continue to bring lawsuits; for example, instead of alleging negligence they will allege reckless behavior").

In addition to reducing directors' exposure by limiting personal liability, some states increased director indemnification rights. *See, e.g.*, LA. REV. STAT. ANN. § 12:83E (West Supp. 1994); MO. ANN. STAT. § 351.355(7) (Vernon Supp. 1991); N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1994); Block & Hoff, *supra*, at 5, 7; DeMott, *supra*, at 317–22; Hanks, *supra*, at 1221–24; Romano, *Aftermath of the Insurance Crisis, supra*, at 1162–63. This approach, however, has also proved problematic. *See* Dennis J. Block, *Advising Directors on the D & O Insurance Crisis*, 14 SEC. REG. L.J. 130, 146–47 (1986); Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 912 (1993); John F. Olson, *The D & O Insurance Gap: Strategies for Coping*, LEGAL TIMES, Mar. 3, 1986, at 25, 33 (stating that "[indemnification is] only as good as the assets of the corporation"); *see also* MICHAEL A. SCHAEFTLER, THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS 143–44 (1976) (listing several instances where indemnification does not protect directors).

Despite these statutory attempts to limit director personal liability, either through liability limitations or indemnification, director concern with potential liability for improper decisionmaking still remains. DeMott, *supra*, at 298 (arguing that directors must continue to be concerned with litigation risks because "[a]s a result of these unfortunate deficiencies [in legislative responses to director liability], the risk exposure of directors and officers to liability is unpredictable"). Therefore, either because of continued fear of personal liability or simply the desire to avoid the embarrassment and inconvenience of a shareholder lawsuit on a particular decision, boards continue to follow the *Van Gorkom* guidelines for "informed" decisionmaking.

64. For criticisms of the *Van Gorkom* reasoning, see Carney, *supra* note 37, at 894; Fischel, *supra* note 52, at 1438; Macey, *supra* note 39, at 1219-22.

65. 634 A.2d 345 (Del. 1993).

66. *Id.* at 366, 367.

amount Communications v. QVC Network,[67] the court cited to its decision in *Van Gorkom* when attacking the defendant Paramount Board's decisionmaking process as "uninformed."[68] So *Van Gorkom* survives. But should it? Has the alteration in board behavior occasioned by the decision really resulted in more "informed" decisionmaking? Have we seen better, more active board oversight and enhanced shareholder wealth? Despite the best intentions of the Delaware court, no such good has resulted. Although, theoretically, the new board procedures that resulted from the heightened attention to the duty of care occasioned by *Van Gorkom* should have acted to compel more informed and circumspect decisionmaking, they have not. And, in fact, some have had the opposite effect and have acted to protect and therefore encourage the dangerous board passivity created by management capture that so perplexed the *Van Gorkom* court.

One major change in board behavior created by *Van Gorkom* involves the time that a board spends on a particular decision. The criticism that the court leveled on the Trans Union Board because it devoted only two hours to deliberating the sale of the company[69] has resulted in boards' devoting much more time to decisionmaking. Accordingly, the decisionmaking process now generally runs for a period of some hours and involves detailed questioning of management by board members on the proposal before the group. Numerous documents involving the decision are made available to the directors, and detailed records are made of the discussions held. While this may create the appearance of an "informed" active process, the reality may be something quite different. It is not unlikely that the proceedings have been informally, or even formally, scripted in advance by corporate counsel keenly aware of the *Van Gorkom* parameters and eager to create a protective paper record.[70] Staged like a good play, such proceedings may evoke a recitation of the required emotions on the part of the

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67. 637 A.2d 34 (Del. 1994).

68. *Id.* at 50.

69. Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).

70. *See* Branson, *supra* note 53, at 110 ("This nearly total emphasis on process may be criticized as resulting in an excessive amount of play-acting, out-of-pocket costs, inefficiency, and reliance upon process by both courts and corporations."); Carney, *supra* note 37, at 924 (stating that the duty-of-care cases after *Van Gorkom* "begin with a presumption of director ignorance and place the burden on directors of demonstrating that sufficient 'evidence' was introduced at the meeting at which the final decision was made"); Macey, *supra* note 39, at 1221 ("[T]he [*Van Gorkom*] case will increase the use of investment bankers and lawyers in corporate decision-making. . . . [This] increased 'papering' of board decisions will not substantially raise the level of deliberations." (quoting Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 139 (1988))). For a list of actions that directors should take to create a protective paper trail, see also Manning, *supra* note 53, at 8–14.

actors that, in the final analysis, when the stage lights dim, have only been an illusion. Nothing is gained by such a charade. Entertaining, maybe; shareholder value-enhancing, absolutely not.

A requirement that one spend a certain amount of time at a task does little to ensure the proper administration of the job. A requirement to provide one with documents pertaining to a decision does little to assure that they will be read. The key is not dictating the time involved or information provided, but giving the participant some incentive to be both well-versed in the subject and actively engaged when it is discussed. The *Van Gorkom* requirements do little to accomplish this goal.

The other major change in board behavior occasioned by *Van Gorkom* has been the active retention of the "independent" third-party advisor to aid boards in their decisionmaking process. As noted earlier, the *Van Gorkom* court suggested that the use of an independent investment bank by the Trans Union Board to assist it in evaluating the fairness of the price being offered for the company would have aided the Board in precluding liability by helping it to meet the "informed" requirement of the business judgment rule.[71] Since then, the use of the third-party advisor as an aid to informed decisionmaking has grown tremendously. In the corporate control transaction area, the procurement of an investment-bank-rendered fairness opinion has become a virtual necessity because it is considered to be a vital prophylactic measure for ensuing business-judgment-rule protection for buy or sell decisions.[72]

Theoretically, the retention of an independent third-party advisor acts to ensure the probity of a particular decision. If an independent expert suggests that all is well with a particular decision, then it would apparently be hard to quibble with the process by which that decision was made. The key to the effectiveness of this theory is that the advice of the third party be objective and independently rendered. Any ties to the decisionmaker that would act to compromise the independence and objectivity of the advice proffered must be avoided. Otherwise, the advice rendered may not really aid the decisionmaking process, but may simply act to "rubber stamp" the decision that the advisee has already made. This kind of compromised advice does nothing to ensure the probity of the decision reached, but, in fact, is terribly harmful to the entire process. It acts to give legitimacy to a potentially illegitimate decisionmaking process and therefore encourages bad decisions through

71. *See supra* notes 55–57 and accompanying text.

72. For a discussion of the necessity of fairness opinions, see *supra* note 55–58 and accompanying text.

protecting the decisionmaker from liability for the decision. This is why the *Van Gorkom*-inspired third-party-advisor concept is so problematic. If there is anything in the relationship between the third-party advisor and the board that acts to compromise the objectivity of the advice given, then the presence of that advisor does nothing to ensure the thoughtfulness of the decision to be made. Thus, giving business-judgment-rule protection to such decisions on the basis of the presence of the third party is not only unwise, but potentially harmful to stockholder interests. If, by engaging a "captured" third party, a passive board may completely shield itself from liability for failing carefully and actively to consider a management proposal, there is absolutely no incentive to challenge management on any issue, but a good reason to remain passive. The legal response to board passivity represented by *Van Gorkom* may thus not only fail to discourage board passivity created by management capture, but may even act to encourage such harmful behavior.

Nowhere is this problem more evident than in the investment-bank-rendered fairness opinion area that was one of the subjects of the *Van Gorkom* ruling. As discussed, following *Van Gorkom*, fairness opinions were sought by decisionmaking boards in virtually all corporate control transactions. However, if the fairness opinion is to provide the necessary "back-up" to a board's decision, the process by which that opinion was formed must necessarily be well-reasoned and honestly and properly performed. Unfortunately, the processes for determining fair value are varied and easily manipulatable,[73] and there exist structural factors implicit in the environment in which investment banks operate that militate against the objective and independent valuation advice necessary for effective board decisionmaking. These structural factors include, among other things, a desire by the opining bank to

73. Elson, *supra* note 56, at 960–65. The procedures available for determining fair value include discounted cash flow analysis, evaluation of comparable companies, evaluation of comparable acquisitions, and liquidation value. *Id.* at 961; *see, e.g.*, ROBERT L. KUHN, INVESTMENT BANKING 97–123 (1990) (surveying valuation methods utilized by investment bankers); Giuffra, *supra* note 56, at 137–39 (summarizing the four traditional valuation methods); Michael W. Martin, Note, *Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers' Duty to Third-Party Shareholders*, 60 FORDHAM L. REV. 133, 139–41 (1990) (listing break-up analysis as a fifth method); Arthur H. Rosenbloom & Arthur H. Aufses III, *On Understanding Investment Banker Liability*, INSIGHTS, Apr. 1990, at 3, 4 (discussing the valuation methods used by investment bankers and their underlying assumptions); Brian H. Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing concisely the strengths and weaknesses of the four traditional valuation techniques).

Although there are arguably merits to each method, it has been suggested that any proper valuation analysis should utilize a combination of some or all of these approaches. Elson, *supra* note 56, at 960–65.

complete a desired transaction so that it can share in the fees to be generated and the need of that bank to build and maintain an active client base created in part by satisfying management, which is responsible for future employment.[74] As a consequence, we have witnessed the development of a "fairness for hire" regime, where the advice rendered by the retained third-party bank is not the result of a truly independent valuation process, but simply reflects what the board (or actually management in many cases) so desires.[75] The investment banker's fairness opinion merely "rubber stamps" a previously reached conclusion. Although the retention of such advisors may act to preclude board liability under *Van Gorkom*, little is accomplished to assure the probity of the board's decisionmaking process.

In fact, because the procurement of a fairness opinion helps to preclude liability, board passivity may even be encouraged in the management-captured entity. If there is no punishment for passivity, those structural factors promoting board passivity[76] will continue to dominate the directors' decisionmaking process. Additionally, because the expense of retaining an investment bank to render a fairness opinion is likely to be quite substantial, often running into the millions of dollars, the passivity protected by the fairness opinion is likely to be costly to the shareholder in more ways than one.[77] The fairness opinion requirement, rather than working to protect shareholder wealth, may thus be having the opposite result, something that could not have been the intention of the *Van Gorkom* court.

A similar phenomenon can be observed in the compensation area. Excessive compensation is the result of a passive bargaining process between boards and executives.[78] Legal protection for a board's inactivity in this process is available through application of the business judgment rule. Provided that a board has no actual interest in the salary recommendations that it is considering, has spent a significant amount of time discussing the compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a salary package, its compensation decisions will be labeled "informed" and, thus, will be protected under the *Van Gorkom* rule.[79] The reten-

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74. *See* Elson, *supra* note 56, at 964–70.

75. *Id.* at 964–65; Giuffra, *supra* note 56, at 123; Dale A. Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 250 (1988); Robert McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52.

76. *See supra* notes 29–32 and accompanying text.

77. Elson, *supra* note 56, at 966-68.

78. *See supra* Part I.

79. For a discussion of how directors could protect themselves under the *Van Gorkom* rule, see *supra* notes 53–63 and accompanying text.

tion of an independent compensation consultant acts to insulate the board from liability.

Theoretically, the use of a third-party advisor helps to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant-corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation.[80] Thus, there is a powerful disincentive for recommending a salary structure that management would consider to be inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lies in the offering.[81] Second, compensation structuring is not a precise art or science. It is based on comparisons with what other businesses are paying. There is tremendous subjectivity involved in deciding with what businesses the client's compensation structure will be compared. The consultant may look to companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture; the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is completely up to the advisor.[82] The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporations that retain them.[83] As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence necessary to assure that a compensation package is reasonably related to

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80. For example, Towers Perrin, one of the nation's largest compensation consulting firms, also designs employee pension and health plans for companies. CRYSTAL, *supra* note 2, at 219–20.

81. *See id.* at 218–19.

82. *Id.* at 42–50; *see* Elson, *supra* note 1, at 974 n.105.

83. *See* Suein L. Hwang, *Ties That Bind, Fired Tambrands CEO Was Unusually Close to a Consulting Firm*, WALL ST. J., Aug. 23, 1993, at A1. Immediately following the ouster of Tambrands Chairman and Chief Executive Martin C. Emmett, the corporation terminated all contracts with Personnel Corporation of America (PCA). *Id.* PCA, a corporation with which Emmett had close personal ties, is a human resources firm that had been retained to advise the board of directors concerning, among other matters, executive compensation. *Id.* As a result of PCA's efforts, Emmett received a lucrative benefit package and options to purchase close to 600,000 Tambrands shares. *Id.* Judith Fischer, publisher of Executive Compensation Reports, says that "it is, or can be, an incestuous relationship" when a chief hires a compensation consultant to advise the board concerning executive compensation. *Id.*

an executive's professional contributions. This compensation consultant "for hire" phenomenon, particularly when combined with boards partly comprised of outside directors who may be unwilling to challenge management, results in compensation arrangements that are acquiesced to and not bargained for and, thus, that are potentially unreasonable.[84] Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, as modified by the *Van Gorkom* decision. The idea that a board's retention of a third-party advisor leads to more effective and responsible decisionmaking has proven to be a great disappointment. It has only led to continued—and it may be argued, heightened—board passivity.

The Delaware court's liability-imposing ruling in *Van Gorkom* was intended to bolster compliance with the duty of care as a means of creating more effective board behavior. As a result of the decision, boards began to follow certain procedures—based on the Trans Union Board's transgressions—that were designed to ensure that each decision made would receive business-judgment-rule protection and thus be in compliance with the duty of care. Theoretically, those procedures should have created more effective decisionmaking. They did not and, in fact, have only resulted in continued board passivity, potentially injurious to shareholder interests. It was a classic triumph of form over function. The duty of care, strengthened by *Van Gorkom*, has proven to be ineffective in resolving the passivity problem. Thus, another approach must be developed.

III. The Equity-Based Approach

How can we motivate a board, compositionally passive, to become an active management monitor? The traditional approach to this problem, reflected in the duty of care, sought to compel effective board behavior through the threat of personal liability for those boards who abrogated their responsibilities. Despite this duty, harm-producing board passivity created by management capture flourished, and it was rare that courts ever found boards to be in violation.[85] *Van Gorkom* attempted to bolster compliance with this duty, but as discussed, has proven unsuccessful in reducing board passivity.[86] This malady illus-

84. *See* Crystal, *supra* note 2, at 214–40. *But see* Frederic W. Cook, *Executive Pay and the Board*, Directors & Boards, Spring 1992, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).

85. *See supra* note 37 and accompanying text.

86. Perhaps recognizing the difficulties inherent in the duty of care, combating the problem of the passive board, and resulting ineffective management, a number of commentators have

trates the difficulty in attempting to induce desired behavior through

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recently focused on the potential of institutional shareholder activism in forcing boards to become more active "monitors" of corporate management. The size and financial sophistication of institutional investors, who increasingly constitute the largest shareholders in many of the largest corporations, make them particularly well-suited to an active role in creating more effective shareholder oversight of both boards and managers. As a corporation's largest shareholders, institutions may have the clout to force a board effectively to monitor corporate management. For example, the Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF) recently promulgated a policy statement on corporate governance. In an effort to improve corporate governance policies and procedures, TIAA-CREF advocates a board comprised primarily of independent directors, implementation of a pay-for-performance executive compensation system, annual board review of CEO performance, and board exercise of fiduciary oversight. TEACHERS INSURANCE AND ANNUITY ASSOCIATION—COLLEGE RETIREMENT EQUITIES FUND, POLICY STATEMENT ON CORPORATE GOVERNANCE (1994). Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would be strong enough to convince otherwise passive directors to act more effectively.

Indeed, much scholarly attention has been devoted to the "promise" of "institutional investor voice." Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 816 (1992). *See generally* MONKS & MINOW, *supra* note 4 (noting that institutional investors closely monitor boards because of their desire to increase portfolio values and to avoid "liability for breach of fiduciary duty"); Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991) (examining the concept of shareholder advisory committees and the appropriate role of institutional investors in corporate governance); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992) (discussing the benefits institutional oversight could have on corporate performance); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991) (analyzing the transnational effects of institutional investments); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM L. REV. 1277 (1991) (discussing the efficiency and development of institutional investors in the United States); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988) (discussing the motivations of institutional investors and the prospective consequences of investor activism); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (1989) (analyzing the separation of ownership and control and offering a solution to corporate governance); Gilson & Kraakman, *supra* note 13 (proposing a strategy for improving corporate governance through increased activity on the part of institutional investors); Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1 (1991) (advising corporations on the proper relationship with shareholders); Thomas C. Paefgen, *Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992) (suggesting that long-term financial strategies of institutional investors will increase effective board monitoring in American and German corporations); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (analyzing the significance of increased shareholder activism); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991) (addressing the underlying premise on calls for proxy reformation).

It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active advocates for change in corporate policy and personnel. Most recently, a number of large institutions have played a major role in forcing boards to make changes in manage-

the threat of punishment for noncompliance with accepted practice. Although external force is sometimes useful in creating desired conduct, it may have little impact or even produce an unanticipated harmful result if not effectively applied.

As a well-known parable suggests, it is not the stick that compels acceptable behavior, but the carrot as incentive. The *Van Gorkom*-enhanced duty of care functions as an ineffective "stick"; we must replace it with a carrot. But how can we incentivize outside directors in the large public corporation to eschew their traditional passivity? We must make it clear that it is in their own self-interest to do so. They must not become active participants in the oversight process because someone is ordering them to so engage, but must act because they feel that it is in their own self-interest.

The board's failure to monitor management effectively and the consequent overcompensation controversy are the result of unchecked initiative and self-interest on the part of management and passive indifference on the part of the corporation's directors. Externally based pressure on a board to monitor actively—and to bargain forcefully on compensation matters—has proven to be ineffective. The real solution lies with stimulating effective board oversight from within the boardroom itself. We must create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force of general corporate affairs for which it was originally created. But how can we create the kind of self-motivation that will

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ment and policy at such prominent corporations as IBM, Westinghouse, American Express, Phillip Morris, and even General Motors. *See supra* notes 15, 21, 27.

Despite this activity, it is unclear whether these groups will be able, over the long run, to place the kind of constant and continual pressure on boards that will result in effective oversight. There are several reasons why sole reliance on institutions to resolve the passivity controversy would be a mistake. First, as Professor Coffee has pointed out, a preference for liquidity in their investment portfolios "chills the willingness of institutional investors to participate in the control of major corporations." Coffee, *supra*, at 1281. Second, because each institution's holdings in the various corporations in which it invests is likely to be quite small proportionally, effective control over the affairs of the target corporation would only be effected through a coalition of institutional investors. Differences over investment goals and strategy may make such coalitions difficult to form and maintain, hindering effective action. Additionally, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations (including the proxy rules), however, such communication may be restricted. There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. But, for the above reasons among others, they may never prove as effective as their proponents suggest in a general corporate monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this voice may not bring as much positive change as earlier envisioned. *See Elson, supra* note 1, at 970–72; *see also* Bainbridge, *supra* note 13, at 1054 n.108 (discussing commentaries that state institutional investors can provide an active voice in corporate governance).

counter the kind of pro-management pressures placed on outside directors due to management capture?

A. *Stock Ownership*

The outside director must be made to consider management activity from the viewpoint of a company stockholder, to whom the director is legally obligated, instead of from the perspective of one beholden to management. It is the stockholders who stand to lose the most from the lackluster corporate performance created by ineffective board monitoring. Thus, it is crucial that the company's outside directors realign their interests and thinking with those of the shareholders.[87] The most

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87. "Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone." Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991). The Michigan Supreme Court stated in *Dodge v. Ford Motor Co.*:

> A business is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919), *cited in* Stephen M. Bainbridge, *In Defense of Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993).

Professor Berle ascribed to the principle that directors owe a fiduciary duty only to the company's stockholders, stating that "you can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else." A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932).

However, Professor Merrick Dodd challenged this theory, thereby providing the basis for the contemporary debate concerning to whom the benefits of the director's fiduciary duty should flow. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustee?*, 45 HARV. L. REV. 1145 (1932) (arguing that directors should represent constituencies other than shareholders). This argument has been coopted and advocated by numerous contemporary scholars. *See generally* John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Shareholders and Bust-Ups*, 1988 WIS. L. REV. 435 (1988) (advocating protection of middle managers whose jobs are threatened by bust-up takeovers); Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993) (arguing for a shift in the law and a new definition of corporate directors' fiduciary duties); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP L. 205, 265–73 (1988) (arguing for protection of bondholders harmed by takeovers); Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991) (arguing why constituency statutes are beneficial and necessary); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991) (arguing that directors should owe employees a fiduciary duty to alleviate employee displacement caused by corporate restructuring); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991) (advocating the creation of fiduciary duties on behalf of employees); Steven

effective way to create such perspective is to appeal directly to these directors' personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director's personal capital is potentially affected by inept or corrupt management, that director is much less likely to acquiesce passively to such a group. From a personal standpoint, there is much less incentive to stand watch over what one considers to be someone else's property than over what one considers to be one's own. Interestingly enough, this was the whole point behind the creation of the externally imposed director's duty of care.

By becoming equity holders, the outside directors would assume a personal stake in the success or failure of the enterprise.[88] Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with a distant legal requirement (or vaguely understood pressures from outside institutions), but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand any less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably.[89] In addition to considering that the active monitoring of management may lead to replacement, an outside director must also consider that the failure to exercise effective oversight may result in the diminution of his or her personal wealth. Under such an arrangement, it would not be quite so easy simply to acquiesce to the demands of management. This dynamic creates a more

M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991) (examining corporate constituency statutes and the benefits of permitting directors to consider the interests of nonshareholder constituencies).

88. *See supra* note 6. Brown Brothers Harriman's Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly $1 million, described that group as a "board that pays attention . . . . I've never seen the pocket calculators come out so quickly in my life." Ted Bunker, *Editor's Page*, INVESTORS' DAILY, July 7, 1993, at 4.

