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EXECUTIVE COMPENSATION: THE LAW AND INCENTIVES

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Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures. Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers. Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders' right to benefit from the corporation's wealth. Shareholders' dividends are directly reduced by the company's expenses, one of which is executive compensation. For most of today's public companies, the executive compensation expense is often negligible when considered in light of mammoth balance sheets. However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders. In the most unfortunate scenario, executives' personal interests can tumble a corporation and send ripples of pain elsewhere. To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for executives. And recently, when these committees have proved to be imperfect, additional legislative efforts have been introduced. As it unfolds, this paper attempts to answer the following three questions.

First, how meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

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Second, how consistent is Business Roundtable’s guiding principle for executive compensation—that executive compensation should be closely aligned with long-term shareholder interests—with the reality of executive compensation in today’s corporate America?

Third, what would be the scope and the efficacy of any proposed legislative check on executive compensation?

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I. INTRODUCTION²

Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures.³ Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers.⁴ Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders' right to benefit from the corporation's wealth. For example, shareholders' dividends are directly reduced by the company's expenses, which include executive compensation. For most of today's public companies the executive compensation expense is often negligible when considered in light of mammoth balance sheets.⁵ However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders.⁶ In the most unfortunate scenario, executives' personal interests can tumble a corporation and send ripples of pain elsewhere.⁷ To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for the executives.⁸ Recently, when these committees have proven to be imperfect, additional legislative efforts have been introduced.⁹ As it unfolds, this paper attempts to answer the following three questions:

Question 1

Against the backdrop of the recent bursting of the real estate bubble and the resulting financial crisis, the populist outcry against

² This paper examines executive compensation as it applies to publicly-traded companies. The analysis could differ significantly for private companies.

³ See generally MICHAEL S. SIRKIN & LAWRENCE K. CAGNEY, EXECUTIVE COMPENSATION (2006).

⁴ See *infra* text accompanying notes 35–36. Prior to AIG's downward spiral, the average salary in Joseph Cassano's business unit was \$1 million a year for the 377 people employed there; Cassano personally received \$280 million in the eight years prior to his resignation in 2008.

⁵ See *infra* text accompanying notes 20–24. For instance, in 2007, WaMu held assets valued at \$327.9 billion, while WaMu's chief executive, Kerry Killinger was compensated with \$88 million for six years from 2001 to 2007.

⁶ See *infra* text accompanying note 31.

⁷ See *infra* text accompanying notes 20–31.

⁸ See *infra* text accompanying notes 41–47.

⁹ See *infra* Part IV.

excessive executive compensation is gaining momentum.¹⁰ Some argue that executive compensation—more specifically the misaligned incentives on executive pay—was one of the chief factors contributing to over-inflation and the bursting of the real estate bubble.¹¹ Those who support this view often place the blame on executives and the compensation schemes at such companies as Washington Mutual (“WaMu”) and American International Group (“AIG”). They argue, *inter alia*, that WaMu was a primary facilitator of bad mortgage debt that “built [an] empire on shaky loans.”¹² Meanwhile, AIG exacerbated the problem by insuring the repackaged mortgage debt in the secondary market. *How meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?*

Question 2

Business Roundtable is an American policy association comprised of chief executive officers of major U.S. companies. The group’s membership controls over \$5 trillion in annual revenues and more than twelve million employees.¹³ The group claims one-third of the total value of the U.S. stock market and pays more than sixty percent of all corporate income taxes. On average, the group pays \$167 billion in dividends and gives away another \$7 billion in charitable donations. As justification for its existence, Business Roundtable routinely issues position statements on relevant economic and societal matters. In 2007, the organization published a white paper titled “Executive Compensation: Principles and Commentary.”¹⁴ The first principle of the white paper states: “Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.”¹⁵ *How consistent is this guiding principle with the reality of executive compensation in today’s corporate America?*

¹⁰ See, e.g., *Executive Pay*, *Times Topics*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html (last visited Jan. 23, 2011) [hereinafter *Executive Pay*].

¹¹ Peter Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1.

