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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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* Associate Professor, Stetson University College of Law; A.B., Harvard University, 1981; J.D., University of Virginia, 1985. The author acknowledges the most helpful comments of Professors Stephen Bainbridge, William Carney, Alfred Conard, Michael Dooley, Allan Farnsworth, Saul Levmore, Jonathan Macey, Marleen O'Connor, Marc Steinberg and Michael Swygert. He additionally thanks Bill Cook, Tripp Gulliford and Angelo Patacca for their excellent research assistance.

[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

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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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> . . . .
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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

[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-

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[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
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> (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?
>
> 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

[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

[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-

[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-

[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

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		Director	Shares
Bank of Boston	Donald Monan	0	Philip Morris	Rupert Murdoch	400
	Thomas B. Wheeler	236		Richard Parsons	500
	Alfred M. Zeien	500	Sears Roebuck	Mandell de Windt	450
IBM	Harold Brown	321		Norma Pace	400
	Nannerl Keohane	321		Nancy C. Reynolds	454
	Richard Munro	421	Ralston Purina	David Banks	200
Mobil	Donald Fites	200		Francis Ferguson	556
Disney	Robert Stern	0			
	Stanley Gold	250			
	Samuel Williams	480			
	Gary Wilson	0			

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]

[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-

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[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

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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

[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.