89. As Professor Stobaugh has observed, "A director with little stock ownership but substantial annual compensation would have little financial incentive to 'rock the boat' if that presents any danger of his or her being replaced as a director." Stobaugh, *supra* note 6, at 3.

balanced relationship between management and equity-holding outside directors and, in turn, encourages the kind of oversight presently lacking in the traditional management-dominated board.[90]

B. Lengthened Director Terms

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors' stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock.[91] Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position in-

90. David McLaughlin, a noted management consultant, has stated:

> Stock ownership obviously helps to align shareholder and director interests . . . . Some boards have been slow to respond to deteriorating company fortunes (witness the sagas of IBM, General Motors, Westinghouse, and Eastman Kodak). Perhaps if the directors of those companies had significant personal stakes in their enterprises, they would have been quicker to reveal and resolve fundamental issues of strategy and leadership. While compensation has been overrated as a motivator, when six-figure sums are involved, even wealthy individuals pay attention to trends in the stock price.

McLaughlin, *supra* note 6, at 59.

91. For example, the current and past holdings of a few noted directors at several larger public corporations are as follows:

volving attendance at only a few meetings a year.[92] In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered to be in the business community,

COMPANY	DIRECTOR	SHARES
Bank of Boston	Wayne A. Budd	200
	Donald Monan	0
	Alfred M. Zeien	500
IBM	Harold Brown	321
	Nannerl Keohane	321
	Richard Munro	421
Mobil	J. Richard Munro	100
	William J. Kennedy, III	400
	Aviana L. Peters	100
Disney	Robert Stern	100
	Gary Wilson	0
Philip Morris	Rupert Murdoch	400
	Richard Parsons	500
Sears Roebuck	Mandell de Windt	450
	Norma Pace	400
	Nancy C. Reynolds	454
Ralston Purina	David Banks	200
	Francis Ferguson	556
Paramount	Benjamin L. Hooks	100
General Motors	Thomas E. Everhart	400
	Edmund T. Pratt, Jr.	200
	Louis W. Sullivan	100
Westinghouse	Paula Stern	411

BANK OF BOSTON CORP., MAR. 24, 1993 PROXY STATEMENT 6 (1993); GENERAL MOTORS CORP., APR. 13, 1993 PROXY STATEMENT 4–6 (1993); IBM PROXY, *supra* note 29, at 11; MOBIL CORP., MAR. 22, 1993 PROXY STATEMENT 8 (1993); PARAMOUNT COMMUNICATIONS INC., JAN. 29, 1993 PROXY STATEMENT 6 (1993); PHILIP MORRIS COMPANIES INC., MAR. 7, 1991 PROXY STATEMENT 10 (1991); RALSTON PURINA CO., DEC. 10, 1991 PROXY STATEMENT 9 (1991); SEARS ROEBUCK & CO., MAR. 21, 1991 PROXY STATEMENT 3 (1991); WALT DISNEY CORP., DEC. 27, 1993 PROXY STATEMENT 2 (1993); WESTINGHOUSE ELECTRIC CORP., MAR. 8, 1993 PROXY STATEMENT 14 (1993).

92. Remuneration for nonemployee directors often exceeds $40,000, including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. *See supra* note 29. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each nonemployee director at Eastman Kodak is covered by group term-life insurance in the amount of $100,000. Nonemployee directors at American Express who have served at least five years are eligible to receive $30,000 per annum upon their retirement from the board; these payments continue for a number of years equal to the time served on the board or until death. AMEX PROXY, *supra* note 29, at 7. Similarly, General Electric's nonemployee directors who have served at least five years, are over 65 years of age, and retire directly from the board are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. GE PROXY, *supra* note 29, at 13; *see* Bruce Overton, *Remuneration of Outside Directors*, *in* A STRATEGIC GUIDE, *supra* note 21, at 383.

which leads to other opportunities for financial benefit.[93] Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.[94]

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and the benefits of the contemplated strategy. When an outside director in a management-controlled enterprise makes a decision that challenges management prerogative, that director risks retribution from the dominant executives, which might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director will, consciously or not, weigh the various benefits that such a decision entails against any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that the director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership, but *substantial* ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decisionmaking process. An outside director's shareholding position must be large enough that, in considering a particular course of action, concern about how a decision will positively affect equity value subsumes traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decisionmaking process than fee-maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the

93. *See* MACE, *supra* note 4, at 87–91; Overton, *supra* note 92, at 383.

94. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 97–98 (1991). At the time of the leveraged buyout, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, *supra* note 92, at 388.

company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fees in company common stock. It seems only natural that each director should be rewarded with an interest in the business itself as compensation for the exercise of oversight as a board member. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.[95] Although some might argue that a stock-option grant to directors may serve the same purpose, and at less cost to the corporation, such an approach would prove less effective than direct equity ownership simply because of the highly tentative nature of an option prior to exercise.[96] Stock ownership provides the director with a tangible stake in the enterprise, not merely some speculative expectancy of a discounted future position.

Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. To have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director's yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director's term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an

95. To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.

96. *See* Elson, *A Board-Based Solution*, *supra* note 2, at A22; Lublin, *supra* note 6, at R5.

immediate equity stake and, without yearly reelection concerns, the promise of a fixed number of future stock grants. Five years' worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.[97] Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, recently advocated such a change in board structure, along with a host of other major governance reforms.[98] They suggested that the creation of a five-year fixed term of office would create a corporate "long-term view" highly beneficial to corporate "vitality."[99] The main goal of their proposal, however, involves the creation of a corporate governance model "that will lead managers and stockholders to work cooperatively towards the corporation's long-term business success."[100] Their arguments advocating term expansion focus primarily on creating a management-shareholder "long-term" cooperation relationship, rather than corporate productivity through active director oversight.[101] Despite this goal, their call for a longer range perspective on company affairs, an obvious byproduct of five-year director terms, is a laudable and desirable result. Who can really argue when management and boards of directors make decisions with the long-term health of the enterprise in mind? Some of Lipton and Rosenblum's other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. However, they should not detract from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity holders.

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97. For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

98. Lipton & Rosenblum, *supra* note 7, at 187-253. The quinquennial election of directors is one part of Lipton and Rosenblum's proposal for comprehensive reform of the present corporate governance system. *Id.* Their proposal would also bar nonconsensual changes in control between elections, provide major shareholders with access to corporate proxy materials relating to elections of directors, require a detailed five-year report on the company's performance and a prospective five-year plan, and tie management compensation awards and penalties to the corporation's performance against the plan. *Id.* at 190.

99. *Id.* at 216.

100. *Id.* at 189.

101. *Id.* at 224–52.

There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish. Second, they could lead to the possible entrenchment of ineffective, or even disloyal, directors. These problems are not as dramatic as they would appear to be at initial glance. First, shareholders always have the right to remove a director for cause,[102] a power that should resolve the problem of the disloyal or inattentive director. Second, provisions could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear to be necessary to compel effective management. Moreover, the "long view" perspective that such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in the proposal's favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong long-term returns even though they may have a negative impact on short-term profitability. The five-year term thus has great potential.

C. *Potential Costs*

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact that an equity-based approach may entail. One difficulty that increased equity ownership may create involves the possible chilling effect of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk that management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individuals' personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of

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102. *See, e.g.*, Campbell v. Loew's, Inc., 134 A.2d 852, 859 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590, 596 (N.Y. 1954). Some state statutes have modified the common-law rule and allow shareholders to remove directors without cause. *See e.g.*, CAL. CORP. CODE § 303(a) (West 1994); N.Y. BUS. CORP. LAW § 706 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); *see also* CAREY & EISENBERG, *supra* note 14, at 153–54.

significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear to be. It assumes that the commitment of a large portion of one's assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage, risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk, and their stockholdings encouraged still greater risk because of the potential to share in the larger returns that such risk brings. What about those in business who are not entrepreneurial in spirit but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely—to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking rather than position preservation.[103] Creating equity positions in outside directors may have the same impact.

Although some individuals are risk-averse by nature (and, indeed, the presence of such persons on a board may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors' fees in cash encourages risk-positive behavior. In

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103. *See, e.g.*, Alisa J. Baker, *Stock Options — A Perk That Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20 (questioning the crusade against stock-based compensation); Gilbert Fuchsberg, *Former Critic of Big Stock Plans for CEOs Now Supports Them*, WALL ST. J., Dec. 16, 1992, at B1 (noting that the United Shareholder Association, a former critic of stock-based compensation, now supports this compensation plan); Michael C. Jenson & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May—June 1990, at 138, 141 ("By controlling a meaningful percentage of total corporate equity, senior managers experience a direct and powerful 'feedback effect' from changes in market value."); Stephen F. O'Byrne, *Linking Management Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91, 97 (listing several strategies to increase management's performance incentive). *But see* Amanda Bennett, *Taking Stock: Big Firms Rely More on Options but Fail to End Pay Criticism*, WALL ST. J., Mar. 11, 1992, at A1 (commenting on the fact that while stock-based compensation is gaining popularity, it also allows for corporations to give more to their CEOs).

the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk-averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk-neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be an exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity, as these individuals could easily convert their cash payments into company stock. This argument misses the point. It was the payment of fees in cash that, in the management-captured enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.[104] Of course, a director is not giving up the right to compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a noncash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders whom they were elected to serve by taking an equity position in the enterprise is a corporation's best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity.

104. One commentator states that he will not serve on private company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial return and decreases the chance of lawsuits from other shareholders. William A. Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., May—June 1990, at 34. David McLaughlin has argued that stock ownership requirements on the part of corporate directors will not make it more difficult "to recruit first rate directors . . . . It is a myth that 'independent' non-corporate directors cannot afford to make an investment. Our analysis shows that directors who represent non-profit institutions own about as much stock as the average director." McLaughlin, *supra* note 6, at 59.

D. The Empirical Evidence

Central, of course, to the effectiveness of an equity-based solution to the board passivity dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to be successful, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the behavior of boards composed of outside directors with substantial stockholdings, as compared with boards whose outside directors do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

Two businesses researchers, Professor Robert Stobaugh of the Harvard Business School and David McLaughlin, a noted management consultant, recently conducted separate studies examining the linkage between director stock ownership and more effective board oversight and corporate productivity. Both found that substantial outside director equity ownership led to heightened performance. In his study, McLaughlin randomly selected seventy of the largest publicly traded United States companies "with median sales of $9.4 billion, and examined the ownership pattern of the 631 non-management directors who sit on the boards of these companies."[105] He discovered that "the higher ownership commitment" on the part of the outside directors, the "greater the total shareholder return."[106] Those companies "whose outside directors have relatively high stock holdings outperform those whose non-management directors have minimal holdings."[107] Additionally, those businesses with the greatest outside director shareholdings "outperform the bottom half [of the companies surveyed] in both five-year compound earnings-per-share growth and average return on shareholders' equity."[108] McLaughlin concluded from his study that, as an aid to performance, boards must establish director-stock-ownership plans and create periodic audits of director shareholdings.[109]

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105. McLaughlin, *supra* note 6, at 55.

106. *Id.* at 56.

107. *Id.* at 53. McLaughlin reported that "our study of 70 companies . . . shows that those with the highest director ownership delivered a return of 174% to their shareholders over the five years from 1988 to 1990, while those with the lowest delivered only a 73% return." *Id.* at 54.

108. *Id.* at 56.

109. *Id.* at 59. McLaughlin argued:

> It seems reasonable, however, to require all directors, within three years of election, to hold an amount at least equal in value to the annual retainer. The ownership level should increase over time, to a value of two to three times the annual retainer after four to six years, and three to five times as the director approaches

Professor Stobaugh conducted a similar study, but with a smaller sampling of companies surveyed. He contrasted the director stockholdings of nine companies on the *Fortune* magazine list of America's "most admired companies" with nine that were "corporate governance 'targets' of varying shareholder rights groups, including the California Public Employees Retirement System and United Shareholders Association."[110] The financial returns of those companies on the "most admired" list substantially exceeded those of the other companies examined.[111] Stobaugh discovered that the median amount of stock held by the directors of the former group of companies was eight times that of the latter group.[112] He concluded that these results were "consistent with the logic that tieing a director's financial well being to a company's performance might be important."[113] On the basis of this survey, he recommended the following:

> Stock ownership by corporations should be increased substantially so that directors will be further motivated to take prompt action in addressing corporate problems. In linking a director's personal financial interest to those of shareholders, shareholder interest will be better served . . . . [I]ncreasing substantially the ownership of stock by directors should improve corporate governance by providing additional incentives for directors to overcome the inertia that sometimes prevents them from making tough decisions.[114]

Expanding on the research conducted by McLaughlin and Stobaugh, I conducted a broader study that yielded similar results. Annually, *Fortune* magazine conducts a survey to determine America's most and least admired companies.[115] In 1992, the survey included 311 companies in 32[116] different industries.[117] The survey polled over 8000

> 10 years of service. The initial ownership goal can be facilitated for new directors if the company offers to supplement the individual's own "going in" commitment with an initial grant, or pays a portion of the annual retainer in stock.

Id.

110. Stobaugh, *supra* note 6, at 2.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* at 3, 4.

115. Jennifer Reese, *America's Most Admired Corporations*, FORTUNE, Feb. 8, 1993, at 44.

116. The 32 industries included were the following: mining, crude-oil production; petroleum refining; utilities; forest & paper products; pharmaceutical; chemicals; textiles; metals; building materials; rubber & plastics products; metal products; electronics, electrical equipment; computers, office equipment; scientific, photographic & control equipment; publishing, printing; apparel; soaps, cosmetics; retailing; furniture; diversified service; life insurance; diversified financial; commercial banking; savings institutions; food; beverages; tobacco; aerospace; motor vehicles & parts; industrial & farm equipment; transportation; and transportation equipment. *Id.*

senior executives, outside directors, and financial analysts, asking them to rate the ten largest companies in their own industry on eight attributes of reputation, using a scale of zero (poor) to ten (excellent).[118] The eight reputational attributes polled involved both financial and nonfinancial measures, including such items as value as a long-term investment, use of corporate assets, quality of management, and quality of products or services.[119] These ratings were then combined to create a total reputational score, also on a zero (poor) to ten (excellent) scale, and each company was ranked by the total score received, from the most admired United States corporation (a score of 8.74) to the least admired (a score of 1.99).[120]

Assuming that there is some validity in suggesting that the companies most admired by the corporate and financial communities are more effectively managed and possess better board monitoring than those that are not, this survey provides an excellent starting point for an examination of the link, if any, between good corporate results and outside director stock ownership. Of the 311 companies examined in the *Fortune* study, I selected for review the 110 companies that were on either extreme of the survey—either receiving the highest or the lowest ratings for overall admiration. Fifty-eight of the companies I examined were "most admired," receiving a score of 7.0 or higher in the study.[121] The remaining fifty-two I studied were "least admired,"

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117. *Id.* at 53.

118. *Id.*

119. The eight attributes included were the following: quality of management; financial soundness; quality of products or services; ability to attract, develop, and keep talented people; use of corporate assets; value as long-term investment; innovativeness; and community and environmental responsibility. *Id.* at 46.

120. *Id.* at 54–55. Additionally, the opinion research firm of Clark Martire & Bartolomeo, who aided in the survey, explained the relationship between the poll data and actual financial performance of the companies surveyed. Twelve measures of performance, "including profits, assets, and return on shareholders' equity," were combined with the survey data into a spreadsheet. A multiple regression was then run to analyze the relationship between financial performance and reputation score. The resulting equation was used to predict a reputational score based solely on financial performance. *Id.* at 44, 53. Interestingly, financial performance did correlate with the reputational rankings, although there were obviously some exceptions. *See id.* at 44.

121. The following were the most admired companies: Merck; Rubbermaid; Wal-Mart Stores; 3M; Coca-Cola; Procter & Gamble; Liz Claiborne; J.P. Morgan; Boeing; Kimberly-Clark; Coring; Johnson & Johnson; PepsiCo; Pfizer; General Mills; Motorola; Golden West Financial; American Brands; Cooper Tire & Rubber; Du Pont; BellSouth; Hewlett-Packard; Sara Lee; Shaw Industries; General Electric; Harley-Davidson; Herman Miller; International Flavors & Fragrance; Dow Chemicals; Morgan Stanley Group; Anheuser-Busch; Gillette; Abbott Laboratories; Apple Computers; Reader's Digest; Illinois Tool Works; AT&T; Springs Industries; Colgate-Palmolive; Eli Lilly; Alcoa; American International Group; Great Western Financial; Bankers Trust N.Y.; Berkshire Hathaway; Southwestern Bell; Philip Morris; Xerox; Amoco; Bell Atlantic; Bristol-Myers Squibb; VF; Bandag; PPG Industries; Exxon; R.R. Don-

receiving a score of 5.5 or lower.[122] I then reviewed the proxy statements of each of the 110 selected corporations to ascertain how much company stock was held by each of the companies' outside directors.[123] Next, I determined how many companies were run by boards in which outside directors with individual holdings valued in excess of $20,000[124] constituted a majority of the full board and, thus, theoretically controlled that institution. This procedure was then repeated for holdings valued in excess of $50,000, $100,000, $125,000, $150,000, $200,000, and $250,000. Finally, I compared the stockholdings of outside directors serving on the "most admired" companies' boards with the holdings of outside directors serving on the "least admired" companies' boards. This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that were well-regarded and consequently better managed were more likely to have substantial equity holdings in those companies than outside directors on the boards of companies that were least admired and thus poorly run.

nelley; Pacific Gas & Electric; and A. Schulman. *Id.* at 44.

122. The following were the least admired companies: Tektronix; W.R. Grace; Dr. Pepper/Seven-Up; Cigna; Whitman; Avondale Industries; Holnam; Collins & Aikman; Northrop; FirstFed Michigan; James River; First Chicago; Seagate Technology; Chase Manhattan; Burlington Industry Cap.; General Motors; USX; Grumman; Borden; Union Carbide; First Interstate Banc.; Inland Steel Industries; USG; Westinghouse Electric; Digital Equipment; Stone Container; Maxxam; Citicorp; Amoskeag; Champion International; West Point-Pepperell; Coast Savings Financial; McDonnell Douglas; Interco; Navistar International; Travelers; Travelers Corp.; USAir Group; Anchor Bancorp; Boise Cascade; Northwest Airlines; Brooke Group; Sears Roebuck; Hartmarx; Bethlehem Steel; Unisys; Crystal; Calfed; Dime; Glenfed; Continental Airlines Holdings; and Wang Laboratories. *Id.*

123. "Outside directors" was defined as those directors who were not and had not served as officers of the corporation. Furthermore, a family member, such as a widow or spouse, of an officer of the corporation was not considered to be an outside director.

124. The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of November 10, 1993. WALL ST. J., Nov. 10, 1993, at C3.

TABLE 1

Total Number of Companies in Survey: 110
Number of Companies That Are Most Admired (score 7.0 +) : 58
Number of Companies That Are Least Admired (score 5.5 -) : 52

Number of Boards Controlled by Directors Who Own Substantial Amounts of Company Stock:

Size of Director Stockholdings	*Most Admired*	*Percentage of Total Companies in Most Admired Grouping*	*Least Admired*	*Percentage of Total Companies in Least Admired Grouping*	*Deviation Factor*
>20K	48	82.7%	32	61.5%	1.344
>50K	37	63.7%	26	50.0%	1.240
>100K	22	37.9%	14	26.9%	1.408
>125K	16	27.5%	10	19.2%	1.432
>150K	12	20.6%	7	13.4%	1.537
>200K	12	20.6%	6	11.5%	1.791
>250K	9	15.5%	4	7.69%	2.015

The results, presented in Table 1, confirm the initial hypothesis on the relationship between equity holdings and better corporate performance and oversight. The companies in the "most admired" category were much more likely to be run by boards with significant equity investments in the business than those that were considered the "least admired" and thus poor performers. Further, the greater the value of outside director holdings, the more likely it was that the corporation surveyed would fall into the "most admired" category.

In the group of companies that were "least admired," at the $20,000 director shareholding level, only 61.5% of the companies surveyed had boards numerically dominated by outside directors with at least $20,000 in company shareholdings. At the $100,000 level, the percentage dropped substantially to 26.9%; and at the $150,000 level, the percentage fell to 13.4%. Finally, in the $250,000 category, the highest level surveyed, only 7.69% of the companies in the "least admired" grouping had outside director equity holdings at that level.

The results for those companies in the "most admired" category differed substantially. To be sure, there was—as the dollar criteria grew—a decline in the numbers of companies meeting the holdings standards at each level. However, at each monetary level, the percentage of companies meeting the relevant criteria was always substantially greater than was seen in the "least admired" category, and the lowest percentage of compliance, seen at the highest survey level, $250,000, was significantly greater than the corresponding percentage in the alternative grouping of companies. At the $20,000 level, 82.7% of the

companies surveyed had outside director shareholdings meeting the relevant criteria. At the $100,000 level, the percentage dropped to 37.9%; and at the $150,000 level, the percentage stood at 20.6%. Finally, in the $250,000 category, 15.5% of the companies in the "most admired" grouping had outside director equity holdings at that level.

Two points about these results are particularly worth noting. First, at every examined level of outside director stockholdings, there were proportionally significantly more companies in the "most admired" category than in the "least admired" category. Second, as the level of director holdings increased, the spread between the two groups of companies grew significantly. At the $20,000 level, only 61.5% of the companies in the "least admired" grouping met the equity-holding criteria; at $100,000, just 26.9%; at $150,000, only 13.4%; and finally at $250,000, just 7.69%. This differed substantially from those companies in the "most admired" grouping, where at the $20,000 level, 82.7% met the criteria; at $100,000, 37.9%; at $150,000, 20.6%; and at the $250,000 level, 15.5%. At the $100,000 level, there were almost one and one-half times as many companies in the "most admired" category as in the "least admired"; and at the $250,000 level, the spread between the two grew to exceed more than twice the number.