¹² *Id.*

¹³ See *About Us*, BUSINESS ROUNDTABLE, <http://businessroundtable.org/about-us> (last visited Nov. 2, 2010).

¹⁴ *Executive Compensation, Principles and Commentary*, BUSINESS ROUNDTABLE (Jan. 30, 2007), http://businessroundtable.org/uploads/studies-reports/downloads/20070130_ExecutiveCompensationPrinciples.pdf [hereinafter *Executive Compensation*].

¹⁵ *Id.* at 1.

Question 3

In recent months, as the bottom has dropped out of the economy and the unemployment rate has surpassed ten percent, excessive executive compensation has generated a significant public firestorm.¹⁶ “Bonus” payments at companies receiving government funds have taken center-stage on several occasions. In 2008, the Wall Street banks paid themselves some \$20 billion in bonuses amidst a year of dismal returns (more accurately “a year of colossal losses”).¹⁷ President Obama called the payouts “shameful.”¹⁸ Moreover, his sentiment is likely shared by most Americans who were not amongst the bonus recipients. Whether the bonuses were “right” or “wrong,” and deserved or undeserved, they gave rise to numerous attempts to “rein in Wall Street pay.”¹⁹ Among other proposals, a legislative response appears more likely than ever. *What would be the scope and the efficacy of any proposed legislative check on executive compensation?*

II. Executive Pay and Misaligned Incentives

How meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

A. The biggest bank failure in U.S. history

In 2007, WaMu held assets valued at \$327.9 billion,²⁰ yet in 2008, WaMu was the biggest bank failure in U.S. history.²¹ Over the last decade, and prior to its failure, WaMu was synonymous with easy lending, and for a time it worked for WaMu. In 1990, Kerry K. Killinger became WaMu’s chief executive. He led the bank to an incredible expansion: during Killinger’s tenure, WaMu made some thirty banking acquisitions—it became the sixth largest American bank—and its stock price and number of branches more than

¹⁶ *Executive Pay*, *supra* note 10.

¹⁷ *See id.*

¹⁸ *Id.*

¹⁹ Eric Dash, *Effort to Rein in Wall Street Pay Hits New Hurdle*, N.Y. TIMES, Aug. 9, 2009, at A1.

²⁰ *See* Wash. Mut. Inc., Annual Report (Form 10-K/A) (Feb. 29, 2008), available at <http://www.sec.gov/Archives/edgar/data/933136/000104746908006870/a2185889z10-ka.htm> [hereinafter Annual Report].

²¹ *See* Press Release, Office of Thrift Supervision, Washington Mutual Acquired by JPMorgan Chase (Sept. 25, 2008), available at http://www.ots.treas.gov/_files/730021.pdf.

doubled.²² In 1999, WaMu made a key acquisition of Long Beach Financial, a California lender specializing in subprime mortgages.²³ From that time onward, WaMu positioned its subprime lending business at the core of its offerings. Killinger was the primary engineer behind WaMu's easy lending philosophy. According to The Corporate Library, a research firm, Killinger's compensation from 2001 to 2007 totaled \$88 million.²⁴

Killinger's compensation levels were set similar to the compensation of any other chief executive officer of a company traded on the New York Stock Exchange.²⁵ Specifically, WaMu's corporate filings disclosed that in addition to a predetermined annual salary, Killinger's total compensation was significantly tied to WaMu's performance. In fact, ninety-four percent of Killinger's total direct compensation for 2007 was considered "at risk"—meaning it was tied to specific performance measures—and seventy-one percent of Killinger's total direct compensation was tied to *long-term* performance measures.²⁶ Consider the following language from WaMu's independent Compensation Committee:

For 2008 we have structured our long-term equity incentive and annual incentive bonus programs for named executives to align with our objective to improve Company performance in 2008 and beyond. We continue to provide at least 50% of total direct compensation to executives (over 70% for the CEO) in the form of long-term equity incentive compensation which is directly linked to stock price and total shareholder return Our 2008 annual incentive bonus plan is designed to align executive bonus compensation with the achievement of four objective performance measures that are core to the success of our business: (i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty.²⁷

In theory and on paper, this compensation scheme would likely pass the scrutiny of most vigilant shareholders who demand the

²² Goodman & Morgenson, *supra* note 11, at A1.