What, then, do these numbers demonstrate, and how do they relate to an equity-based solution to the passive board problem? The results of my survey, particularly if read in light of the Stobaugh and McLaughlin studies, suggest that the positive impact of outside director stock ownership on corporate performance and, obviously, effective board conduct is notable at all levels of director equity ownership. And, as the value of director holdings increases, the impact of stock ownership is even more notable, as the two groups of companies experience even greater divergence in results. Substantially fewer of the corporations that are considered poor performers, at least by the standards of the *Fortune* study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses. Many more of the companies that are performing in a respected fashion have boards numerically controlled by outside directors with large equity positions. At the $250,000 level, there are more than twice as many companies that are considered good performers as those in the "least admired" category. Although this is not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity ownership and better corporate performance, an important consequence of effective board oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to desired company performance.

Missing, of course, from an interpretation of the results of the study is any indication of the effect of a five-year board term on director behavior. None of the 110 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact, not simply of stock ownership, but of substantial stock ownership. The key to more effective board monitoring, then, is to create in each outside director a substantial equity position in the business itself. Payment of director fees in stock, combined with five-year terms of office, will create such holdings. As noted earlier,[125] implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit becomes pronounced.

The empirical evidence yielded by this study suggests that companies with boards composed of outside directors with significant shareholdings tend to outperform those without such boards. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based attack on board passivity may be potentially helpful and warranted.[126]

E. *The Duty of Care, Equity Ownership, and* Van Gorkom

The equity-based approach to resolving the problem of the passive board has great potential and must be strongly encouraged. But what should become of corporate law's traditional response to the inattentive director—the duty of care? Should we abandon this institutionalized legal rule entirely? Not necessarily. The problem with the duty as it is now formulated, post-*Van Gorkom*, is that it has created a Byzantine pattern of behavior among corporate boards that, as discussed, leads nowhere helpful. We must therefore abandon the *Van Gorkom* ap-

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125. *See supra* notes 88–97 and accompanying text.

126. Apparently as a result of the recognition of the beneficial aspects of director stock ownership, within the last year, the number of large United States corporations providing stock grants to outside directors has risen dramatically. According to an analysis of varied 1994 proxy statements by William M. Mercer, Inc., nearly three-fourths of a group of 350 large industrial and service companies reported using stock grants as part of their directors' compensation programs. *In Review—Recent Notes & Events: Compensation & Recruitment*, CORP. BOARD, July-Aug. 1994, at 28. Despite this trend toward creating stock grant programs for outside directors, it is rather disappointing to note that in its recently promulgated "Board Guidelines," designed to promote effective board behavior, General Motors failed to require or even suggest outside director equity ownership in the company. GENERAL MOTORS CORPORATION, GM BOARD GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (199[illegible]).

proach to the duty and transform it from a rule of law that attempts to coerce desired behavior through the threat of liability for noncompliance with mandated procedure to one that, as Professor Coffee has suggested, is more "aspirational"[127] in nature. A duty of care that serves more as a guide to desired behavior on the part of corporate directors through its "socializing and exhortative impact,"[128] though still available to punish extreme conduct, is, in combination with substantial board equity ownership, much more likely to have a positive impact on board behavior than the present *Van Gorkom*-styled approach. The real issue that we must confront is motivation. How do we create desired behavior—through coercion or individual-based self-motivation? Self-motivation is always more effective. When it is in an individual's own self-interest to act in an appropriate manner, that individual will so act. Equity ownership creates such motivation and synergistically, in combination with a return to a less rigid approach to the duty of care, will stimulate the effective board oversight that has been so lacking in both the pre- and post-*Van Gorkom* eras.

This point becomes much clearer through a reexamination of several aspects of *Van Gorkom* that until now have received scant attention. There are two most interesting facts relating to the compositional nature of the Trans Union Board that, in light of my empirical data, are highly relevant in explaining why the Board's actions might be seen as problematic. First, at the time of its fateful merger decision in late 1980, the Trans Union Board was comprised of ten members—five of whom were officers of the corporation and five of whom were "outside" directors.[129] None of the five outside directors, all of whom apparently supported the proposed merger, could be characterized as "substantial equity holders" in the company. Their rather paltry individual holdings ranged in size from 101 to 599 shares of stock. In fact, four out of the five owned less than 300 shares, which—at a then market price of $37.25 per share—represented total Trans Union holdings for these four directors (all present or former CEOs of very large publicly held corporations) ranging from $3763 to $11,175 in value.[130]

Second, cross-directorships abounded on this Board. Most of the

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127. Coffee, *supra* note 40, at 798.

128. *Id.*

129. Trans Union's "inside" directors, those who served as directors and officers of the corporation, were Sidney H. Bonser, William B. Browder, Bruce S. Chelberg, Thomas P. O'Boyle, and Jerome W. Van Gorkom. Trans Union's "outside" directors were William B. Johnson, Joseph B. Lanterman, Graham J. Morgan, Robert N. Reneker, and W. Allen Wallis. TRANS UNION CORP., APR. 24, 1980 PROXY STATEMENT 3-6 (1980) [hereinafter TUC PROXY].

130. The stockholdings of Trans Union's "outside" directors were as follows:

outside directors, in addition to Van Gorkom, who was the Trans Union Chairman and CEO, served either on one another's boards or as directors of common corporations.[131] It is no stretch logically to conclude that all of these individuals were probably either financial or social acquaintances of Van Gorkom, with fairly strong ties binding them together. It must also be noted that there appeared to be no one shareholder or group of shareholders holding enough Trans Union shares to exercise control of the company. From the small number of outside directors serving on the Board and the insubstantial stockholdings of each, it is fairly clear that management controlled the enterprise. Additionally, the average yearly fee paid each director, $10,000 plus $700 for each board and board committee meeting attended, adding up to about $18,000 in 1979,[132] well exceeded most of the outside directors' total equity holdings in the company. In sum, given the absence of a dominant shareholder control group at Trans Union, the

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DIRECTOR	SHARES OWNED
William B. Johnson	101
Joseph B. Lanterman	200
Graham J. Morgan	200
Robert W. Reneker	300
W. Allen Wallis	599

TUC Proxy, *supra* note 129, at 4-6.

131. An examination of Trans Union's Board of Directors reveals a network of interlocking directorships and provides one with an excellent case study of the cross-directorship phenomenon. The other directorships held by Trans Union's directors were as follows:

COMPANY	DIRECTOR
IC Industries	Johnson (Chairman/CEO, IC Industries) Van Gorkom Morgan
U.S. Gypsum	Morgan (Chairman/CEO, U.S. Gypsum) Reneker
Illinois Bell	Lanterman Morgan
Esmark	Reneker (Chairman, Esmark) Johnson
Continental Illinois	Johnson Reneker
International Harvester	Lanterman Morgan

TUC Proxy, *supra* note 129, at 4–6.

132. Trans Union's nonemployee directors received $10,000 annual compensation in 1979 and $700 for each board meeting attended in person. Additionally, directors received $700 for each committee meeting, unless the committee meeting was in communication with a board or other committee meeting, in which case they were paid $350 for attending such committee meeting. TUC Proxy, *supra* note 129, at 2.

small shareholdings of the outside directors; the numerous cross-directorships, and the fact that the annual board fees exceeded most of the outside directors' total shareholdings, the Trans Union Board had all the markings of a group subject to management-capture or at least serious management domination. This may explain why the Board's rather quick decision to sell the company, following Van Gorkom's brief presentation, appeared to some, including the Delaware court, to be so problematic. There were structural factors inherent in the composition of the Trans Union Board that may have compromised the Board's independent decisionmaking, even with regard to so important a step as the sale of the company.

As discussed, the Delaware court's liability-imposing response to what it considered to be the Trans Union Board's "uninformed" decision in effect rejuvenated the duty of care. The heightened compliance with the duty required by *Van Gorkom* in its end result did nothing to resolve the problem of board passivity created by management domination, which was perhaps the source of the Trans Union Board's "uninformed" decision. In light of the empirical data collected on the potentially positive effect of equity ownership on board performance, one has to wonder what sort of review process the Trans Union Board might have conducted before making its decision to sell the company had each of the outside directors maintained a substantial equity stake in the company. Had the Board held the kind of equity position in Trans Union that might have counterbalanced the potentially compromising impact of management domination, they might have reached a decision on the merger in a very different manner and foreclosed the kind of shareholder and judicial concern that led to the *Van Gorkom* ruling. The facts of *Van Gorkom*, then, rather than providing the basis for the creation of a heightened duty of care, may actually lend support to an equity-based approach to the problem of board passivity.

IV. Conclusion

The most critical problem confronting United States corporation law today is not the overcompensation of corporate executives, but the flourishing of the passive board created by management capture. Board passivity has resulted in not only the overcompensation controversy, but the lackluster corporate performance that has made our basic industries falter in the international marketplace. Executive overcompensation is but a symptom of the much more serious malady affecting the modern corporation—the presence of management unresponsive to shareholder welfare because unchecked by active board monitoring and oversight. Such self-interested management, either generally unproduc-

tive or motivated primarily by personal gain, creates the kind of ineffective corporate enterprise that results in both diminished shareholder profit and lessened overall societal wealth.

The problem of unproductive or self-serving management can be resolved by stimulating effective board oversight. However, the creation of active management monitoring in a board compositionally suited to passivity because of management capture is not an easy task. Traditionally, the corporate law has attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. This approach did little to halt the growth of the passive board. The Delaware court in *Van Gorkom* attempted to bolster compliance with the duty through the creation of certain guidelines that a board must follow to avoid liability for a duty-of-care violation. Unfortunately, this decision did not lessen, but compounded, the passivity problem. Its approach must therefore be abandoned. This does not mean that we should abrogate the duty of care, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and must be reconsidered.

The solution then lies, not in compelling, but in somehow encouraging effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The most promising solution to the corporate malaise created by poor management and the attendant executive overcompensation problem is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity ownership on the part of the outside directors. To create the sizable shareholdings that will effect such positive monitoring, corporations should pay directors' annual fees in company stock. To ensure that directors' holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove to be the comprehensive cure to the passive board, but the costs of this approach are minimal, and it is a good beginning. This proposal will result in more reasoned executive compensation schemes, more effective board oversight, and most importantly, a healthier and more competitive corporation.

ADDENDUM

On August 30, 1994, the Scott Paper Company, the nation's 108th largest public corporation, announced that henceforth all nine outside members of its Board of Directors would be compensated solely in

company stock.[133] Specifically, each director would receive 1000 shares of Scott common stock.[134] The stock ownership plan replaced Scott Paper's existing compensation arrangements, which provided directors with retainers, meeting fees, stock option awards, and retirement benefits.[135] Immediately following the release of the announcement, Scott Paper stock—trading on the New York Stock Exchange—rose three percent, $2.125 a share, to close at a fifty-two week high of $65.875.[136] Scott Paper Chairman and CEO Albert J. Dunlap, in announcing the company's action, stated: "The directors unanimously decided to directly align themselves with our shareholders' interests [in an effort] to increase shareholder value."[137]

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133. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, SCOTTNEWS, Aug. 30, 1994, at 1; *see* Glenn Collins, *Scott Paper to Pay Directors in Stock*, N.Y. TIMES, Aug. 31, 1994, at 3; *Scott Paper Co. to Pay Outside Directors in Stock*, WALL ST. J., Aug. 31, 1994, at B3.

134. *Scott Paper Board of Directors to Be Compensated in Company Stock*, *supra* note 1, at 1; *see* Tim Ferguson, *Tissues Turnaround Comes in Shades of Goldsmith*, WALL ST. J., Sept. 13, 1994, at A19; Jacqueline M. Graves, *While Directors Get Stock*, FORTUNE, Oct. 3, 1994, at 18; Keith H. Hammonds, *Austerity Starts at the Top*, BUS. WK., Sept. 12, 1994, at 46; Mike Seemuth, *Taking Stock*, FLA. TREND, Nov. 1994, at 67-70.

135. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, *supra* note 1, at 1.

136. Collins, *supra* note 1, at 3; *see* Graves, *supra* note 2, at 18.

137. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, *supra* note 1, at 1.

MONDAY, SEPTEMBER 27, 1993

A Board-Based Solution to Overpaid CEOs

Manager's Journal

By Charles M. Elson

In many U.S. corporations, executives are paid much more than their performance seems to justify. The problem of overcompensation will not be solved, however, by the Clinton administration's approach to the question.

Arguing on Feb. 11 that "the tax code should no longer subsidize excessive pay of chief executives," President Clinton requested in his budget, and Congress then mandated, that executive compensation over $1 million a year "unrelated to the productivity of the enterprise" no longer be deductible by the offending corporation as a legitimate business expense. The president apparently concluded that all executive salaries above $1 million were somehow inherently suspect. He has missed the point completely.

There is nothing inherently wrong with a large salary. The problem is overcompensation, not high compensation. Many executives who earn well over a million dollars are worth every penny, considering their contributions to corporate profitability. Corporations will gladly pay high-performing executives handsomely, not only to reward their performance but to retain their services in the competitive labor marketplace. High compensation can also be a valuable incentive for future performance. To limit arbitrarily the compensation that all corporations may offer limits the effectiveness of this important incentive.

Furthermore, the Clinton approach to corporate overcompensation fails to address its root cause. Overcompensation is usually the result of a failure in the bargaining process between a corporate board and management over salary.

In many of America's leading corporations, management is supervised by a board largely appointed by management. Excessive compensation results when passive boards beholden to management agree to salary packages on demand, in the absence of spirited negotiation.

An empirical study I recently conducted suggested that bargaining between board and management will be more effective when outside directors have substantial stockholdings in the corporation. Business Week, in conjunction with Standard & Poor's Compustat Services Inc., conducts an annual survey of executive compensation in 500 of the nation's largest publicly traded corporations. Compensation is then compared with executive performance as measured by corporate profitability and total return to the stockholders in stock appreciation and dividends. My own study reviewed the 158 businesses in the Business Week survey that received either the poorest possible rating for compensation in relation to performance or the best.

An intriguing fact emerged from my examination. Those companies with apparently excessive levels of executive compensation tended to have corporate boards controlled by outside directors with insignificant equity holdings in the business. On the other hand, those businesses with levels of executive pay considered in line with services delivered tended to be controlled by boards whose outside directors held substantial equity positions in the companies. There appeared to be a link between substantial stock ownership and more effective compensation oversight by the outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession of large shareholding positions, would explain this phenomenon.

Based on the findings of my study, I believe that some reform in board structure is warranted to create more effective board-level review of executive compensation and to promote more reasonable compensation schemes. The outside directors must be made to consider management compensation proposals not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Corporations should pay their directors their annual fees in company stock that is restricted as to resale during the director's term in office. In a few years, each outside director will have accumulated a reasonably substantial portfolio and will therefore possess a powerful financial incentive to act more independently of management.

Although some might argue that a stock-option grant to directors may serve the same purpose, such an approach would prove less effective than direct equity ownership, simply because of the highly tentative nature of an option prior to exercise. Stock ownership provides the director with a present tangible stake in an enterprise, not merely some speculative expectancy of a discounted future position.

Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decision making; by stretching out the time between elections, it would also make it harder for management to bully directors with a threat not to renominate them.

Director stock ownership may not prove the comprehensive cure to the overcompensation controversy—but it will have a strong salutary effect and is a much more positive approach than the Clinton administration's taxation-based plan.

Mr. Elson is an associate professor law, Stetson University, St. Petersburg, Fla., and a fellow at the Heritage Foundation in Washington, D.C.

Answers to Questions for the Record From Charles Elson

From Chairman Grassley:

1. For the record, I'd like to get the panel's views on these three questions. How would you rate the results of efforts to deal with what are viewed as high corporate salaries through the tax code such as section 162(m)?

2. The second question, do you believe that improved transparency as recently proposed by the SEC is more effective than the tax code in dealing with high corporate salaries?

3. And finally, how important is it that we have improved governance and independence of board members, that several of you have cited in your testimony, if the SEC's new transparency rules are going to have a strong impact on addressing high corporate salaries?

1. As I stated in my oral testimony, I believe that the tax code's efforts to reign in executive overcompensation have been unsuccessful, particularly section 162(m). It has had the regrettable result of ratcheting up base salaries substantially to the now ubiquitous $1 million level and, more importantly, has had no impact on creating more performance-based compensation. It has resulted in either the "lawyering" of the process to create phantom performance-based pay or having corporations simply pay heightened compensation without the deductibility. Both ways, the shareholders lose—they either pay excessive compensation, performance-based in name only, or are subjected to significant additional taxation on non-performance labeled compensation.

2. I believe that the heightened compensation disclosure recently enacted by the SEC is helpful in combating excessive compensation—certainly more effective than provisions in the current tax code. But, as I testified, I do not believe that disclosure in and of itself is the ultimate solution. This will only come with a reconfiguration of corporate boards to ensure that its members are independent of management and significant equity holders in the corporation.

3. Ultimately, the solution to the compensation crisis can only be derived from a boardroom consisting of independent, stockholding directors. This effort will be bolstered by shareholder pressure, aided by the greater compensation transparency now mandated by the SEC. I believe that additional disclosure is also warranted in two areas. Firstly, we need better disclosure on director independence—particularly those quasi-financial linkages to management, such as corporate charitable donations to entities on whose boards the director sits. Secondly, we need better disclosure on the work of compensation consultants advising the board—especially any additional work a consultant may do for the company. This potential conflict of interest is similar to that presented in the audit area now eliminated by Sarbanes-Oxley, where an auditor provides non-audit services to

the company. This information on potential compensation consultant conflicts of interest is vital to shareholder oversight of the compensation process.

4. I would ask the panel two questions: First, Ms. Minow, you did a good job of highlighting in your testimony what are some of the current practices in executive compensation, and I was wondering if you could expand on those, particularly those with a tax play?

I also would ask the rest of the panel for their comments on what they believe are the new things out there in executive compensation that give you pause or concern and that should be considered by Congress.

5. Second, I would ask the panel do you believe it is possible to estimate the amount of known performance pay that escapes taxation under section 162(m), and, if so, what is that amount? You can round up to the nearest billion.

4. One new problem with executive compensation that concerns me and should be examined by Congress is the increasingly common practice of corporations "grossing up" their executive pay to cover the tax that is due on the salaries. In effect, not only are the shareholders having to pay excessive compensation to their executives, but have the additional burden of paying the executives' taxes—a luxury no other American taxpayer is granted. This overreaching by executives demoralizes the rest of the company's workforce and erodes public confidence in the propriety and integrity of our management establishment. Additionally, personal use of corporate aircraft by executives needs to be highly discouraged, as it is clearly a misuse of shareholder assets.

5. I believe that it is possible for the Internal Revenue Service to estimate the amount of performance-based pay that escapes taxation under 162(m). I would imagine that the number is substantial. I do not believe that the amount totally escapes taxation as the individual, or corporation as noted above, does pay income taxes on the proceeds.

6. We have talked about high compensation with publicly traded companies quite a bit, but we have all read many headlines about excessive compensation in the nonprofit sector. It seems that similar problems of board failure exist in dealing with excessive executive salaries in the nonprofit sector.

But I'd like to get the panel's views on this. I know that you, Professor Elson, have in particular thought about this, so I would appreciate your thoughts and views and anyone else on the panel as well.

6. Unfortunately, ineffective board oversight is not limited to the public company arena. Nonprofit boards are too large and are not properly incentivized to be effective monitors of the managers of the charitable institutions that they oversee. The numerous compensation-based scandals that we have seen in the nonprofit world were a direct result of board oversight failures. The solution is highly

similar to that proposed in the public company area and involves changes in board composition and structure.

To be effective, nonprofit boards need to be smaller in size and limited to independent directors with no financial or quasi-financial connections to the charity and its management other than individual monetary support or service donation. The directors must make personally significant economic contributions to the organization on a regular basis to ensure the necessary stake in its success. Similar in approach to the equity-holding requirements expected of public company directors, this will encourage the active and objective monitoring of the charity's management.

From Senator Kerry:

1. Should backdating be illegal?

1. Backdating defeats the point of awarding incentive-based options. Additionally, the backdating now being examined violated the applicable disclosure, taxation and accounting rules.

2. Are there any legitimate instances in which backdating should be allowed?

2. Backdating is always problematic and should not be allowed. However, should, in an extremely rare circumstance, a board have a legitimate reason for awarding an in-the-money option, it should have limited flexibility to do so, as long as it is appropriately disclosed to the shareholders and accounted for under the appropriate accounting and taxation rules. To ensure the highly limited and appropriate use of this option, board composition should be changed, as I have testified, to reflect greater independence and personal ownership amongst the directors.

3. What can be done to prevent spring-loading?

4. What are your recommendations for making boards more accountable?

3&4. Spring loading is highly problematic from a shareholder standpoint. The solution is not a blatant prohibition, but, as I have discussed above, a change in board composition to ensure better board alignment with shareholder interests, better accountability to shareholders and more effective compensation negotiation and oversight. A board that is comprised of directors who are financially and quasi-financially independent of management and have personally significant equity stakes in the business will have the objectivity and incentive needed to properly monitor management for shareholder benefit. Additionally, some state and federal rule changes to encourage greater shareholder involvement in the director

selection and retention process—such as a proposed expense reimbursement scheme for short-slate director contests—would be helpful in creating greater board accountability.

5. Are they any legislative changes that you would recommend in the area of executive compensation, including disclosure?

5. Rule changes involving heightened disclosure in two areas would be helpful. Firstly, we need better disclosure on director independence—particularly those quasi-financial linkages to management not particularly well disclosed, such as corporate charitable donations to entities on whose boards the director sits. Secondly, we need better disclosure on the work of compensation consultants advising the board—especially the work a consultant may do for company management in addition to the advice provided to the compensation committee. This is a potential conflict of interest similar to that presented in the audit area now eliminated by Sarbanes-Oxley, where an auditor provides non-audit services to the company. This information on potential compensation consultant conflicts of interest are vital to shareholder oversight of the compensation process. Federal rule changes that encourage director stock ownership and director independence are also helpful.

6. Do you think changes need to be made to code section 162(m)? Do you think it is appropriate to limit the amount of compensation that a company is able to deduct? If so, what is an appropriate limit?

6. As I stated in my oral testimony, I believe that the tax code's efforts to reign in executive overcompensation have been unsuccessful, particularly section 162(m). It has had the regrettable result of ratcheting up base salaries substantially to the now ubiquitous $1 million level and, more importantly, has had no impact on creating more performance-based compensation. It has resulted in the "lawyering" of the process to create phantom performance-based pay or having the corporation simply pay heightened compensation without the deductibility. Both ways, the shareholders lose—either paying excessive compensation, which is performance-based in name only, or being subjected to significant additional taxation on non-performance labeled compensation. Consequently, I believe that code section 162(m) should be repealed and concurrently, federal and state rule changes that encourage better disclosure of executive compensation and greater director independence and stock ownership should be pursued.

WRITTEN TESTIMONY OF THE COMMISSIONER OF INTERNAL REVENUE MARK EVERSON BEFORE THE SENATE COMMITTEE ON FINANCE ON BACKDATING OF STOCK OPTIONS AND OTHER EXECUTIVE COMPENSATION ISSUES

SEPTEMBER 6, 2006

Good morning Chairman Grassley, Ranking Member Baucus, and the Members of the Senate Finance Committee. It is good to appear before you again to discuss the issue of executive compensation and the Internal Revenue Service's efforts in administering and enforcing our nation's tax laws.

It is hard to pick up a newspaper or hear a financial report on the evening news without learning of some new or continued excess in executive compensation. When this excess violates the securities or tax laws, it undermines not only investor confidence and corporate governance, but also tax administration.

This morning, my focus will be on executive compensation issues for corporate executives. I want to discuss our efforts and procedures in this area, what we are finding, and impediments that lie in our way.

The IRS examines corporate returns in two of our business units. Our Large and Mid-Size Business (LMSB) division handles the examinations of corporations with assets greater than $10 million while other companies would fall into the Small Business and Self Employed (SB/SE) business unit.

The Service has, by design, increased the coverage rate of corporations and high income individuals that we audit over the last several years. In Fiscal Year (FY) 2005, we audited over 10,800 corporations with assets over $10 million as opposed to approximately 9500 in 2004. This is a coverage rate of 20 percent in FY 2005, compared to a coverage rate of 16.7 percent in FY 2004 and 12.1 percent coverage rate in FY 2003. Based on year to date data we anticipate we will maintain the same level of audits in FY 2006 and the same coverage rate.

Similarly, for corporations with assets under $10 million the coverage rate has increased as well. In FY 2005, we examined 17,858 small corporations, a coverage rate of 0.79 percent. This is more than double the audit rate in FY 2004 (0.32 percent). We expect our FY 2006 numbers to be similar to the 2005 rates.

We see a similar increase in audits of high income taxpayers, those with incomes in excess of $100,000. In FY 2004, we examined 166,221 high income taxpayers. That number rose to almost 220,000 in FY 2005. Similar increases can also be seen in the

coverage rates. The rate in FY 2004 was 1.25 percent, as opposed to 1.57 percent in FY 2005. The coverage rate for those with incomes over $1 million is 5 percent. Our plan in FY 2006 is to complete 234,000 high income individual audits. We are well ahead of that schedule currently and may reach as many as 240,000 or more.

While we are doing more, we are not where we want to be or need to be. Compliance by large businesses and high-wealth individuals remain two of the Service's strategic priorities.

Executive Compensation

When examination teams examine a large corporation, executive compensation issues are required to be considered. There are a variety of issues in the executive compensation arena confronting IRS examiners. These issues relate both to the company and to key executives within the company. Issues include such items as stock-based compensation, (including stock options), parachute payments made when control of the company changes, non-qualified deferred compensation, split dollar life insurance, and various fringe benefits. More recently, we have been confronting the issue of backdating of stock options.

From an overall corporate perspective we need to make sure that the company has complied with section 162(m) of the Internal Revenue Code (IRC), which potentially limits the amount of compensation that the company can deduct.

A Compliance Initiative Project was established for many of these issues and Audit Technique Guides (ATG) have been written and published for the use of our examiners and the public.

As I indicated, as part of our corporate examinations, the examiners not only look at the overall corporate return, but also inspect the returns of executives in the corporation. They then make a decision, or a risk assessment, as to whether they should engage in a full scale examination of any executive's individual return. This decision is based on a number of risk factors, such as the amount of tax paid by the executive in question, whether there has been proper reporting of all income and fringe benefits known to the examiner through audit of the corporation, the use of tax shelter activities, and the existence of reportable deferred compensation. In general, risk assessments are based on return information, audit history, and public information, including filings before the Securities and Exchange Commission (SEC).

The choice and number of executive returns we inspect in any particular company are determined by the examination team, but the inspected returns generally extend beyond those filed by the top five executives that are relevant to the corporation's section 162(m) issues. For example, in the largest corporations we would typically inspect 15-20 executive returns. If the inspection on an individual executive's return does not demonstrate the presence of risk factors, the return will not be subjected to a full examination.

In some cases, the risk factors seen on the individual returns of executives do indicate the need for further examination. In FY 2005, for example, LMSB conducted formal examinations of the individual returns of 90 executives, resulting in adjustments of just over $16 million. For FY 2006, through July, LMSB has examined 95 returns of corporate executives, leading to adjustments of over $84.5 million. It is important to remember these examinations were of *only* those returns identified by LMSB auditors through an assessment of risk factors they identified in the course of examining a corporate return and an inspection of personal income tax returns from executives of that corporation.

These audits are part of our overall program to increase the examinations of high income taxpayers that I mentioned earlier.

While the number of audits and the audit coverage rates are increasing, they are still too low. We plan to deploy additional resources to the area of high income taxpayer examinations. Some of those resources will likely come from the drawdown of resources now devoted to examining small estates under the estate and gift tax program. It is important to remember that this drawdown will not affect large estates (those in excess of $5 million), where our coverage rate will still be in the range of 28 percent.

For FY 2006, through July there have been approximately 25 corporate executive compensation fraud cases referred for criminal investigation. Of those, 20 were sourced from SB/SE. These referrals deal primarily with the diversion of corporate income to corporate executives, resulting in the underreporting of compensation on the executive's personal income tax return.

Tax Administration and Corporate Governance

It is important to distinguish between tax administration and the oversight of corporate governance. The IRS is, of course, responsible for the former, but does touch on issues of corporate governance with some regularity, while our colleagues at the SEC focus more directly and undoubtedly more often on the latter. It is critical that we work together to the extent possible under existing law.

I have stated publicly before that clearly Sarbanes/Oxley and the post-Enron environment have improved corporate governance, including in the tax arena. It has also increased and improved the contacts between the Service and the SEC, as well as with the Financial Accounting Standards Board. We have had useful and productive discussions on the recent significant changes to FASB Statement No. 109, *Accounting for Income Taxes,* on the implications for certain SEC reporting companies of their participation in real-time tax examinations through LMSB's Compliance Assurance Process, on the ways in which large corporate examiners, analysts and researchers can best access and understand data filed with the SEC and maintained and made available through the SEC's EDGAR database and non-SEC sources, and most recently, on the backdating of stock options.

The SEC's cooperation and willingness to share information about what it is finding from its investigations of options backdating, which is referenced below, are particularly significant for us. The SEC's authority, expertise and ability to access information on a real-time basis allow us to identify potential options backdating exam subjects more precisely and more quickly than we would be able to do on our own.

From a tax administration standpoint, we sometimes identify issues in the course of an audit of a corporation that surface problems from a corporate governance perspective. But for several reasons, including the relevant reporting periods for tax purposes and the lag time between return filing and return examination, we are unlikely, in many cases, to identify governance issues before they have become known through the media or identified by other organizations, such as institutional shareholders, research analysts, or the SEC. In any event, we are generally precluded from sharing that information with the SEC or other government agencies by section 6103 of the IRC.

In addition, tax provisions that might be expected to have an impact on corporate governance may, for a number of reasons, not always have the impact that had been anticipated when they were drafted. Take section 162(m) of the IRC for example. It is intended to limit the income tax deduction that may be taken by a publicly held corporation for certain compensation in excess of $1 million paid to its chief executive officer and the four other highest paid executive officers unless certain specific requirements are met. Only compensation that is considered "performance-based compensation" is deductible above the $1 million level. The limit applies only to publicly traded corporations.

Section 162(m) is a relatively straightforward section of the IRC that most companies understand and with which they are able to comply. They commonly structure compensation arrangements with their highly paid executives that allow the executives to earn compensation in excess of the $1 million limit in the form of performance-based bonuses, particularly in the form of stock options. As a result, corporations subject to section 162(m) are generally entitled to deduct these performance-based bonuses and we generally find this is not a significant area of noncompliance from a tax administration perspective.

This may be the case even if a company paying substantial or even unsettling amounts of deductible performance-based compensation is actually not doing well from an earnings per share or earnings growth standpoint. This development is partially a product of the latitude corporate law grants companies in compensating executives, and partially a product of the use of that latitude by corporate boards. The standards of section 162(m) are no more stringent than the corporate law standards upon which this corporate largesse is sustained.

Backdating of Stock Options

One of the issues this hearing is focused on is the backdating of stock options. Company after company is restating earnings upon discovery of proof or indications of backdating

of options for their executives. Such backdating not only raises corporate governance concerns if proper approval was not obtained from the corporation's shareholders and directors, but can indicate tax compliance issues as well.

In general, corporate stock options are granted to employees with an exercise price equal to the market price of the stock on the date of grant. An employee benefits from an option if the market price of the stock on the day the option is exercised exceeds this exercise price. The practice of backdating options allows the use of hindsight to pick a date for the exercise price on which the market price was low. Picking a date on which the stock price was low in comparison with the current price gives the employee the largest potential for gain on the option and makes it possible for the employee to benefit from corporate performance that occurred before the option was granted. While this practice does not guarantee income on the exercise date, it increases the value of the option and makes it more likely the employee will be able to exercise the option at a time when the market price exceeds the exercise price (i.e., at a time when the option is "in the money").

As this simplified description of the practice suggests, backdated options that are in the money do not measure the performance of the company from the date of grant, and as a consequence, may not be treated as performance-based compensation under section 162(m). Thus, for the company, the tax implications are that any deduction of compensation related to the backdated option would be subject to the $1 million IRC section 162(m) limitation and would be disallowed if paid to the chief executive officer or one of the four other highest paid executive officers.

In addition, if an Incentive Stock Option (ISO) is backdated, the option will no longer qualify for preferential ISO treatment and will be reclassified as a nonqualified stock option. The difference between the exercise price and the sales price would be additional wages to the executive and must be included on the employee's Form W-2 in the year of exercise. The executive will lose the deferral and rate benefits associated with ISO qualification, but the corporation may be eligible for an additional wage deduction if IRC section 162(m) limitations are not triggered.

Under new section 409A of the IRC, enacted as part of the American Jobs Creation Act of 2004, serious tax implications can now exist for the executive of a corporation that backdates options. He or she may now be responsible for the payment of tax on income previously deferred until the exercise of the options. In addition, there can be substantial additional taxes under section 409A. This provision applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004.

We are currently in a transition period with the rules relating to section 409A. During the transition, options that were in the money on the grant date can be amended to avoid violating section 409A in either of two ways. The parties can increase the exercise price to equal the fair market value on the original grant date and eliminate any other deferral feature, or the parties can amend the options to provide for a fixed exercise date after

which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised.

In recent months, we have set aside and are reviewing cases identified as involving or potentially involving the backdating of stock options by the SEC, the Department of Justice, or companies announcing that they must restate earnings. We have met with SEC representatives and they agreed to share information regarding ongoing backdated stock options investigations.

This information sharing is critical to our efforts. I mentioned earlier that there are substantial tax implications *if* the backdating is discovered. The truth is we are not likely to discover something like backdating of options in the course of our ordinary examinations of taxpayers, either corporate or individuals, since backdating is not readily apparent from inspection of the tax return.

Within the IRS we have taken numerous steps to both increase awareness of the issue among our examiners and assist them when cases of backdating are identified. We have:

- approved a Compliance Initiative Project to allow for examination of cases with potential backdating;
- posted a Backdating Issue Alert on our internal web pages;
- issued and posted a proposed backdating Information Document Request Form (IDR); and
- provided Technical Advisor support to teams that have open examinations.

Executive Compensation in the Tax Exempt Arena

Tax exempt organizations also face their fair share of issues related to executive compensation. I know this is an issue of great concern to members of this Committee.

In late 2004, our Tax Exempt/Government Entities (TE/GE) group began the Exempt Organization Executive Compensation Project to explore the seemingly high compensation paid to executives and others who were controlling exempt organizations. We contacted over 1800 organizations. From that number we sent out 1225 compliance letters requesting information on how compensation was set and reported. Roughly 30 percent of those contacted by letter submitted amended returns or schedules as a result of the process and over 170 of the responses to these letters resulted in a full examination of the organization contacted. The balance of the 1800 organizations contacted, over 600, were contacted through an examination. The examinations we have closed to date and the other contacts we have made with exempt entities have shown compliance issues associated with reporting and with loans to executives or other controlling officials. Our examination work continues.

To help combat reporting problems, we have modified the Form 990 in an effort to better capture executive compensation data from the tax exempt community. Executive compensation will continue to be a prime area of focus for our TE/GE group in FY 2007.

For example, we currently have 532 non-profit hospital contacts on executive compensation issues outstanding.

Challenges Faced In the Area of Executive Compensation

Many of the challenges faced in the area of executive compensation are similar to those faced in other areas of tax administration – the lack of transparency and the inability to share information with other agencies.

Transparency

Despite the fact that we have ramped up efforts in this area in recent years, adjustments on executive and corporate returns as a result of executive compensation issues are relatively infrequent. Our examiners find relatively few indications of executive compensation non-compliance in return information they inspect and the returns they examine.

This is an area where, as we well know, corporations can comply with the law without inordinate risk or expense and still manage to pay their executives handsomely. While there may be non-compliance, we may well not find it reflected on the tax return.

When I testified before this committee on June 13, 2006, I spoke of book-tax differences and how they were growing for corporations. In the area of executive compensation, we estimate from Tax Year 2004 aggregate Schedules M-3 data that the book-tax difference is $47 billion. To a significant degree, this number is made up of the book-tax differences arising from non-qualified stock options. These options are popular with senior management in many public companies because they are a way for the company to offer performance-based pay that is deductible under section 162(m). We anticipate that the recent changes in the accounting standards by the Financial Accounting Standards Board (FASB) will reduce this difference considerably. Many Nonqualified Stock Options that were deductible by the corporation for tax purposes were not required to be expensed for book purposes prior to 2005.

The M-3 is the schedule that corporations with assets of over $10 million must file to reconcile differences between what they report on their books, consistent with generally accepted accounting principles, and what they report to the IRS for tax purposes. The M-3 is critical to our enforcement efforts in that it provides greater transparency over the specific bases for the differences between financial statement income and expense and tax income and expense.

We use the M-3 to guide examiners to potential areas of non-compliance. Our examiners are instructed to pay attention to items on corporate schedules M-3 that are large, unusual or questionable.

The M-3 does not necessarily identify non-compliance, but it does give us an indication of areas that merit further analysis. Together with other aspects of the M-3, however, this

information can be useful. For example, lines 2b and c ask the question: "Has the corporation's income statement been restated for the current year or any of the five income statement periods preceding?" If the corporation answers yes, it may prompt an examiner to raise additional questions and could lead potentially to the discovery that stock options have been backdated.

With respect to corporate executives, we have no tool similar to the M-3 that would help identify otherwise non-transparent issues on the tax return and in such cases enable us to identify where to ask the right questions with respect to an executive's compensation. A corporate executive's 1040 return elicits information with respect to the same line items that are required to be filled in by the assembly line worker or groundskeeper. Without more specific information, we are not well positioned to pick out problematic returns and not bother the compliant executive.

I might compare this dynamic to the situation we faced with respect to the creation and promotion of abusive tax shelters before the disclosure regime was created. Prior to the regime's establishment, we had no ready mechanism to identify abusive, or potentially abusive, transactions. Much of what we currently have the opportunity to look at was not ascertainable from the return, and consequently went undetected. Now, taxpayers and promoters are required to report, using Form 8886, certain tax shelters and potentially abusive transactions to our Office of Tax Shelter Analysis. This data has been invaluable to us both in terms of better understanding the nature of the potentially abusive transactions and in identifying specific taxpayers that are participating in the shelter and those that might promote them.

Information Sharing

I want to thank the Chairman, Senator Baucus and members of this committee for their efforts in allowing us to share data with State Charity Officials under the Pension Protection Act. This provision is an important step in our cooperative efforts with the states in the tax exempt arena. But, unfortunately, this type of information sharing initiative is the exception rather than the rule.

As I indicated earlier, our discussions with the SEC served to remind us of two recurring themes related to our efforts to coordinate compliance efforts with other Federal agencies. First, the IRS and other federal law enforcement agencies frequently gather and analyze information, independent of the other agencies, concerning the same parties and matters. Second, while the other agencies can provide considerable information to the IRS, we are precluded from providing any information from a tax return. We cannot even confirm the existence of many facts relevant to their investigations.

Section 6103 of the IRC broadly states that tax returns and return information are confidential and cannot be shared except for very specific purposes identified in the IRC. This is an important taxpayer protection that should only be modified after careful consideration. We are working with the SEC to determine whether there might be

limited areas in which broader information sharing would be helpful, and will work with this Committee on any proposals that may be developed.

Conclusions

Abuses in the areas of executive compensation are a concern from both a tax administration and a corporate governance perspective. The IRS will continue to prioritize its efforts in the entire area of executive compensation. As I indicated, this is an area where we, in many instances, are unlikely to identify significant noncompliance through our traditional corporate audits. To fortify our ability to identify such noncompliance, greater transparency concerning the details of each executive's total compensation might be considered. In the meanwhile, we will apply our resources to this area with full rigor.

We will also prioritize our coordination with the SEC and our use of both public and non-public information that may be available to us. We are heartened by the Commission's collaboration and the utility of the information they are willing to make available to us in the area of backdated stock options.

I appreciate the opportunity to appear before the Committee this morning and I would be happy to respond to any questions.

Questions for the Record for
The Honorable Mark Everson

From Chairman Grassley:

1. I think this question is primarily for Justice, but I encourage the other panelists to comment. These backdating stock options cases are across the country, and, as we see with today's hearings, involve many different legal issues that are the responsibility of different branches of the federal government.

While your testimony touches on this, I wanted you to expand a little further about how Justice is coordinating these cases geographically and across different agencies to encourage uniformity of treatment of similarly situated individuals to the extent possible.

As you answer that, I'd also like to understand better how many legal actions you anticipate or estimate taking – that is, how many executives and companies will be affected at the end of the day by this backdating? And finally, what steps is the federal government taking to ensure there are adequate staffing resources to investigate and prosecute these cases?

Answer: The Service will not have an estimate of the number of companies and executives that will ultimately be affected by backdated stock options until we have completed our examinations.

The Service is currently applying resources to investigate companies that backdated stock options.

2. This question is for the panel. It is my understanding that the board also often played a role in the backdating of stock options.

The *New York Times* reported this Sunday that the SEC recently informed the board of Mercury Interactive that the SEC was considering filing a civil complaint against three board members in connection with backdating.

The rules of corporate governance place great emphasis that board members are there to represent the shareholders. If the board members are not doing their job of putting the shareholders first, that hurts investors and ultimately our economy. What are the panel's views on holding board members responsible – when is that appropriate in backdating and what actions can we expect from the federal government in this area?

Answer: Director accountability would fall within corporate governance, which is not regulated through the Internal Revenue Code. Outside directors have direct responsibility to develop, approve, and monitor executive stock option plans, and other forms of executive compensation in publicly traded companies.

3. I would like you to comment on the suggestion of one of our panelists of having the new transparency rules updated to require corporations to make shareholders aware if the executive

compensation fails to meet the section 162(m) performance-based exemptions. That is, if the corporation is going to pay additional tax for failure to meet the tests of section 162(m), it should tell its shareholders. Perhaps sunshine here may help.

Answer: Taxpayers have the ability to pay compensation to covered employees that exceeds $1 million and is non-deductible as the result of IRC section 162(m). The compensation may be non-deductible because either the compensation was not intended to meet the performance-based exceptions of IRC section 162(m) or the compensation is paid even though the covered employee fails to meet the established performance goals. The disclosure of the specific performance goals established under IRC section 162(m) and whether these goals were met at year-end would provide shareholders with greater transparency of executive pay practices.

4. This question is for you, Ms. Thomsen, but it is based on comments that Commissioner Everson has made. Commissioner Everson has made public comments that Congress should consider whether to change the tax privacy rules to allow the SEC to review certain limited corporate tax information. The thought being that the SEC may be able to better identify problems if it had access to what corporations told the tax man.

This is a matter I've written on earlier in this administration and think it bears serious consideration. I would like your views – I know you can't speak for policy change – but just your views as the head of enforcement of whether having access to tax information would assist your work. And, Commissioner, if you wish to add anything.

Answer: The sharing of information by the IRS with other agencies presents important tax policy considerations. Treasury and IRS will carefully consider this option.

5. We have heard about the backdating of stock options first in the papers, not from actions by federal law enforcement. I'm worried that in this area, like it has been the case in the past with tax shelters, that we are way behind the curve – both law enforcement and Congress.