²³ *Id.*

²⁴ *Id.*

²⁵ See N.Y. STOCK EXCH., FINAL NYSE CORPORATE GOVERNANCE RULES 8–9, available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>. For a more detailed discussion of executive compensation rules, see *infra* Part III.

²⁶ Annual Report, *supra* note 20, at 88.

²⁷ *Id.* at 84.

highest dividend possible, especially in the long-term. In reality, however, WaMu did not make it through the end of 2008.

The demise of WaMu was brought on by subprime mortgages. In 2007, WaMu recorded a \$67 million loss in its subprime lending unit and shut it down.²⁸ In total, by 2007 WaMu had accumulated \$180 billion in mortgage-related loans. Intriguingly, prior to the burst of the housing bubble, it was this enormous mortgage portfolio that inflated WaMu's stock price and created value out of thin air (or out of empty IOUs). With the increase in stock price, the level of Killinger's compensation also increased. Consistent with the formulas drawn out by the Compensation Committee, Killinger's compensation was directly related to the growth in the mortgage portfolio.²⁹ This growth, however, was achieved through reckless lending, and a day of reckoning was still several years away.

In 2007, when WaMu's shareholders' wealth was essentially wiped out entirely, the calculation of Killinger's bonus still excluded the losses from mortgage securities, thus igniting shareholders' rage³⁰ and rightfully posing the question: whose interests were the executives advancing after all? Despite seemingly infallible language and the intent of WaMu's Compensation Committee, reality proved that the executives' incentives were entirely misaligned with the long-term interests of the shareholders.³¹

Even worse for everyone else, WaMu's resale of mortgage securities in the secondary market spread the pain elsewhere. Contrary to the well-known colloquialism, this is one case where spreading the manure around did not do much good.

B. "Business acumen" in AIG's "shop"

When these "shaky" WaMu loans were resold in the secondary market, they were sliced up, bundled, and repackaged into sophisticated derivatives intended to minimize the risk of default. AIG then insured these instruments.³² This novel type of insurance

²⁸ Goodman & Morgenson, *supra* note 11.

²⁹ See Annual Report, *supra* note 20, at 88.

³⁰ Goodman & Morgenson, *supra* note 11.

³¹ We can hardly expect the compensation committee to have a greater foresight into the company's core business than the company's CEO. Nevertheless, it is the compensation committee that is charged with defining long-term incentives for the company's executives. Herein lies one of the paradoxes.

³² Gretchen Morgenson, *Small Unit in London Pushed AIG into the Skid that Nearly Destroyed It*, N.Y. TIMES, Sept. 28, 2008, <http://www.nytimes.com/2008/09/28/business/worldbusiness/28iht-aig.4.16538680.html?emc=eta1>.

was pioneered by one Joseph Cassano with the help from a handful of people in AIG's London-based banking unit.³³ While the entire unit employed only 377 of AIG's 116,000 employees, it was the primary cause of AIG's downward spiral, posting \$25 billion in losses two quarters into 2008.³⁴ These losses translated into direct and immediate cash outflows for AIG. Suddenly, a company with a trillion dollar balance sheet was lining up with an outstretched hand for the largest corporate "bailout" in history.

Prior to all the trouble, the compensation in Cassano's unit averaged \$1 million a year for the 377 people employed there;³⁵ Cassano personally received \$280 million in the eight years prior to his resignation in 2008.³⁶ The incentives at AIG were clear: write more insurance, get more money. Unfortunately, when the dust settled, the American taxpayers were the ones who ultimately paid for the salaries of these London-based bankers.³⁷

C. Executive compensation as the cause? Likely not, but a trigger?

So, how meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

Killinger and Cassano hardly knew that they were operating in tandem when they were writing and insuring risky mortgages. Their expectations for the future were based on their knowledge of the past. Killinger and Cassano both had incentives to increase their corporations' revenues, thereby increasing their own compensation; they did this by relying on "constantly rising housing prices and inflated appraisals, conditions that could not possibly last."³⁸

Of course, it would be an overstatement to place the responsibility for a worldwide financial collapse squarely on the shoulders of these

³³ These instruments are known in the Wall Street jargon as CDOs or collateralized debt obligations, where the ownership of the mortgages has been sold to individual investors and the repayments of principal and interest are separated into maturity streams, known as tranches. See Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model*, 3 HARV. L. & POL'Y REV. 369, 382 n.63 (2009).