I would ask that if both you, Mr. Commissioner, and you, Ms. Thomsen, could tell us about those things – beyond backdating of stock options – that you are seeing now in audit or review in the area of executive compensation that give you pause and concern. What are those things that make your eyebrows rise? What are the things your staff are seeing in the field that give you concern that Congress should know about?

Answer: We have several areas of concern. IRC section 280G (golden parachute payments) has been a particular compliance challenge since the recent re-emergence of significant corporate mergers and consolidations. The Service has several ongoing examinations for various aspects of this issue including the valuation of taxpayer covenants not to compete. Another issue is that bonuses paid to executives to stay through the transition period are not treated as parachute payments and are not subject to section 162(m) because the executives cease to be covered employees as a result of the transaction.

Another concern is compliance issues related to the rehiring of retired executives by businesses as consultants/independent contractors. The executives generally retain the use of offices and secretaries, are not permitted to work for competitors, and maintain many of the same benefits enjoyed when employed. Contracts may contain clauses such as "same benefits afforded a

senior executive." The compliance risks related to retired executives are that income may not be reported, may be reported incorrectly as "other income" rather than as business income, and if the income is reported on Schedule C, expenses paid by the corporation may be taken against the income.

Supplemental health benefits provided by corporations to their executives over and above the usual health benefits provided to all employees are also a concern. The cost or premiums for executive health benefits are generally fully paid and deductible by the corporation. The concern is that most often the supplemental health benefits are provided through an insured arrangement, are not taxable to the executive and are not available to all employees.

6. Mr. Commissioner, my understanding is that while in general section 162(m) requires that executive compensation over $1 million at a publicly traded corporation must be performance-related, the reality is that this requirement has more holes than Swiss cheese.

Business Week today in a story online shows how easy it is to get around section 162(m). BellSouth provided a dozen different benchmarks to qualify executives as performance-based – including this one: "individual achievement of personal commitments."

Jello has more bones in it then these performance based benchmarks. In addition, Professor Bebchuk in his testimony highlights other benchmarks that are more molehill than mountain.

Mr. Commissioner, I'd like you to address two points: First, what has the IRS been seeing in audits in this area? Is the performance test bar an easy one to pass if a corporation actually wants to meet it?

Second, members of our second panel note that one of the failings of section 162(m) is that the corporation doesn't have to provide shareholders numbers when it comes to approving performance-based contracts. This seems to add even more holes to the Swiss cheese – if that is possible. I would ask for your commitment to reviewing that and requiring that companies provide shareholders real numbers to determine whether a performance-based contract is of real value.

Answer: Yes, the performance test bar can be relatively easy to meet provided the proper procedures are followed in establishing the performance goal. The regulations require that the performance goal be objective and established at a time when it is substantially uncertain to be met.

The Service would agree that IRC section 162(m) could be more transparent to the shareholders; however, as the second panel agreed, this facet of corporate governance may not be an issue that can be regulated effectively through tax legislation.

From Senator Baucus:

1. In your testimony, you stated that the time may be right to revise IRC section 6103 to allow IRS disclosure of executive compensation data with the SEC and the DOJ. Describe how

this information sharing might work and what benefits would be derived from sharing this data. Please provide suggestions for legislative language to make this revision.

Answer: The ability to disclose specific information in specific instances could reduce taxpayer burden. Information sharing would enable the taxpayer to present the facts and documents in a more cost-saving fashion for consideration by all impacted agencies when multiple agencies are addressing the same transaction or arrangement.

IRS coordination with the SEC and other federal agencies that investigate and enforce compliance with executive compensation and securities laws would be significantly enhanced if we could on some basis provide tax information for corporate taxpayers and top executives who may also be in violation of related federal laws.

IRS's discovery of corporate/executive non-compliance could be helpful to the SEC in determining compliance with required securities law disclosure and the adequacy of reported tax-based financial data, which are valuable to financial markets.

Legislation could be narrowly drafted to allow for disclosure of information for publicly traded entities and their top executives under specific circumstances. Information could be shared by the IRS with the SEC in a limited and targeted way that would require the SEC to protect the information. As always, however, it is important to balance taxpayers' interest in privacy with the need for tax law compliance, and to carefully consider the impact on the self-assessment system before making changes to the confidentiality rules.

2. Disclosure of reportable transactions has been helpful in detecting abusive tax shelters, scams and schemes. To what extent would a comparable disclosure requirement for executive compensation packages, including wages, deferred compensation, stock options and perquisites, deter abusive arrangements and assist the IRS in detecting them before they become widespread?

Answer: Disclosure could enable the IRS to get in front of potentially abusive transactions or arrangements. Guidance could be issued before transaction or arrangement participation became widespread or covered several tax periods.

From Senator Conrad:

In Headliner 163 (May 15, 2006), the Service stated that the above-the-line health insurance premium deduction (IRC §162(l)) could not be claimed by an individual operating a business as an S corporation when such individual is the sole shareholder and sole employee and the health insurance is purchased in the individual's name and not that of the business. The Headliner acknowledges that its conclusion is contrary to that of Chief Counsel Advice (CCA) 200524001, where it was held that a sole proprietor was entitled to §162(l) relief if the health insurance was purchased in the name of the individual and not that of the business.

The principal goal in enacting relief under §162(l) was to make the tax treatment of employment-related health insurance premiums the same for both employees and the self-employed, whether the latter operated as sole proprietors or as S corporation shareholders. If a taxpayer relied on the Headliner's conclusion, the level playing field could not be achieved. An S corporation sole shareholder/employee who purchases health insurance in his or her own name would not receive the same treatment as those who purchase their health coverage in the name of the business. As the Headliner concedes, this would be the case even when obtaining business coverage in such a situation is prohibited by state law. Practitioners in my state are concerned that relying on Headliner 163 would result in an unintended tax increase for some S corporation sole shareholder/employees.

In view of the intent of Congress to ensure that self-employed individuals can fully deduct their health insurance premiums, it concerns me that the Service would use this form of communication to announce a different conclusion. The disclaimer at the top of the Headliner ("This headliner is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.") could also confuse taxpayers. It is my hope that, upon further review, you will overrule the guidance on §162(l) expressed in Headliner 163 and issue more definitive guidance that is consistent with Congressional intent. Does your agency have any plans to address the issue in a form that carries any higher level of legal authority?

Answer: As discussed below, we believe that the conclusions reached in Chief Counsel Advice (CCA) 200524001 and the Headliner are each correct, but that they address different and distinct issues. Although IRS Headliner #163 (May 15, 2006) does state that its holding is "contrary to the holding in CCA 200524001," we believe the author meant to say not that the two documents are in conflict but rather that they deal with two entirely different situations. We are, however, studying the situations the Headliner covers and are seeking additional information to determine whether clarification or other steps would be appropriate.

The CCA addresses the issue of a sole proprietor who purchases health insurance in his or her own name. Specifically, the question addressed was whether, under section 162(l), a sole proprietor who purchases health insurance in his or her own name may deduct the cost of the health insurance premiums from the earned income of the business. The CCA held that a sole proprietor may do this and that the sole proprietor can take an above-the-line deduction for the cost of the health insurance premiums, provided of course that the sole proprietor met the other requirements under 162(l).

The Headliner, on the other hand, addresses the issue of health insurance covering S Corporation shareholders. Section 1372 provides that with respect to accident and health insurance premiums paid by an S Corporation on behalf of a 2% shareholder, the S Corporation will be treated as a partnership and any 2% shareholder of the S Corporation will be treated as a partner of such partnership. Moreover, under Revenue Ruling 91-26, 1991-1 C.B. 184, accident and health insurance premiums paid by an S Corporation on behalf of a 2% shareholder as consideration for services rendered are treated like guaranteed payments under section 707(c). As guaranteed

payments, the premiums are deductible by the S Corporation under section 162, and includible in the shareholder's gross income under section 61.

As the Headliner points out, under section 162(l)(5), a 2% shareholder of an S Corporation that is treated as a partner under section 1372 (i.e., premiums paid by the S Corporation) may deduct the health insurance premiums paid by the S Corporation on his behalf as an above-the-line deduction. Thus, under section 162(l)(5), the 2% shareholder can utilize this above-the-line deduction if he or she is treated as a partner under section 1372.

The Headliner also addresses the situation where the 2% shareholder purchases the health insurance in his or her own name rather than having the S Corporation purchase the health insurance on behalf of the 2% shareholder. In that case, section 1372 would not come into play, meaning that the 2% shareholder would not be treated as a partner and the S Corporation would not be treated as a partnership. As a result, it appears the provisions of section 162(l)(5) permitting an above-the-line deduction for a 2% shareholder do not apply.

We have recently become aware, however, that some states may preclude sole-shareholder S corporations from buying health insurance in the name of the S corporation. We understand that this has resulted in the practice of the sole shareholder purchasing the insurance in his or her own name and being reimbursed for premiums by the S corporation. This practice may be technically inconsistent with the requirement of section 162(l)(2)(A) that medical care coverage plans be "established" with respect to the taxpayer's trade or business. Because there appears to be a disconnect between what sole shareholders are doing and the conclusions reached in the Headliner article, we believe it is appropriate for us to study the issue more thoroughly.

From Senator Kerry:

1. In your testimony, you specifically mention information sharing. Do you believe legislative changes need to be made to Internal Revenue Code Section 6103? If so, what changes would you recommend? What safeguards should be included to protect taxpayer privacy?

Answer: Modifications to section 6103 should be carefully considered. If section 6103 is modified to allow for disclosures by the IRS to the SEC, the SEC should be required to keep information from the Service confidential, except as needed to enforce disclosure requirements and remedies under SEC's then-existing disclosure regime. More generally, the SEC should be required to follow the tax information security guidelines for federal agencies, which provides safeguards for protecting tax returns and return information, and should be required to make an annual accounting of these disclosures, which are reported annually to the Joint Committee on Taxation.

2. It is my understanding that currently the Department of Justice and the SEC can provide the IRS with information, but due to section 6103 the IRS is restricted from providing information. In the response to my July letter about this issue, you indicated that you were not aware of backdating until the media wrote about it. The SEC indicated that they were aware of

backdating in 2003. Why were there not communications between the SEC and the IRS about the backdating of stock options?

Answer: The SEC's focus regarding the issuance of backdated stock options was in conjunction with addressing corporate governance and securities irregularities associated at the time of issuance of such options, and not the tax impact of backdated stock options which is driven by the exercise of the backdated stock options that typically occurs several years after the issuance.

3. What are the possible changes that can be made to section 162(m) that would make this provision more of a deterrent to companies?

Answer: The Service has reviewed the statute and found that the following rules are easy for taxpayers to avoid through planning and therefore might be candidates for a legislative change:

- The clause requiring the covered employee to be employed by the corporation on the last day of the tax year (162(m)(3)(A)): The limitation could apply to the year of departure without regard to whether the executive was employed on the last day of the tax year. Companies use this requirement as a planning tool to avoid the limitation.
- The definition of covered employee: this provision does not include all individuals whose compensation is required to be disclosed under applicable SEC requirements (162(m)(3)(B)). For example, generally the principal accounting officer's compensation is required to be disclosed but he or she may not be a covered employee.
- The performance-based exceptions (162(m)(4)(C)): more specific standards for performance measures could be set and the requirements of performance goals/measures could be strengthened (162(m)(4)(C)(i)).

In addition, greater transparency would be achieved if corporations were required to disclose the performance goals and the measures used to determine successful performance.

4. Recently, it has come to my attention that the IRS will close ten paper tax return submissions facilities, including the facility in Andover, MA. What is the rationale for closing this facility?

Answer: Over the past several years, the IRS has gained efficiency from the increase in electronically filed (e-filed) returns and the decrease in the more labor-intensive paper returns. The number of individual e-filed returns has grown from 4 million in 1990 to an estimated 73 million in 2006, reducing the need to manually process paper returns. E-filed individual returns now exceed paper filings by more than 10 million.

As a result of the decrease in paper return filings, the IRS must plan for a corresponding reduction in staffing needs for paper processing activities. Consolidation and centralization of paper processing into fewer sites is a key element in our overall strategy to streamline the IRS and improve efficiency and customer satisfaction. Toward that end, the Brookhaven, New York Submission Processing Center was closed in January 2003, followed by the Memphis, Tennessee site in September 2005. The Philadelphia Submission Processing function is scheduled to close effective September 30, 2007, and, based on our consolidation strategy, the Andover Submission

Processing Center will cease operations on September 30, 2009. At this point in time, our efforts are focused on Philadelphia because that consolidation is much more imminent and requires our full attention. We anticipate working exclusively on the projected Andover consolidation beginning late in 2007, or early 2008.

We conducted an extensive business analysis before making any consolidation decisions. The analysis included real estate costs, labor market factors, and economies of scale as well as other qualitative factors. Our business case will result in greater efficiencies throughout the agency.

5. What will happen to the 1,900 employees at this facility and its satellite offices in Massachusetts?

Answer: As of September 2, 2006, there are 1,731 employees assigned to Andover's Submission Processing operation. The following table summarizes the types of appointments and the overall decrease seen in total career conditional permanent and seasonal Submission Processing employees over the last 3 years:

Type of Appointment	As of 9/6/03	As of 9/2/06
Permanent Full Time	422	285
Permanent Part Time	6	6
Seasonal Full Time	989	592
Seasonal Part Time	210	110
Term	160	627
Temporary	0	111
TOTAL	**1,787**	**1,731**

Source Data: IRS Human Resources Reporting Center/Strength Report for Centers

As part of its recruitment efforts for the 2003 filing season, Andover began hiring term employees as a strategy to mitigate the impact of consolidation on our employees. Since that time, the career conditional workforce (full and part time) in Submission Processing has declined by almost 40%, from 1,627 employees to 993. In contrast, higher-graded permanent jobs in our Compliance function at the Andover campus have seen a net increase of about 250 positions. We are hopeful that, with three years remaining before the Andover site consolidates and with strong emphasis on employee communication, even greater progress will be made in reducing the number of impacted employees.

The Andover campus will continue to be a viable employment center for other IRS operations after we close the submission processing site, and we are committed to exploring every option that will minimize negative employee impact. For example, even though it is too early for specific details to be available, we already know that additional positions will be created to support a residual mail support operation and that the e-file help desk operation will remain in Andover.

When we begin to work more exclusively on the Andover consolidation, we will also have the cumulative benefit of lessons learned in Brookhaven, Memphis and Philadelphia and will leverage that to full advantage in order to make the Andover consolidation as smooth as possible. For example, job fairs can be organized to support our employees in their job search efforts and job swaps can be approved to further reduce the number of employees who might be subject to involuntary separation. The benefit of more formal mitigation strategies such as Reassignment Preference Notices (RPNs) and, subject to OPM approval, VERA/VSIP (early out/buyout) opportunities will also be extended to impacted employees. Based on our current experience in Philadelphia and in accordance with our National Agreement with NTEU, these options will become available to employees approximately one full year in advance of an anticipated Reduction in Force (RIF).

There are currently a significant number of IRS employees across all business units who either work on the Andover campus or who work at remote locations but are assigned to Directors on the campus. There are no plans to consolidate business units other than submission processing. A breakdown of positions is summarized below based on data available through September 2, 2006.

Summary of Staffing by Business
Andover Campus

Business Unit	**Total Employees**
National Headquarters	95
Agency Wide Shared Services	117
National Taxpayer Advocate	39
Criminal Investigation	44
Information Technology Services	87
Wage and Investment	4,137
Small Business/Self Employed	6
Large & Mid-Size Business	4
Total on rolls as of 09/02/06	**4,529**
Minus Submission Processing (W&I) employees	**1,731**
Remaining Andover Campus population	**2,798**

Note – of the 4,137 W&I employees that report to the Andover campus, 1,175 work in locations outside the Andover commuting area in the following Posts Of Duty: Baltimore, Pittsburgh, Richmond, Buffalo, and Cincinnati.

Source Data: IRS Human Resources Reporting Center/Post of Duty and Building Reports

6. I understand that the IRS will close paper return submission facilities as e-filing becomes more prevalent. For 2005, how many returns were e-filed and what was the increase from 2004?

Answer: The nationwide total of individual e-filed returns for 2005 was 68.5 million, which was about a 7.1 million increase from 2004. The projected end-of-year total for 2006 is 73.0 million.

7. Has the amount of paper returns filed increased for 2005?

Answer: The nationwide total of individual paper returns for 2005 was 64.6 million, which was a decrease of 5.3 million from the prior year. The projected end-of-year total for 2006 is 61.7 million.

Testimony of

Paul J. McNulty
Deputy Attorney General
United States Department of Justice

"Executive Compensation: Backdating to the Future, Oversight of Current Issues Regarding Executive Compensation including Backdating of Stock Options; Tax Treatment of Executive Compensation, Retirement and Benefits."

September 6, 2006

Chairman Grassley and Members of the Committee, thank you for the opportunity to be here today to discuss the practice of backdating stock option grants to executives at publicly-held corporations. As you know, this practice received wide-spread publicity when it was initially uncovered, and it is now being investigated by civil regulators and by the Department of Justice.

Let me begin my testimony with a brief description of the mechanics of this practice and then discuss how it can violate the criminal statutes. Options are contractual rights to purchase a share of stock on a future date at a set price (known as the "strike" price"), and they are often granted to corporate employees as part of their compensation package. Under most plans, the employees cannot exercise the options until a vesting period has passed. Typically, the strike price is the market or trading price of the stock on the day the option was granted by the corporation's board of directors, commonly acting through its compensation committee. The employee can buy the stock at the end of the vesting period at the strike price and realize a profit by selling it when it is trading at a higher price than the strike price. Thus, options are often

granted to give employees incentives to work hard – their hard work will theoretically result in more profit for the company and a corresponding increase in the market price of the stock.

Of most concern in the practice of backdating options is that when certain options are granted the options are already "in the money" or show a profit to the option-holder. It might be beneficial to define some of these terms so that in discussing this issue, we are all using a common vocabulary. Let me differentiate between "at the money" and "in the money." Options with a strike price equal to the current trading price of the underlying stock are referred to as being "at the money" and options with a strike price below the current trading price of the stock are "in the money." The practice we are investigating involves stock options that are backdated so that they are "in the money" at the time of the grant. Options that are "in the money" give the option-holder a paper profit, since they have a value based on the difference between the strike price and the current higher trading price, even though the employee has not exercised the option and sold the stock. When options are backdated in this way, the strike price is fixed on a certain date when that day's market price for the stock was lower, but in actual fact, the options were granted at a later date when the share price of the stock was higher. The practice of backdating allows corporate wrongdoers to fix a lower strike price for the options, locking in an immediate gain to the option holder.

Significant accounting, disclosure and tax consequences resulting from grants of "in the money" options provide an incentive for corporate executives to covertly backdate these options. As a result, some corporate executives have engaged in schemes to falsify corporate books and records, to mislead the corporation's board of directors and outside auditors, to file false reports

and financial statements with the Securities and Exchange Commission (SEC), and to mislead shareholders, the investing public and the financial press.

How can stock option backdating become a crime? There are several possibilities. First, a grant of "in the money" options is treated under accounting principles as compensation to the option holder, and therefore should be treated as an expense by the corporation and be deducted from reported revenue. In contrast, grants of options with an exercise price either above or at the trading price on the real grant date are not considered an expense of the corporation. Thus, if a corporation both backdates options and prices them "in the money" without properly disclosing this fact, the corporation is falsifying its books and records, fraudulently decreasing expenses and falsely inflating profits. Second, backdating of stock options also conceals the fact that employees are being given the right to purchase the underlying stock at a discount from the fair market value on the date the option was really granted – and that misrepresents the employee's compensation. Finally, the sale of the underlying stock to these favored employees at a discount to the market price dilutes the value of the shares held by stockholders.

Corporations are required to accurately report compensation and other remuneration to officers, including the nature of the compensation. Corporations are also required to accurately describe the stock option plans for which they request shareholder approval. When stock options are surreptitiously backdated, the corporation will file false and misleading reports and financial statements with the SEC and other regulatory authorities. By doing that, the corporation disseminates false and fraudulent information to the investing public. Failing to report the backdating of options misrepresents the true nature of stock option plans and executive compensation and thus, a company obtains shareholder approval for the company's

compensation plans under false pretenses. Grants of backdated options contrary to the terms of shareholder-approved option compensation plans can also be considered an embezzlement of corporate assets because the defendants are misappropriating shares of the company at an unauthorized and discounted value.

Secretly backdating options to a date with a lower market price may also have tax consequences for the employee and the corporation. If the stock option is a qualifying Incentive Stock Option, the employee can, under certain circumstances, defer tax for many years and pay tax at lower capital gains rates. However, to qualify as an Incentive Stock Option, the option price must not be "in the money" or less than the fair market value at the time of the grant; otherwise, the employee must pay ordinary income tax rates when the option is exercised. Also, corporations may not qualify under the Internal Revenue Code for certain deductions for stock issued under "in the money" options to highly paid executives. Consequently, backdating options may lead to the filing of false tax returns by the corporation and the employee if the true nature of the option is misrepresented.

When this practice was first disclosed, the Department of Justice moved quickly to determine whether it warranted criminal investigation. Many companies had restated their earnings and made public filings to that effect. At the same time, the United States Attorneys' Offices throughout the country, assisted by agents of the Federal Bureau of Investigation, initiated contact with the SEC and began to investigate. In Silicon Valley, where much of this backdating occurred, an organized team approach to assess the criminal implications of backdating was needed. On July 13, 2006, the United States Attorney for the Northern District

of California announced the formation of a stock options backdating task force to investigate allegations that corporations and individuals in Northern California had "retroactively changed the grant dates of stock options with the intent to defraud." The Task Force, consisting of personnel from the United States Attorney's Office and the FBI, is investigating companies in the Northern District of California to determine whether any of these companies or individuals engaged in fraudulent option backdating or related criminal conduct.