³⁴ Morgenson, *supra* note 32.

³⁵ *Id.*

³⁶ David Glovin & David Voreacos, *Cassano-Run AIG Unit Structured Shelters*, U.S. SAYS, BLOOMBERG (Sept. 24, 2009), <http://www.bloomberg.com/apps/news?pid=20601203&sid=aiFvZGiTwQ2c>.

³⁷ The American taxpayers also paid for the large insurance sums that AIG owed to many foreign-owned banks, pursuant to insurance written by Cassano.

³⁸ Canova, *supra* note 33, at 382.

two men. After all, it was not Killinger and Cassano who were delinquent on their mortgage payments, nor did they erase margin requirements or make easy lending commonplace through lax monetary policies and low interest rates.³⁹

They have, however, proved to be far less insightful than they held themselves out to be. In 2007, a year prior to AIG's embarrassing demise, Cassano said:

We're sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?⁴⁰

The irony of the situation is blatant. Fortunately for Killinger and Cassano, they emerged largely unscathed, stripped only of their egos. The author argues that the compensation schemes at WaMu and AIG were not the least of the reasons that brought on the recent financial turmoil,⁴¹ and that the independent compensation committees at these companies were as near-sighted as Cassano and Killinger themselves.

D. Conclusion

Without a doubt, Killinger and Cassano were motivated by their paychecks. Today, with the benefit of hindsight, many accuse this duo of engineering worldwide financial turmoil. But the accusers rarely link compensation with the men's behavior.⁴² The author believes this omission to be material. What people do at work is motivated by a paycheck; otherwise they would not be collecting one. If a person is given an opportunity to increase the amount of his pay, he will most likely pursue that opportunity. It must be mentioned that neither Cassano's nor Killinger's contract had a "clawback" provision. Therefore, both men expected to keep their money once they received it.

On paper, WaMu did everything right, and yet it failed. The compensation incentives spoke of long-term value for the shareholders, but the reality proved the opposite. Cassano and

³⁹ See, e.g., John B. Taylor, Op-Ed., *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19.

⁴⁰ Morgenson, *supra* note 32.

⁴¹ See discussion *infra* Part III.

⁴² See, e.g., Goodman & Morgenson, *supra* note 11, at 22 (compensation mentioned but not discussed as a contributing factor).

Killinger most likely did not foresee the mayhem or cause it intentionally: after all, they were considered the all-stars of their trade. If that's the case, this underscores the difficulty of determining the company's long-term interests and deriving meaningful incentives for executive pay therefrom.

III. The Difficulty of Allocating Incentives on Executive Compensation: The Paradoxical American Reality

How consistent with reality is Business Roundtable's maxim on executive compensation?

A. Introduction

This section examines the structure and role of compensation committees and reviews practical constraints affecting the committees' work. Specifically, this section considers the independence of committee members, the role of compensation consultants, and the difficulty of formulating effective long-term incentives.

B. Compensation committee on paper

For the majority of U.S. public companies, the compensation of top executives is determined by a compensation committee,⁴³ and the favorite task of any compensation committee is benchmarking—that is, comparing one company's executive pay to that of its peers.⁴⁴ As a result, in 2007, an average S&P 500 CEO made 344 times the pay of an average American worker,⁴⁵ 724 times the pay of a minimum-wage worker, and about \$10.5 million more than 15 million unemployed Americans.⁴⁶ These “populist” figures aside, the compensation committee is meant to ensure integrity in corporate compensation schemes. It embodies the principles of corporate law commonly known as the duties of loyalty, care, and good faith; it prevents

⁴³ See David N. Swinford & Matt Vnuk, *The Compensation Committee: From Competence to Excellence*, DIRS. MONTHLY (Nat'l Ass'n of Corporate Dirs., Wash., D.C.), Oct. 2008, available at <http://www.pearlmeyer.com/Pearl/media/PearlMeyer/PDF/CompetencetoExcellence.pdf>.