To date, there have been two criminal cases filed alleging that backdating of options constituted violations of the federal securities laws and other criminal statutes. In *United States v. Reyes, et al.*, an eight count indictment was filed in the United States District Court for the Northern District of California, charging the former CEO, President and Chairman, and the former Vice President of Human Resources of Brocade Communications Systems, Inc., with conspiracy, securities and mail fraud and falsifying books and records. The allegations involve a scheme from 2000 to 2004 to defraud Brocade, the Board of Directors, its shareholders and auditors, the public and the SEC when the defendants caused the corporation to grant "in the money" options to both new and current employees by backdating documents to make it appear the options were issued at fair market value -- concealing millions of dollars in expenses from investors. The defendants allegedly created false documents such as employment offer letters and compensation committee minutes which purported to document that options were granted to employees earlier and at a lower price than they actually were granted. The government alleges these activities resulted in the creation of false and misleading financial statements, audited reports and other documents and false filings with the SEC.

In *United States v. Jacob Alexander, et al,* in a Criminal Complaint filed in the Eastern District of New York, the former CEO, CFO and General Counsel of Comverse Technology, Inc., are charged with conspiracy to commit securities fraud, wire fraud and mail fraud for a fraudulent scheme between 1998 and 2002 to grant secretly backdated "in the money" options to themselves and others. It is alleged that they backdated stock option grants to coincide with low closing prices of the underlying stock. According to the Complaint, two of the defendants also created a "slush fund" by causing backdated options to be issued to fictitious employees and later used these options to recruit and retain key employees. Finally, it is alleged that they made material misrepresentations to Comverse investors, issued false proxy statements, and filed false reports and financial statements that concealed and misrepresented the results of operations and expenses of Comverse.

The cases I have just described have only recently been indicted and the defendants are presumed innocent of these allegations, unless and until proven guilty in a court of law.

Backdating cases that are viewed as appropriate for criminal resolution are being prosecuted on the theory that the defendants violated the federal securities statutes and other anti-fraud statutes by (1) falsifying corporate books and records to conceal the fact that option grants were backdated; (2) causing the preparation of false and misleading financial statements and other documents; (3) lying to the corporation's board of directors, and auditors and the SEC; and (4) misleading investors and the financial press and filing false reports with the SEC. In other words, our theories of prosecution are concerned with the accuracy and adequacy of disclosure of material information and, in that respect, they are similar to many other DOJ prosecutions for

corporate fraud. Our corporate fraud indictments typically allege falsification of books and records, concealment of material information, causing false and misleading information to be disseminated to the investing public and financial analysts, and filing false reports and documents with the SEC.

In discussion of this issue, defense counsel and corporate officials have argued that granting "in the money" options is not *per se* illegal and may serve a legitimate corporate purpose in attracting and retaining the most competent employees in the industry. Let me emphasize this -- we do not attack the legitimacy of granting "in the money" options if the practice is fully disclosed and shareholder approval is obtained where necessary. Our cases concern falsification of corporate records, concealment and misrepresentation in the way in which the options were granted and priced, and deceptive conduct that may mislead the corporation, its directors, auditors, shareholders, and the investing public. Indeed, in the *Alexander* case the defendants are alleged to have falsely promised institutional investors that the company would not grant "in the money" options at the very same time the defendants were causing the company to grant such options by secretly backdating them.

In addition to the charges I previously mentioned, fraudulent conduct involving backdated options can be investigated and prosecuted under other criminal statutes enacted as part of the Sarbanes-Oxley legislation, such as securities fraud, 18 U.S.C. § 1348; knowingly certifying false statements filed with the SEC, 18 U.S.C.§ 1350; destroying, falsifying or altering records in federal investigations, 18 U.S.C. § 1519; and destroying corporate audit records, 18 U.S.C. § 1520. Of course, some of this conduct may predate Sarbanes-Oxley, and in those instances, that

legislation cannot be used. These cases may also be amenable to prosecution under criminal statutes relating to obstruction of justice, perjury, and criminal tax violations. Thus, the Department can rely on a number of statutes in charging this conduct. To the extent that the Committee is considering taking action to prevent this practice, the Department has a range of statutory options and it is not requesting any new legislation to deal with this specific problem.

The practice of stock option backdating to conceal information from corporate boards and regulatory authorities can only be seen as a brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders. By fraudulently backdating grants, defendants evade significant accounting, disclosure and tax requirements that flow from granting "in the money" options. Properly accounting for these grants would have reduced reported corporate earnings, created tax liability for option recipients and the company, and obligated the company to inform shareholders that it was offering stock at a discounted price. For some of those companies that have now disclosed backdated grants, corporate reputations have been tarnished and shareholder value has diminished substantially.

Like other forms of corporate fraud, the Department of Justice takes stock option backdating seriously, and we will continue to use our best efforts to uncover criminal conduct where it occurs. While we cannot say at this juncture how many cases we will ultimately investigate or what number will be more appropriately resolved as criminal, rather than as civil matters, we are committed to using the resources of our experienced securities fraud prosecutors and investigative agencies throughout the country to ensure that each matter we open is

thoroughly investigated. Moreover, as Chairman of the Corporate Fraud Task Force, I made this issue a top priority during our July 27, 2006, meeting, and there was a productive discussion about backdating with task-force member agencies. In addition to the SEC, the Internal Revenue Service is now reviewing this practice to determine the tax consequences for companies and executives. In short, federal law enforcement agencies are working together to prevent fraudulent stock option backdating practices and to promote transparency in corporate governance whenever we are able to do so. This is a duty we owe to the American people, whose hopes, dreams and futures are tied more and more to the integrity of our stock markets.

Thank you again for the opportunity to appear before you today, and I look forward to answering the Committee's questions.

Committee on Finance
United States Senate

September 6, 2006

Hearing on
"Executive Compensation: Backdating to the Future
Oversight of Current Issues Regarding Executive Compensation, Including Backdating of Stock Options; and Tax Treatment of Executive Compensation, Retirement and Benefits"

Responses of
Paul J. McNulty
Deputy Attorney General
Department of Justice

Questions From Chairman Grassley:

1. I think this question is primarily for Justice but I encourage the other panelists to comment. These backdating stock options cases are across the country and as we see with today's hearings involve many different legal issues that are the responsibility of different branches of the federal government.

While your testimony touches on this, I wanted you to expand a little further about how Justice is coordinating these cases geographically and across different agencies to encourage uniformity of treatment of similarly situated individuals to the extent possible.

As you answer that, I'd also like to understand better how many legal actions you anticipate or estimate taking - that is how many executives and companies will be affected at the end of the day by this backdating? And finally, what steps is the federal government taking to ensure there are adequate staffing resources to investigate and prosecute these cases?

ANSWER: The bulk of the stock option backdating cases are being investigated in two districts, the Northern District of California and the Southern District of New York. Two stock option backdating cases have been filed: *United States v. Reyes et al.* in the Northern District of California and *United States v. Alexander et al.* in the Eastern District of New York. Because of the concentration of these types of cases in a limited number of jurisdictions, no national task force has been created. However, the Northern District of California created its own task force to review cases in an effort to make criminal charging decisions before the statute of limitations on certain conduct has expired. Since so few cases have actually been charged to date, no issue has arisen with respect to disparities in charging among districts. The Department anticipates

that relevant criminal charges, if criminal conduct is identified, will include securities fraud, mail fraud and the falsification of books and records violations.

The Department cannot anticipate how many criminal cases will be filed. Backdating is not a *per se* illegal activity so the fact that backdating occurred is not determinative of whether we bring a criminal prosecution. Backdating becomes criminal activity when done by fraudulent means, such as preparing and misusing false documents to misrepresent the date of the grant, utilizing fraudulent information to obtain authorization from the corporation's board of directors and shareholders to authorize the options, deceiving auditors to conceal the scheme, or filing false and misleading reports with the SEC. Proving these deceptive practices is much more difficult than proving a particular company engaged in this practice.

The Department is working jointly with the Securities and Exchange Commission to ascertain which cases are better resolved civilly and which cases warrant criminal investigation. The Department is in contact with the districts investigating these cases and it has been assured that staffing levels are sufficient to pursue backdating investigations. These investigations are also a priority of the investigating agencies, the Federal Bureau of Investigation and the U.S. Postal Service. Should circumstances change and we perceive a need for additional staffing, trial attorneys in the Fraud Section at Main Justice are available to participate in these prosecutions as they have done in the past.

2. This question is for the panel. It is my understanding that the board also often played a role in the backdating of stock options.

The New York Times reported this Sunday that the SEC recently informed the board of Mercury Interactive, that the SEC was considering filing a civil complaint against three board members in connection with backdating.

The rules of corporate governance place great emphasis that board members are there to represent the shareholders. If the board members are not doing their job of putting the shareholders first -- that hurts investors and ultimately our economy. What is the panel's views on holding board members responsible -when is that appropriate in backdating and what actions can we expect fiom the federal government in this area?

ANSWER: The assumption that the board of directors often played a role in the backdating of stock options may not be accurate. However, to the extent that the members of certain boards of directors played a role in backdating stock options and were subsequently sued by shareholders, any perceived breach of their fiduciary duty to those shareholders is properly handled in the civil context. The Department's interest is to bring criminal prosecutions for fraudulent and deceptive practices related to stock option backdating. The Department will evaluate on a case-by-case basis whether any board member is implicated in a scheme to prepare or use false documents to misrepresent grant dates or file false reports with the SEC. We cannot comment on the specifics of pending investigations in this regard.

Questions from Senator Kerry:

1. Do you recommend any legislative changes that would help you crack down on backdating?

ANSWER: The Department does not recommend further legislation to supplement the criminal violations we could already charge for fraudulent options backdating. Moreover, in 2002, the SEC amended its rules and regulations to require option grants to be reported to the SEC within two business days. This reporting restriction makes it much more difficult for companies to argue that grant dates were selected weeks or months earlier and sloppy paperwork practices were the cause for late reporting. In 2006, as part of its comprehensive changes to disclosure requirements of executive and director compensation, the SEC also adopted changes to the rule requiring disclosure by reporting companies of additional information relating to corporate plans to grant options. We believe that these reporting requirements will go a long way toward curtailing fraudulent options backdating in the future.

2. Should backdating be illegal?

ANSWER: The practice of backdating should not be made illegal. If backdating is fully disclosed, the practice is condoned by the company's board and the shareholders, and taxes are paid by the appropriate parties in compliance with the tax laws, it is not criminal activity. With the 2002 change in reporting, however, studies have shown that backdating is not as prevalent as it once was.

3. Are they any legislative changes that you would recommend in the area of executive compensation, including disclosure?

ANSWER: The Department defers to the SEC to recommend legislative changes, if necessary, in the area of executive compensation and disclosure. The SEC has already implemented extensive changes through its rule-making. *See Executive Compensation and Related Person Disclosure*, Release No. 34-543-2 (July 26, 2006).

United States Senate
Committee on Finance

Testimony of Nell Minow
Editor, The Corporate Library
September 6, 2006

Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern.

The economist John Kenneth Galbraith said, "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."

He said that in the 1950's. The primary change since then is the number of zeroes at the end of the figures.

My firm, The Corporate Library, maintains an extensive database on corporate governance in public companies, and that includes a great deal of information and analysis of executive compensation. The data show that the disparity between pay and performance is enormous and growing.

Backdating and spring-loading of options are only the latest in a series of abuses and dodges that have escalated CEO pay to levels that Marie Antoinette would have been embarrassed by. I am particularly outraged by those who suggest that there is nothing wrong with this manipulation. Everything is wrong with it.

The entire justification for options is to align the interests of management with those of the shareholders. The great challenge of capitalism is exactly this issue – how do you keep the managers as committed to creating shareholder value as those who are providing the capital? Options seemed like a good answer, and that was the theory behind 162-M. But, as you know, that well-intentioned provision has had unanticipated perverse consequences.

When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance, two things happened. First, everyone got a raise to $1 million. Second, everyone got boat-loads of options. The very definition of a "mega-grant" had to be changed, so it now can be as much as eight times the CEO's base pay and bonus.

Option grants only work when:

1) The executives make money based on how the company does, not on overall market gains,

2) The number of options is not so excessive that there is a mountain of pay-out for a molehill of performance, and

3) All information relating to the options is promptly, clearly, accessibly, and comprehensibly disclosed.

The failure of 162-M shows how difficult it is for the federal government to address the issue of executive compensation. Ever since 1789, corporate governance has been a matter of state law. So, at the federal level, our only tools are the tax code and disclosure requirements. The result has been a sort of whack-a-mole game, as every time we slam down one abuse, others start popping up.

Back-dating and spring-loading have been among the most shocking, however, because they so fundamentally subvert the entire justification for option-based compensation. If options are supposed to align the interests of shareholders and executives, then it is monumentally unfair for executives to get a chance shareholders do not to retroactively change the starting of the clock. I can just imagine the reaction if an investor called his broker to say that he'd like to change his mind and move the date of his last purchase of stock to another time, when the share price was lower.

I am appalled by those who suggest there was nothing wrong here. If, in fact, it was not illegal, it is only because it is such an obvious outrage no one thought outlawing it was necessary. Apologists have suggested that it was just a clever way to grant executives more compensation in the pre-expensing days without having to take a hit to the income statement. If that is true, what did they have to hide? Why didn't they disclose it? And why would we want to give executives more compensation if it wasn't tied to performance?

I have also heard the argument that even pre-expensing investors could tell the cost of the options from the disclosures in the financials. This analysis completely ignores the other ways that investors use the information that executives have received in-the-money options. There's informational value in companies' compensation practices, so telling investors that all the options are at-the-money when they are not misleads investors, who could use the information to (1) make decisions about the management team's abilities, (2) decide how to vote the next time an equity compensation plan came up for a vote, (3) decide whether to withhold votes from members of the compensation committee and (4) evaluate whether to sell the stock. In January 2000, I wrote a report noting a problem at one company because it gave the CEO two million options at $10 a share below market. It seemed clear that was a bet that the stock was going to decline in value. I got a lot of criticism; it was the fastest-growing stock in the history of the NYSE. But I was right. That company, Global Crossing, was soon to set another record as the fourth-largest bankruptcy in U.S. history.

If there is nothing wrong with the compensation arrangements, companies should be happy to provide full disclosure to encourage and reassure investors that their interests are paramount.

Earlier this year, The Corporate Library conducted a special study for our latest CEO compensation survey, designed to test whether the highest compensation increases in the S&P 500 reflected significant long-term improvements in company performance. The results of the study showed that the largest percentage increases in total compensation had very little connection to long-term value creation. This table shows the examples of the greatest disparity between pay and performance:

Company Name	Ticker	Fortune Rank	Current CEO	Total CEO compensation in last two fiscal years	TCL Rating	5-Year TSR	Performance vs. Peers
AT&T Inc.	T	33	Edward E. Whitacre	$34,435,596	D	-40.32	Underperformed
BellSouth Corporation	BLS	87	F. Duane Ackerman	$22,747,700	D	-26.33	Underperformed
Hewlett-Packard Company	HPQ	11	Mark V. Hurd	$27,056,129	D	-9.88	Underperformed
Home Depot, Inc. (The)	HD	13	Robert L. Nardelli	$50,717,002	F	-19.05	Underperformed
Lucent Technologies Inc.	LU	247	Patricia F. Russo	$17,317,113	F	-82.05	Underperformed
Merck & Co. Inc.	MRK	84	Richard T. Clark	$40,754,311	D	-49.80	Underperformed
Pfizer Inc.	PFE	24	Henry A. McKinnell	$26,365,439	D	-34.11	Underperformed
Safeway Inc.	SWY	46	Steven A. Burd	$33,510,855	D	-54.99	Underperformed
Time Warner Inc.	TWX	32	Richard D. Parsons	$26,058,130	D	-57.71	Underperformed
Verizon Communications Inc.	VZ	14	Ivan G. Seidenberg	$26,580,200	D	-26.83	Underperformed
Wal-Mart Stores, Inc.	WMT	1	H. Lee Scott	$27,961,065	D	-13.90	Underperformed

It's a very small group in the stratosphere of pay: rock stars, movie stars, athletes, investment bankers, and CEOs. Of that group, the first four are in the ultimate pay-for-performance category, with a tiny percentage at the very top making millions of dollars, and with deals that evaporate quickly if a movie, a CD, or a business deal tanks. Their pay is set through tough arms-length negotiations.

CEOs are the only ones who pick the people who set their pay, indeed they pay the people who set their pay. And no matter what "independence" standard we try to impose, the board room culture of congeniality and consensus is so powerful that it makes it very hard to object, especially when the compensation consultant helpfully provides an avalanche of numbers designed to justify pay increases. In the wonderful world of CEOs, like the children in Lake Woebegon, everyone is above average. Even Warren Buffett acknowledges his own failings as a director, particularly in approving excessive compensation: "Too often, collegiality trumped independence." If Warren Buffett, always a significant shareholder in any company on whose board he serves, does not feel able to oppose excessive pay, something is wrong.

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for*

Charismatic CEOs, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

Disclosure is important. The SEC's new rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:

1. Accelerated vesting of options
2. Manipulation of earnings to support bonuses
3. Imputed years of service
4. Setting the bar too low (guaranteed bonus)
5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

Until we remove the impediments to a market response from shareholders, we will never be able to address these problems.

I leave you with two key points. First, executive compensation must be looked at like any other allocation of corporate assets. Currently, the ROI for executive pay does not measure up to just about any other use of corporate capital.

Second, the pay-performance disparity is so outrageous, so atrocious that in my opinion it undermines the credibility our system of capitalism. In a global environment, information and the ability to trade in any market at any time will provide our system with the toughest market test in the history of our country. As we compete for capital, we must be able to show those inside and outside our country that we deserve their trust and will provide them with a competitive return instead of shoveling more money into the pockets of the top executives.

Ultimately, as long as the CEOs determine who sits on their board, and, in the overwhelming majority of cases, who sits on the compensation committee, the real mis-aligned incentive we have to worry about is the incentive of the compensation committee members to give the CEO whatever he wants.

We speak of the "election" of directors, but management picks the slate, no one runs against them in well over 99% of the cases, and management counts the votes. Even one vote for a candidate will insure his election. In my opinion, a requirement that board candidates get a majority of votes cast and, as in the UK, the ability of shareholders to vote on CEO compensation are meaningful changes that will be effective in addressing the abuses.

Many thanks, and I will be glad to answer any questions.

Questions for the Record From Ms. Nell Minow
September 6, 2006

From Chairman Grassley:

1. For the record, I'd like to get the panel's views on these three questions. How would you rate the results of efforts to deal with what are viewed as high corporate salaries through the tax code such as section 162(m)?

As I discussed in my testimony, I believe that 162(m) had the perverse consequence of contributing to the increase in CEO compensation and the further disconnect between pay and performance. Once the maximum deductible salary level was set at $1 million, just about every CEO got a raise to that level. And once stock option awards were deemed per se tied to performance, the number of options granted mushroomed. I think that as well-intentioned as it was, 162(m) could not have produced results further from those intended if it had been designed to do the opposite.

The second question, do you believe that improved transparency as recently proposed by the SEC is more effective than the tax code in dealing with high corporate salaries?

Yes, I believe transparency is more effective than the tax code. However, it must be in the context of some ability on the part of investors to act on the information made available to them.

And finally, how important is it that we have improved governance and independence of board members, that several of you have cited in your testimony, if the SEC's new transparency rules are going to have a strong impact on addressing high corporate salaries?

The new transparency rules are an essential but not in and of themselves adequate component of a structure for creating a tighter link between pay and performance. Those in the best position to ensure appropriate pay are the members of the board, especially the compensation committee. As long as the CEO controls the make-up and committee assignments on the board, there is no such thing as "independence." Our studies show that the single biggest predictor of excessive compensation is the number of sitting CEOs on the compensation committee. While those directors may be considered "independent" under the SEC and NYSE definitions, their records show that they have not been independent or effective in their judgments.

2. I would ask the panel two questions. First, Ms. Minow, you did a good job of highlighting in your testimony what are some of the current practices in executive compensation, and I was wondering if you could expand on those, particularly those with a tax play?

Some of the practices that concern me are: "imputed" years of service and other manipulation of the pension system for CEOs, disparate treatment for CEOs on all forms of deferred compensation (we recently issued a report on the only group of employees still overwhelmingly covered by defined benefit plans—CEOs), manipulation of the "peer group" to support higher pay, accelerated vesting of options to avoid the new accounting rules, spring-loading and bullet-dodging timing in option grants (harder to discover and prevent than back-dating but just as harmful). I am not a tax expert by any means, so I cannot provide any guidance on the role that the tax rules play in creating incentives and loopholes for these various elements of pay.

I also would ask the rest of the panel for their comments on what they believe are the new things out there in executive compensation that give you pause or concern and that should be considered by Congress.

Second, I would ask the panel do you believe it is possible to estimate the amount of known performance pay that escapes taxation under section 162(m), and if so, what is that amount? You can round up to the nearest billion.

I do not have an estimate for this calculation.

From Senator Kerry:

1. *Should backdating be illegal?*

It is virtually prohibited now by Sarbanes-Oxley, and to the extent it is permitted, it must be disclosed.

I believe those limits are adequate.

2. *Are there any legitimate instances in which backdating should be allowed?*

No.

3. *What can be done to prevent spring-loading?*

Increased adoption of "pre-programmed" or "automatic pilot" plans with specified regular times for stock awards and stock sales can be used to avoid spring-loading and bullet-dodging if they are carefully designed.

4. *What are your recommendations for making boards more accountable?*

I believe that shareholders must have the chance to remove directors who do not earn their confidence. I support a majority vote requirement (which could be adopted through listing standards) and access to the proxy for shareholder nominees under limited

circumstances. But it as important to examine the "demand side" of corporate governance as the "supply side." The Labor Department has never been effective at examining or enforcing the fiduciary obligation of pension trustees with regard to the exercise of share ownership rights, and as a result conflicts of interest prevent effective oversight. The same goes for the banking regulatory agencies that have authority over trust departments, the SEC, which has authority over money managers and mutual funds, and the IRS, which has authority over foundations and endowments. This could be the subject of a worthwhile GAO study.

5. Are they any legislative changes that you would recommend in the area of executive compensation, including disclosure?

I support the "say-on-pay" legislation.

6. Do you think changes need to be made to Code Section 162(m)? Do you think it is appropriate to limit the amount of compensation that a company is able to deduct? If so, what is an appropriate limit?

I would not have a ceiling on base pay or a per se assumption that all stock option awards are performance-based. I would give a safe harbor only to stock option awards that are indexed to the market as a whole or to the industry and otherwise put the burden of proof on the company to demonstrate that the award ties pay to performance.

Testimony of Linda Thomsen
Director, Division of Enforcement
U.S. Securities and Exchange Commission

"Executive Compensation and Options Backdating Practices"

Before the United States Senate
Committee on Finance

September 6, 2006

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I. Introduction

Thank you for inviting me to testify today about the tax aspects of options backdating. I am pleased to testify next to Deputy Attorney General Paul McNulty and IRS Commissioner Mark Everson. While each of us has different law enforcement responsibilities, backdating can impact criminal and tax laws as well as the federal securities laws. Because of this, I want to assure the Committee that the SEC's Enforcement staff has been sharing information with the Department and the Service as warranted and appropriate. Recently, in fact, the Commission and the Department of Justice jointly announced the filing of two enforcement actions concerning backdating.

Today, I hope to provide the Committee with an understanding of our law enforcement efforts relating to stock options as they, in turn, relate to your interest in overseeing our tax laws. I realize, however, that your interests may go beyond what I, as Director of the Division of Enforcement, can expertly speak to in my testimony, so I am appending a copy of the testimony being given today in the Senate Banking Committee by my Chairman, Chris Cox, also on the issue of options backdating.

II. Options Backdating Practices

In a simple stock option, a company grants an employee the right to purchase a specified number of shares of the company's stock at a specific price, known as the exercise price. The exercise price is usually set as the market price of the stock on the grant date, or "at-the-money." If an option is awarded at a lower market price, it is said to have been granted "in-the-money." Typically, an employee cannot exercise the option and acquire the underlying stock until the passing of a specified period of time, known as the vesting period. Options generally vest in equal but staggered amounts—for example, 20 percent per year over five years. Once vested, options generally are exercisable until they expire; however, when an employee leaves a company, he or she generally loses any

unvested options and has only a limited period (such as 90 days) to exercise options that have already vested. Such terms are spelled out in a company's stock plan.

Options became more popular after Section 162(m) of the federal tax laws went into effect in 1993, which limited to $1 million the tax deductibility of compensation awarded to certain top executives. This change in the tax law tilted compensation practices away from salary and other forms of compensation in favor of performance-based compensation to which the cap didn't apply, such as stock options.

As the use of options compensation has increased, however, so apparently has its abuse. We have learned that some issuers and their executives abused stock option programs by improperly backdating grant dates. The type of "backdating" I'm referring to is the practice of misrepresenting the date of an option award to make it appear that the option was granted at an earlier date – and at a lower price – than when the award was actually made. The intent of backdating option grants is to award disguised "in-the-money" options. This allows the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money."

We have also learned that employees, including executives, may at times have backdated option exercises. This practice involves misrepresenting the date an option is exercised to make it appear that the exercise occurred at an earlier date – and at a lower price – than when the exercise actually occurred.

Both of these practices – backdating grants, and backdating option exercises – have tax implications.

A. Backdating Stock Option Grants

Under the federal tax laws, grants and exercises of stock options can have income tax consequences to companies and individuals alike. Various tax benefits can arise from stock options, and often with more favorable tax treatment afforded to at-the-money option grants as opposed to in-the-money option grants. Backdating option grants can seriously imperil these benefits and potentially result in underpayment of taxes, and associated interest and penalties. These implications are best seen in the context of the two common forms of employee options—non-statutory stock options, or "NSOs", and incentive stock options, or "ISOs".

When an employee exercises a non-statutory option, the difference between the exercise price and the fair market value of the company's stock on the date of exercise is treated as ordinary compensation and the employee is generally taxed on the gain at his or her ordinary income tax rates. The company incurs employee withholding obligations on this gain, but also is entitled to an

associated tax deduction on the gain. When companies backdate option grants to a lower exercise price, employees can obtain a larger taxable gain upon the exercise of an NSO and companies can obtain a correspondingly larger tax deduction and withholding obligation on that gain.

Unlike the exercise of NSOs, incentive stock options, or ISOs, afford employees favorable tax treatment because any gain at exercise is not taxed as ordinary income, although the gain may be subject to alternative minimum tax. Accordingly, a company does not obtain any corresponding tax deduction (or incur withholding obligations) at the time of exercise. In addition, if an employee holds the stock for the statutory holding period prior to sale – one year after exercise and two years after grant – then the sale is considered a "qualifying disposition" and the entire gain on sale is taxed at favorable capital gains rates. However, among the statutory requirements of ISOs is that they be granted at-the-money. An ISO that is granted in-the-money loses its favorable status and instead is treated under the tax code as a non-statutory option (NSO), including ordinary income recognition by the employee on any gain at exercise and a corresponding tax deduction by the company on that gain. Backdating allows an employee to treat what is in fact a non-qualified option as an incentive stock option, which can result in the employee underpaying taxes while causing the company to lose the tax deduction to which it otherwise would have been entitled.

Finally, backdating implicates a company's ability to benefit from tax deductions normally available under Section 162(m) of the tax code. Section 162(m) exempts from its $1 million tax deduction cap compensation that is performance-based. Compensation an employee obtains as a result of *at-the-money* option grants is considered performance-based under this provision, because the compensation ultimately received is based solely on an increase in the value of the stock after the date of the grant. Thus, Section 162(m) generally entitles companies to a tax deduction for the ordinary compensation income that a named executive officer recognizes upon the exercise of an NSO or upon the disqualifying disposition of an ISO. However, when options are *in-the-money* on their award date, companies lose these tax advantages. Backdating option grants therefore can result in a company unjustly receiving tax deductions it otherwise would not have been entitled to under Section 162(m).

B. Backdating Stock Option Exercises

So far, I've focused on the tax implications of backdating stock option grants. But we have also seen that executives have backdated option exercises. This practice benefits employees at the expense of shareholders.

As I mentioned earlier, when an employee exercises a non-statutory stock option (NSO), the employee is required to pay taxes on any gain at the time of exercise, measured by the amount the company's stock price on the date of exercise

exceeds the exercise price, and the company receives an associated tax deduction on this gain. Thereafter, if the stock obtained through the exercise is then held for at least one year prior to sale, any additional gain to the employee between exercise and sale is treated as a capital gain under the tax laws.

We have seen that employees may backdate exercise dates to correspond with low points of the closing price of a company's stock. In doing so, they are able to minimize the gain at exercise that they report as ordinary income on their tax returns, while maximizing the capital gains treatment of any eventual profits by starting the clock ticking early on the holding period for capital gains treatment. At the same time, the reduced gain at the exercise of an NSO results in a corresponding reduction in the tax deduction for the company.

Similarly, backdating exercise dates of incentive stock options, or ISOs, also starts the holding period early for the favorable long-term capital gains treatment an employee ultimately can receive at the time of a qualifying disposition.

III. SEC Enforcement Efforts to Address Backdating Issues

With this background, let me describe one of our Enforcement cases that more clearly illustrates the fraudulent option practices I have described.

Symbol Technologies

In 2004, the Commission levied fraud and other charges concerning option exercises as part of a case that involved various fraudulent accounting practices to overstate revenues or earnings. In this case, the SEC charged Symbol Technologies, Inc. and its former general counsel, Leonard Goldner, with manipulating stock option exercise dates to enable certain senior executives, including Goldner, to profit unfairly at the company's expense. The complaint alleged that rather than use the actual exercise date as defined by Symbol's option plans, Goldner instituted, without board approval or public disclosure, a practice of using a more advantageous date chosen from a 30-day "look-back" period so as to reduce the cost of the exercise to the executive. The SEC charged that, to create the false appearance that these exercises actually occurred on the selected dates, Goldner had his staff backdate the requisite transactional documents and use the phony exercise dates in the forms on which the executives reported their acquisitions to the Commission and the public.

According to the complaint, by backdating the exercise to a date when the company's stock price was lower, the executives obtained a benefit at the shareholders' expense: the executives realized less gain at the date of exercise and thus reduced their tax liability, while the company, among other things, received less of a tax deduction for the exercises (by the same amount of the reduced taxable gain to the executives). The complaint alleged that Goldner's regular use of the fraudulent "look back" practice caused Symbol to misstate its

stock option expenses by material amounts—the company's restatement of its improper accounting included a cumulative net increase of $229 million in stock option expenses from 1998 through July 30, 2002. The Department of Justice also filed parallel criminal proceedings against Goldner and another Symbol executive relating to the backdated exercises.

Ongoing Investigations

The SEC's Enforcement Division is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The investigations are being coordinated from our Washington, DC headquarters and are being carried out at our SEC offices nationwide. The companies under investigation are located around the country. They involve Fortune 500 companies and smaller cap issuers. And while a large number of the companies involved are from the technology sector, the companies under investigation span multiple industry sectors.

Because of the importance of these matters and the different laws they implicate, our Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice and the Internal Revenue Service. We continue to be vigilant on the enforcement front.

IV. Conclusion

Mr. Chairman, that concludes my testimony. Thank you again for inviting me to appear before you today on this important subject. I am happy to take any questions you may have.

Testimony of Christopher Cox
Chairman
U.S. Securities and Exchange Commission
"Options Backdating"

Before the Committee on Banking, Housing, and Urban Affairs
United States Senate

September 6, 2006

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today about options backdating. This issue is one of intense public interest because it strikes at the heart of the relationship among a public company's management, its directors, and its shareholders. I appreciate the opportunity to explain the Commission's initiatives to deal with abuses involving the backdating of options.

I am especially pleased to testify together with Chairman Mark Olson of the Public Company Accounting Oversight Board. I will let Chairman Olson speak to the steps the PCAOB is taking to address these issues from the auditing regulator's perspective, but I'd like to assure the Committee, and the public, that the Commission is working in close cooperation with the PCAOB in this important area.

There are many variations on the backdating theme. But here is a typical example of what some companies did: They granted an "in-the-money" option—that is, an option with an exercise price lower than that day's market price. They did this by misrepresenting the date of the option grant, to make it appear that the grant was made on an earlier date when the market value was lower. That, of course, is what is meant by abusive "backdating" in today's parlance.

The purpose of disguising an in-the-money option through backdating is to allow the person who gets the option grant to realize larger potential gains—without the company having to show it as compensation on the financial statements.

Rather obviously, this fact pattern results in a violation of the SEC's disclosure rules, a violation of accounting rules, and also a violation of the tax laws.

The SEC has been after the problem of abusive options backdating for several years. As a preliminary step in explaining the Commission's response to the problem of fraudulent options backdating, it would be useful to put the whole topic of options compensation into some perspective.

As you know, during the last year the Commission has been intensely focused on the quality of disclosure of executive compensation. Very recently, we enacted new rules that will require, beginning with the next proxy season, the full disclosure of all aspects of executive and director pay and benefits. A key component of that disclosure will be

compensation in the form of stock options, which has been a fast growing portion of executive pay since the early 1990s.

Under the new SEC rules, all of an executive's compensation will now be totaled into one number, so that it can be compared easily from person to person, company to company, and industry to industry. The new rules also require detailed disclosure of compensation in the form of stock options, which will show whether a company has backdated options, and if so, why. The purpose of the new executive compensation rules is to make the CEO's pay understandable to the shareholders who own the company.

Of course, no new SEC rules would be necessary to make executive pay transparent, if executives were all paid in the form of salary. But beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.

There are other accounting and tax reasons, as well, that stock options over the years were increasingly included in the compensation packages of executives and non-executives.

Beginning in 1972, the accounting rule was that employee stock options wouldn't have to be shown as an expense on the income statement—so long as the terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day. Indeed, no expense would ever need to be recorded in the financial statements for fixed options that weren't granted in-the-money.

In addition to this favorable accounting treatment, there was a tax benefit. The million-dollar cap on the tax deductibility of executive compensation, which I mentioned earlier, doesn't apply to options granted at fair market value. So for companies that wanted or needed to pay compensation in excess of $1 million per year, the tax code outlawed deducting it if it was paid in a straightforward way through salary, but permitted a deduction if the compensation was paid through at-the-money options.

And of course there were other reasons, many of them good ones with solid economic rationales, that companies wanted to use options as a form of compensation. For example, a properly-structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive markets.

All of these factors have contributed to the now-widespread use of stock options as compensation. But just as option compensation increased, so did the potential for abuse. And Congress deserves credit for taking preemptive action that we now know was critical to stopping the spread of the backdating contagion.

Four years ago, in 2002, the Sarbanes-Oxley Act very presciently tightened up on the reporting of stock option grants. Before Sarbanes-Oxley, officers and directors didn't have to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. So a grant in January might not have to be disclosed until more than a year later. SOX changed that, by requiring real-time disclosure of option grants. And in August 2002, shortly after the law was signed, the SEC issued rules requiring that officers and directors disclose any option grants within two business days.

Not only must option grants now be reported within two business days, but this information was among the first required to be filed electronically using interactive data. Thanks to this new data-tagging technology, the public now has almost instant access to information about stock option grants.

The following year, in 2003, the SEC took another important step that has helped increase the transparency of public company options plans. The Commission approved changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market that for the first time required shareholder approval of almost all equity compensation plans. Companies have to publicly disclose the material terms of their stock option plans in order to obtain shareholder approval.

Very importantly, the required disclosures include the terms on which options will be granted. And companies must tell their shareholders whether the plan permits options to be granted with an exercise price that's less than the market value on the date of grant.

Then, in December 2004, the FASB issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued at-the-money. Since this new accounting rule took effect, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. This rule is nearly fully phased in.

Most recently, in January of this year, the SEC proposed that public companies be required to more thoroughly disclose their awards of in-the-money options to certain executives. The Commission also proposed that companies be required to disclose the fair value of the option on the grant date, as determined under the new accounting rules. The Commission adopted final rules on these subjects on July 26, 2006. As a result, in the next proxy season beginning in the spring, all public companies will now report this information in clear, easy to understand tabular presentations.

The tables will include:

- The grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer);
- The FAS 123R grant date;
- The closing market price on the grant date if it is greater than the exercise price of the option; and
- The date the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.

Because the dates and numbers often don't tell the whole story, companies will also be required to discuss the policies and goals of their compensation programs—in plain English. The reports to investors will describe whether, and if so how, a company has engaged (or might engage in the future) in backdating or any of the many variations on that theme concerning the timing and pricing of options. For example, if a company has a plan to issue option grants in coordination with the release of material non-public information, that will now be clearly described.

So, to recap, here is what has been done by way of prophylactic rules to eliminate the opportunities for abusive backdating. First, Sarbanes-Oxley has closed the disclosure loophole that permitted months and sometimes more than a year to elapse before option grants had to be reported. Second, a new accounting rule—FAS 123R—has eliminated the accounting benefit of granting at-the-money options. And third, the SEC's brand new executive compensation rules now require a complete quantitative and narrative disclosure of a company's executive compensation plans and goals. That enhanced disclosure will make it clear whenever options are being backdated, and it will require an explanation of the reasons.

Each of these steps by itself is an important contribution to preventing backdating abuse. In combination, they have effectively slammed the door shut on the easy opportunities to get away with secretive options grants. That's why almost all of the stock option abuses our Enforcement Division has uncovered started in periods prior to these reforms.

But while these accounting and disclosure rules changes have made it easier to detect and punish backdating abuses going forward, uncovering the problems from prior years has been quite a challenge.

A few years ago, the SEC began working with academics to decipher market data that provided the first clues something fishy was going on. One of the academics with whom the SEC worked was Erik Lie of the University of Iowa, who subsequently published a paper in 2005 that showed compelling circumstantial evidence of backdating.

Dr. Lie's data showed that before 2003, a surprising number of companies seemed to have had an uncanny ability to choose grant dates that coincided with low stock prices.

(In a follow-up paper this year, co-authored with Dr. Randall Heron of Indiana University, Dr. Lie demonstrated that this problem has greatly diminished since 2002, when the Sarbanes-Oxley Act shortened the time for reporting option grants to two business days.)

With a fair amount of detective work, and with the aid of economic research conducted by the SEC's Office of Economic Analysis, the Commission succeeded in turning what had begun as mere evidentiary threads into solid leads. Eventually, some of the evidence we began turning up was so compelling that several U.S. Attorneys took a criminal interest. Over the past several years, our inventory of backdating and related investigations has grown substantially. And beginning three years ago, the SEC has brought several enforcement actions against companies and individuals for fraudulent option practices.

For example, in 2003, the Commission charged Peregrine Systems, Inc. with financial fraud for failing to record any expense for compensation when it issued incentive stock options. The SEC's complaint alleged that at each quarterly board meeting, the company's directors would approve a total number of options for employees. The company would then allocate the options to the employees during the quarter. But the options wouldn't be priced until the day after the next quarterly Board meeting. On that day, the company looked back at the market price of its stock between the two quarterly Board meetings, and picked the lowest price. That turned the options into in-the-money grants. But even though accounting rules required that they then be recorded as compensation expense, the company didn't do that. As a result, Peregrine understated its expenses by approximately $90 million.

The following year, in 2004, the SEC brought a case involving the manipulation not of option grants, but of exercise dates. Our complaint charged that Symbol Technologies, Inc. and its former general counsel fudged option exercise dates so that senior executives could profit unfairly at the company's expense. Rather than use the actual exercise date as defined by the company's option plans, the general counsel picked the most advantageous date from a 30-day "look-back" period in order to come up with a lower exercise price. This was done without board approval or public disclosure. The SEC charged that to create the false appearance that these exercises had actually occurred on the chosen dates, the company's general counsel had instructed his staff to backdate the relevant documents, and to substitute phony exercise dates on the forms the executives used to report their option exercises to the SEC and the public. The result, according to the complaint, was a serious misstatement of the company's stock option expenses.

When the company subsequently restated its improper accounting, the cumulative net increase in reported stock option expenses was $229 million. The amount would undoubtedly have been higher had it not been for the passage of the Sarbanes-Oxley Act. Thanks to the Act's new two-day deadline for reporting options transactions by officers and its prohibition on company loans to officers and directors, the company and its general counsel had put a halt to the "look-backs" because the law had rendered the practice unfeasible.

While the alleged manipulations of option grants and exercises in these two cases were part of larger accounting fraud charges, two more recent cases have focused solely on option practices. These are the Brocade and Comverse actions that the SEC filed in July and August of this year. The executives charged in these cases are contesting the SEC's allegations.

In July, the SEC filed a civil fraud action against three former executives of Brocade Communications Systems, alleging that the former CEO and the former Vice President of Human Resources routinely backdated stock option grants to give employees favorably priced options without recording the necessary compensation expenses. Specifically, the SEC's complaint alleges that the CEO caused Brocade to grant in-the-money options to both new and current employees between 2000 and 2004, and then backdated documents to make it appear that the options were at-the-money when granted. This had the effect of concealing millions of dollars in expenses from investors.

The complaint alleges that the CEO repeatedly used hindsight to select a date with a lower stock price from the recent past as the purported option grant date, and that, to facilitate the scheme, the Human Resources executive created, or directed others to create, false paperwork making it appear that the options had been granted on the earlier date. The complaint alleged that, in some instances, employment offer letters and compensation committee minutes were falsified to suggest that options had been granted to employees before they had even been hired by the company.

The SEC's complaint also charged Brocade's former CFO, alleging that he learned of the backdating after joining the company but took no action to correct or halt the practice and instead signed Brocade's SEC filings. When these stock option practices surfaced, Brocade was required to restate and revise its financial statements for six fiscal years, from 1999 through 2004. The scheme resulted in the inflation of Brocade's net income by as much as $1 billion in the year 2000 alone. Simultaneously with the filing of the SEC's complaint, the U.S. Attorney's Office for the Northern District of California separately filed criminal charges against the former CEO and the former Vice President of Human Resources for the same misconduct.

In the second recent case, the Commission filed a civil fraud complaint last month against three former senior executives of Comverse Technology, Inc., alleging that they engaged in a decade-long fraudulent scheme to grant undisclosed, in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock.

The complaint alleges that from 1991 to 2002, Comverse's founder and former Chairman and CEO repeatedly used hindsight to select a date when the closing price of Comverse's common stock was at or near a quarterly or annual low. According to the complaint, the CEO then communicated this date and closing price to Comverse's former general counsel who, with the CEO's knowledge, created company records that falsely indicated that a committee of Comverse's board of directors had actually approved the option grant on the date the CEO had picked.

The complaint also alleges that Comverse's former CFO joined the scheme no later than 1998, and assisted in selecting backdated grant dates. It is alleged that each of the three defendants realized actual illicit gains from the backdating when they sold stock they acquired from exercises of backdated options, including at least $6 million by the CEO alone. In addition, the complaint alleges that the former CEO and CFO created a slush fund of backdated options between 1999 and 2002 by causing options to be granted to fictitious employees and, later, used these options to recruit and retain key personnel.

Comverse has publicly announced that it expects to restate historical financial results for multiple years in order to record material charges for option-related compensation expenses. Simultaneously with the filing of the SEC's complaint, the U.S Attorney's Office for the Eastern District of New York unsealed a criminal complaint charging these three executives with conspiracy to violate the antifraud provisions of the federal securities laws, wire fraud, and mail fraud by engaging in the same scheme.

These cases demonstrate some of the variations on the basic theme of fraudulent backdating that the Commission has uncovered. They involve backdated option grants that are more profitable to recipients; backdated option exercises that reduce recipients' taxes at the expense of shareholders; options granted to top executives; and options granted to rank and file employees. They involve actual personal gain to wrongdoers, and real harm to companies that failed to properly account for the options practices.

Unfortunately, these cases that I've used as illustrations are not the only matters the SEC has under investigation. The SEC's Division of Enforcement is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors.

You should not expect that all of these investigations will result in enforcement proceedings. At the same time, we have to expect other enforcement actions will be forthcoming in the future.

The SEC's Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice, the President's Corporate Fraud Task Force, U.S. Attorney's offices around the country, the Federal Bureau of Investigation, and the Internal Revenue Service.

In our rulemaking, our provision of accounting and final regulatory guidance, and our enforcement programs, the SEC has been and will remain vigilant in the battle against fraudulent options backdating. The agency is grateful for the opportunity to provide you with this update on a very important subject. I am happy to take any questions you may have.

United States Senate
Committee on Finance
Questions Submitted for the Record

Linda Thomsen
Director, Division of Enforcement
U.S. Securities and Exchange Commission

"Executive Compensation: Backdating to the Future/Oversight of current issues regarding executive compensation including backdating of stock options; and tax treatment of executive compensation, retirement and benefits"

September 6, 2006

From Chairman Grassley:

1. How is the Commission coordinating these cases geographically and across different agencies to encourage uniformity of treatment of similarly situated individuals to the extent possible. How many legal actions do you anticipate or estimate taking - that is how many executives and companies will be affected at the end of the day by this backdating? What steps is the federal government taking to ensure there are adequate staffing resources to investigate and prosecute these cases?

ANSWER:

With over 120 options cases in inventory, uniformity of treatment, as well as efficient use of resources, is a key concern of the Commission. Consequently all of the options cases are being coordinated through the Enforcement Division's headquarters in Washington DC. In addition, all staff with options cases participate in biweekly calls to discuss developing issues and share information. The Office of Chief Counsel in Enforcement reviews all staff recommendations for consistency, among other things, prior to Commission consideration. The Enforcement Division also is coordinating its efforts on the options cases with the Division of Corporation Finance, the Office of the Chief Accountant and the Office of Economic Analysis. All of these coordination efforts are helping us better ensure that we have adequate staffing resources to investigate and, where appropriate, take enforcement action in these cases.

In addition to internal coordination within the Commission, where appropriate, the Division of Enforcement is sharing information with the Department of Justice and the Internal Revenue Service. Both of the recent enforcement actions in this area, Brocade and Comverse, were announced with parallel DOJ criminal indictments.

While we do not believe that all of the ongoing investigations will result in

enforcement proceedings, I do expect other enforcement recommendations will be forthcoming. Moreover, I expect a number of companies that do not become the subject of enforcement action will nonetheless be affected by their review of accounting practices and records for employee stock options.

2. The New York Times reported this Sunday that the SEC recently informed the board of Mercury Interactive, that the SEC was considering filing a civil complaint against three board members in connection with backdating. What is the panel's views on holding board members responsible -when is that appropriate in backdating and what actions can we expect from the federal government in this area?

ANSWER:

Board members serve an essential oversight role in corporations, particularly in areas such as executive compensation. Accordingly, when gatekeepers like board members participate in fraudulent activities, the Commission takes it very seriously. If board members have participated in fraudulent activities relating to options backdating, I would expect to see them held accountable.

3. Please explain briefly the new Commission Executive Compensation Rules. What impact does the Commission expect these new rules to have on informing shareholders and dealing with concerns of excessive executive compensation. In addition, I ask you to respond to statements made by the second panel that while the transparency guidelines are a step forward that there still need to be real changes to governance and independence of board members if the efforts for transparency are going to have a strong impact on excessive corporate pay. Finally, I would also like you to comment on the suggestion of one of our panelists of having the new transparency rules updated to require corporations to make shareholders aware if the executive compensation fails to meet the 162(m) performance based exemptions. That is, if the corporation is going to pay additional tax for failure to meet the tests of 162(m) it should tell its shareholders. Perhaps sunshine here may help.

ANSWER:

On July 26, 2006, the Commission unanimously passed significant revisions to its rules regarding public disclosure of executive compensation and related matters. Those revisions refined the tabular disclosure that is required in annual filings with the Commission and combined that tabular disclosure with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors. For the first time, with these rules the Commission has required that all companies disclose a single "total compensation" number for each of its named executive officers who are covered by our rules.

In addition to the requirement to provide one number for total annual compensation, some of the other notable advances in the rules that the Commission passed in July include:

- The requirement for a new Compensation Discussion and Analysis section to provide investors with enhanced, principles-based narrative disclosure of the compensation information that is most meaningful to them;

- The requirement for the first time that stock options and stock grants be valued and disclosed in dollar amounts, consistent with the accounting method that is used in expensing the option and stock grants for purposes of a company's financial statements; and

- The requirement for the first time to provide detailed descriptions of payments that could be made if an executive is terminated.

It is important to note that the Commission intends and anticipates that its new rules will enhance the transparency and the usefulness of information that is available to investors. Providing investors and the boards of directors that represent them with better information should help those stakeholders make better decisions about the appropriate amount to pay the people who they retain to run their companies. The Commission has not tried, nor does it want, to affect either the form or the amount of the compensation that is paid to America's corporate executives. Those decisions are appropriately made by shareholders and corporate boards of directors, including the compensation committees of those boards.

With regard to corporate governance and board member independence and the role those play in safeguarding the interests of shareholders in America's public companies, I would note that the Commission does have rules addressing those matters as well, including required disclosure. The stock exchanges also, of course, have important regulations in these areas. With regard to independence and compensation committee members, important SEC disclosure requirements include:

- Disclosure of whether each director and director nominee is independent;

- A description, by specific category or type, of any transactions, relationships or arrangements not disclosed as a related person transaction that were considered by the board of directors when determining if applicable independence standards were satisfied;

- Disclosure of any audit, nominating and compensation committee members who are not independent; and

- Disclosure about the compensation committee's processes and procedures for the consideration of executive and director compensation.

Finally, I would like to respond to the last prong of your question, regarding possible additional rulemaking. The rules and revisions that the Commission adopted in July were the most significant revisions to its executive compensation disclosure rules in almost 15 years. Those rules are not yet effective and we have not yet had an opportunity to review and evaluate the disclosures that American companies will be making in response to our new disclosure requirements. While it may be premature to address whether the Commission should consider further updating the rules to to require additional disclosures specifically linked to the 162(m) performance based exemptions, in its July 2006 Release of the new rules the Commission made clear that companies may need to address in their new Compensation Discussion and Analysis disclosures "the impact of accounting and tax treatments of a particular form of compensation." The Commission will monitor the implementation and effects of the new disclosure rules and will remain attentive to the needs of investors and the marketplace in this regard as we move forward.

4. Commissioner Everson has made public comments that Congress should consider whether to change the tax privacy rules to allow the SEC to review certain limited corporate tax information. The thought being that the SEC may be able to better identify problems if it had access to what corporations told the tax man.

This is a matter I've written on earlier in this administration and think it bears serious consideration. I would like your views - I know you can't speak for policy change - but just your views as the head of enforcement of whether having access to tax information would assist your work.

ANSWER:

Certainly having access to the tax records of corporations and/or individuals under investigation by the Commission would provide us with additional evidence whether, and in some cases how, corporations and/or individuals profited from inappropriate behavior. We would welcome such access. In addition, we understand that the IRS is always looking for new and better ways to identify tax filings that appear out of the normal range of similarly situated filers. This information may in some instances prove useful to enforcement efforts to identify new forms of corporate fraud. Finally, where appropriate, intra-agency sharing of information serves a critical resource-saving function and the Commission and the Division supports such synergies.

5. We have heard about the backdating of stock options first in the papers, not from actions by federal law enforcement. I'm worried that in this area, like it has been the case in the past with tax shelters, that we are way behind the curve -- both law enforcement and Congress. I would ask that if both you Mr. Commissioner and you Ms. Thomsen could tell us about those things - beyond

backdating of stock options - that you are seeing now in audit or review in the area of executive compensation that give you pause and concern. What are those things that make your eyebrows rise? What are the things your staff are seeing in the field that give you concern that Congress should know about?

ANSWER:

As far back as 2003, before the recent wave of press attention, the Commission was looking seriously at executive stock option grants, and filed a case at that time against Peregrine Systems Inc. Relatedly, during that time, the Commission's Office of Economic Analysis and Division of Enforcement had developed a database of relevant literature on potential abuses of executive options grants, with particular focus on timing of grants and news publications. By early 2004, there were news articles describing SEC probes related to potential options timing abuses. And since then, we have brought additional important cases. So in this case, law enforcement was ahead of the curve, and we intend to continue applying a thoughtful, risk-based approach to stay ahead of the curve on other issues.

The Commission's enforcement program has been active in the area of executive compensation beyond options backdating as well. The recent cases against Tyco and General Electric, both instances where senior executives received millions of dollars in undisclosed perquisites, are demonstrative of these efforts. With the passage of the new executive compensation rules, still in their infancy, we expect to see much less abuse in this area. Of course we cannot talk about our nonpublic investigations; however, we can say that we continue to work with the Examination staff, the Division of Corporation Finance, the Office of Economic Analysis and our other Divisions to stay attuned to areas of likely abuse.

From Senator Hatch:

1. It is my understanding that the issue of backdating was before the SEC as early as 1999 when Microsoft announced an accounting issue related to the backdating of stock options. Today, over 100 companies have already announced that they are dealing with stock option backdating issues, and one academic study has indicated that over 2,000 companies appear to have backdated stock options. In other words, while there are documented cases of outright fraud, it also seems that in corporate America and in the accounting and legal professions, some informal option grant practices were known, accepted, and broadly condoned.

Given the widespread reach of this behavior, and given that it was brought to the attention of the SEC as early as 1999, I have a few questions. First, did the SEC offer any guidance to public companies on this issue? Second, what has the SEC found with regard to the accounting firms that were auditing these companies when these option grants were taking place? And third, is the SEC taking care to make sure that companies that acted in good faith, followed standard corporate practice, and relied on the advice of their lawyers and accountants, will not be punished in the rush to crack down on genuine abuse?

ANSWER:

Beyond the Enforcement actions taken by the Commission in 2003 and 2004 (*see* response to Senator Grassley, Question No. 5 above) and prior to the additional guidance that OCA issued last week, accounting firms should have looked to APB 25 and related accounting literature for guidance on the appropriate accounting and attendant disclosure required for option grants. While the details of ongoing investigations are nonpublic, the Commission is looking closely at the role, if any, that various gatekeepers, including audit firms, had in the options backdating scandals. The Division of Enforcement has no intention of recommending enforcement actions against companies, audit firms or individuals that acted in good faith to follow both generally accepted accounting principles and executive compensation disclosure obligations to accurately report stock option information to investors. Each case will be evaluated on its unique facts and circumstances and we expect there will be a number of investigations that do not result in any enforcement action, and we expect there will be a number of situations that will not even merit an extended investigation.

2. It seems clear to me that the Commission is vigorously pursuing investigations of possibly fraudulent reporting of stock option grants. And it is good to see that the SEC is working so closely with DOJ on this issue. Obviously, any fraud has to be rooted out. The behavior that has been reported in the press and described at the September 6, 2006 Senate Finance Committee Hearing has real tax implications and is a fraud on investors. At the same time, this issue is having a wide-ranging impact on the market. It is my understanding that the number of companies delaying their SEC filings is substantial and that many of the delays can be attributed to accounting issues related to stock option investigations at these companies.

On July 6, 2006 Commissioner Atkins gave a speech in which he commented on options backdating issues, in what I thought was a very balanced way. He pointed out that it was important to distinguish between "black-and-white fraud" and "legitimate practices that are being attacked with attenuated theories of liability." He concluded that "there is no securities law issue if backdating results from an administrative paperwork delay." This is the example that he gave. "A board, for example, might approve an options grant over the telephone, but the board members' signature may take a few days to trickle in. One could argue that the grant date is the date on which the last directors signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent-" Is this the view that the SEC intends to adopt as it proceeds to deal with these companies, and if not, why not? Also, is the SEC giving accounting firms informal guidance which takes into account the approach described above when

companies are assessing compensation expense as a result of their option grant procedures?

ANSWER:

The Enforcement Division does not intend to recommend enforcement actions in cases that boil down to instances of administrative paperwork delay, where no one intended to backdate options or to account for them in violation of GAAP.

Consistent with ordinary practice, in option grant cases the Commission encourages companies to seek information from the Office of Chief Accountant that is relevant to the unique facts and circumstances of their respective cases. In addition, the Office of the Chief Accountant issued a September 19, 2006 letter, summarizing the staff's views regarding the accounting for stock options in the historical financial statements of public companies. The letter discusses the accounting consequences under Opinion 25 of dating an option award to predate the actual award date, option grants with administrative delays, uncertainty as to the validity of prior grants, and other related circumstances. The letter can be accessed on the SEC's website at the following link: http://www.sec.gov/info/accountants/staffletters.shtml.

3. Because there are so many companies involved in the backdating of stock options, and because the potential damage to the market, to shareholders, and to investor confidence is so high, it seems that some sort of global resolution might be in order. Cases of outright fraud should be thoroughly investigated and charged, but for the many companies that are dealing with backdating problems that are administrative or clerical in nature, it seems that a global resolution might be appropriate. Given the broad market implications of these administrative backdating problems, has the SEC considered the possibility of such a settlement?

ANSWER:

As noted in response to Question 2 above, the Office of Chief Accountant has issued a September 19, 2006 letter setting forth, among other things, the staff's views regarding the accounting consequences under Opinion 25 of option grants with administrative or clerical delays. As for cases that do not clearly involve such good faith errors, we have found the cases each have very unique facts and circumstances. Consequently, we are evaluating each case on its facts and we expect to recommend action as and where appropriate. We do not expect that all of the matters currently under investigation will result in enforcement actions.

From Senator Kerry:

1) What steps is the SEC taking to improve its communications with the IRS about backdating?

ANSWER:

The Commission has granted the IRS access to our investigative files in a number of our options backdating investigations. In addition, Commission staff have met with IRS staff to determine how best to communicate and share appropriate additional information.

2) Was the IRS made aware of the tax implications of backdating when the SEC discovered it in 2003?

ANSWER:

Yes. The Commission provided information to the IRS in its 2003-2004 investigation of Symbol Technologies and the company's former General Counsel, Leonard Goldner. In addition to being charged by the Commission, Goldner pled guilty to one count of conspiracy to commit tax fraud in a charges brought by the United States Attorney's Office for the Eastern District of New York.

3) What type of taxpayer data does the SEC need to combat backdating?

ANSWER:

Unfortunately, prior to the recent availability of electronically filed corporate tax forms, we probably would not have been able to make much use of tax forms in detecting the current wave of option grant abuse cases. However, with the newly instituted electronic filing requirements, corporate tax returns may prove more beneficial in detecting executive abuses. We look forward to a continued dialogue with the IRS and Congress regarding sharing appropriate information. In addition, where fraudulent conduct has been identified, taxpayer records can be very useful in quantifying the amount of illicit gain by which wrongdoers benefited, particularly where backdating of option exercises has occurred.

Conforming Version (To Conform to Release Published in the Federal Register)

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 228, 229, 232, 239, 240, 245, 249 AND 274

[RELEASE NOS. 33-8732A; 34-54302A; IC-27444A; FILE NO. S7-03-06]

RIN 3235-AI80

EXECUTIVE COMPENSATION AND RELATED PERSON DISCLOSURE

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence and other corporate governance matters and security ownership of officers and directors. These amendments apply to disclosure in proxy and information statements, periodic reports, current reports and other filings under the Securities Exchange Act of 1934 and to registration statements under the Exchange Act and the Securities Act of 1933. We are also adopting a requirement that disclosure under the amended items generally be provided in plain English. The amendments are intended to make proxy and information statements, reports and registration statements easier to understand. They are also intended to provide investors with a clearer and more complete picture of the compensation earned by a company's principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors. In addition, they are intended to provide better information about key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members. In Release No. 33-8735, published elsewhere in the proposed rules section of this issue of the Federal Register,

- material terms with respect to payouts, withdrawals and other distributions.

Where plan earnings are calculated by reference to actual earnings of mutual funds or other securities, such as company stock, it is sufficient to identify the reference security and quantify its return. This disclosure may be aggregated to the extent the same measure applies to more than one named executive officer.

c. Other Potential Post-Employment Payments

We are adopting the significant revisions that we proposed to our requirements to describe termination or change in control provisions. The Commission has long recognized that "termination provisions are distinct from other plans in both intent and scope and, moreover, are of particular interest to shareholders."[312] Prior to today's amendments, disclosure did not in many cases capture material information regarding these plans and potential payments under them. We therefore proposed and are adopting disclosure of specific aspects of written or unwritten arrangements that provide for payments at, following, or in connection with the resignation, severance, retirement or other termination (including constructive termination) of a named executive officer, a change in his or her responsibilities,[313] or a change in control of the company.

Our amendments call for narrative disclosure of the following information regarding termination and change in control provisions:[314]

- the specific circumstances that would trigger payment(s) or the provision of other benefits (references to benefits include perquisites and health care benefits);

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311 Item 402(i)(3).

312 1983 Release, at Section III.E.

313 We confirm that this aspect of the disclosure requirement is not limited to a change in responsibilities in connection with a change in control.

314 Item 402(j).

- the estimated payments and benefits that would be provided in each covered circumstance, and whether they would or could be lump sum or annual, disclosing the duration and by whom they would be provided;[315]
- how the appropriate payment and benefit levels are determined under the various circumstances that would trigger payments or provision of benefits;[316]
- any material conditions or obligations applicable to the receipt of payments or benefits, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality covenants; and
- any other material factors regarding each such contract, agreement, plan or arrangement.[317]

The item contemplates disclosure of the duration of non-compete and similar agreements, and provisions regarding waiver of breach of these agreements, and disclosure of tax gross-up payments.

A company will be required to provide quantitative disclosure under these requirements even where uncertainties exist as to amounts payable under these plans and arrangements. We clarify that in the event uncertainties exist as to the provision of

[315] We have eliminated the $100,000 disclosure threshold that was specified in the rule prior to today's amendments. For post-termination perquisites, however, the same disclosure and itemization thresholds used for the amended Summary Compensation Table apply. See Section II.C.1.e.i. above. We have modified Item 402(j)(2) from the proposal in response to comments to clarify that the required description covers both annual and lump sum payments. See letter from ABA.

[316] We have modified Item 402(j)(3) from the proposal to clarify the scope of the required disclosure. The proposal would have required the company to describe and explain the specific factors used to determine the appropriate payment and benefit levels under the various triggering circumstances. A commenter suggested that the proposed language was overly broad and ambiguous and could result in mere repetition of the pension payout formula and actuarial assumptions. See letter from ABA.

[317] This would include, for example, disclosure of whether an executive simultaneously receives both severance and retirement benefits, a practice commonly known as a "double dip." See letter from WorldatWork.

payments and benefits or the amounts involved, the company is required to make a reasonable estimate (or a reasonable estimated range of amounts), and disclose material assumptions underlying such estimates or estimated ranges in its disclosure. In such event, the disclosure will be considered forward-looking information as appropriate that falls within the safe harbors for disclosure of such information.[318]

We have modified the requirement somewhat in response to comments that compliance with the proposal would involve multiple complex calculations and projections based on circumstantial and variable assumptions.[319] We adopt commenters' suggestions that the quantitative disclosure required be calculated applying the assumptions that:

- the triggering event took place on the last business day of the company's last completed fiscal year; and
- the price per share of the company's securities is the closing market price as of that date.[320]

We have also revised the rule to provide that if a triggering event has occurred for a named executive officer who was not serving as a named executive officer at the end of the last completed fiscal year, disclosure under this provision is required for that named executive officer only with respect to the actual triggering event that occurred.[321] These modifications will both facilitate company compliance and provide investors with disclosure that is more meaningful. We further clarify that health care benefits are

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318 See, e.g., Securities Act Section 27A and Exchange Act Section 21E.

319 See, e.g., letters from Cleary; Foley; HRPA; and Top Five Data.

320 Instruction 1 to Item 402(j). See, e.g., letters from Emerson; Foley; and Frederic W. Cook & Co.

321 Instruction 4 to Item 402(j). See letter from ABA.

included in this requirement, and quantifiable based on the assumptions used for financial reporting purposes under generally accepted accounting principles.[322]

We further clarify in response to comments that to the extent that the form and amount of any payment or benefit that would be provided in connection with any triggering event is fully disclosed in the Pension Benefits Table or the Nonqualified Deferred Compensation Table and the narrative disclosure related to those tables, reference may be made to that disclosure.[323] However, to the extent that the form or amount of any such payment or benefit would be increased, or its vesting or other provisions accelerated upon any triggering event, such increase or acceleration must be specifically disclosed in this section.[324] In addition, we have added an instruction that companies need not disclose payments or benefits under this requirement to the extent such payments or benefits do not discriminate in scope, terms or operation, in favor of a company's executive officers and are available generally to all salaried employees.[325]

6. Officers Covered

a. Named Executive Officers

As proposed, we are amending the disclosure rules so that the principal executive officer, the principal financial officer[326] and the three most highly compensated executive officers other than the principal executive officer and principal financial officer comprise

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322 Item 402(j)(1) and Instruction 2 to Item 402(j). These would be the assumptions applied under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 106, Employer's Accounting for Postretirement Benefits Other Than Pensions (FAS 106). See, e.g., letters from Peabody Energy and WorldatWork.

323 See letter from Academy of Actuaries.

324 Instruction 3 to Item 402(j).

325 Instruction 5 to Item 402(j).

326 We are adopting the nomenclature used in Item 5.02 of Form 8-K, which refers to "principal executive officer" and "principal financial officer."