⁴⁴ JAMES F. REDA, ET AL., *THE COMPENSATION COMMITTEE HANDBOOK* 24 (3rd ed. 2008).

⁴⁵ Walt Barnhart, *Sounding the Pay Gap Alarm*, DENVER POST, May 9, 2009, http://www.denverpost.com/headlines/ci_12327984.

⁴⁶ Minimum wage assumed at \$7.25 an hour; 15 million unemployed Americans is the present estimate. BUREAU OF LABOR STATISTICS (Sept. 2010), <http://www.bls.gov/news.release/empsit.nr0.htm>.

potential conflicts of interest and ensures the greatest possible return for the shareholders.

Organizations such as Business Roundtable, consisting exclusively of top-tier CEOs who are accustomed to frictions with shareholders over executive pay, recognize the importance of compensation committees.⁴⁷ Because the “oversized” executive pay packages originate from these committees and not from the executives themselves, compensation committees serve as a deflection from scrutiny. A compensation committee also serves a tax purpose. The IRS requires such a committee before a company can claim the \$1 million limit on salary deductibility.⁴⁸

Therefore, Business Roundtable wisely allots a central role for compensation committees. Business Roundtable’s principles on executive pay include the following provisions, among others: (1) long-term interests of the shareholders; (2) executive pay where a large portion of the compensation is tied to long-term performance and is represented by executives’ equity investment in the company; (3) existence and operation of an independent and well-educated compensation committee that determines the pay and the incentives; and (4) complete, accurate, understandable, and timely disclosure of compensation schemes to the shareholders.⁴⁹

It is difficult to argue against the soundness of these principles. But how consistent are they with reality?

C. Practical Hurdles of a Typical Compensation Committee

i. Independence of Directors

Jiang Jianqing, chairman of the world’s largest bank, made just \$234,700 in 2008.⁵⁰ The Industrial and Commercial Bank of China is one of three Chinese banks in the world’s top five, and each of Jiang’s Chinese fellow CEO colleagues made roughly the same sum last year.⁵¹ HSBC, England’s largest and the world’s third-largest bank, paid its CEO Michael Geoghegan \$2.8 million in 2008.⁵² In contrast, America’s JPMorgan Chase, the world’s fourth-largest bank, rewarded

⁴⁷ BUSINESS ROUNDTABLE, *supra* note 13.

⁴⁸ See I.R.C. § 162(m) (2010).

⁴⁹ See *Executive Compensation*, *supra* note 14, at 1.

⁵⁰ Steve Eder, *Study Shows U.S. Bank CEO Pay Dwarfs Rest of World*, REUTERS.COM (Sept. 23, 2009), <http://www.reuters.com/article/ousivMolt/idUSTRE58M2QU20090923?pageNumber=1&virtualBrandChannel=10522> (“largest” determined by market capitalization).

⁵¹ *Id.*

⁵² *Id.*

its CEO, Jamie Dimon, with a hefty \$19.6 million for the same time period.⁵³ As it turns out, in 2008, the Chinese bankers made less than 2 percent, and Mr. Geoghegan made less than 15 percent of Mr. Dimon's pay.

Skeptics link this disparity to the work of U.S. compensation committees. To fully ascertain the independence of compensation committees, it is first necessary to understand the general makeup of an average board of directors. A typical board consists of past and present CEOs of major U.S. companies, which are often from within the same industry.⁵⁴

Independent board members are those who are not employed and those without "strong ties" to the company on whose board they sit. Several independent board members then make up a compensation committee.⁵⁵ Most commonly, the committee also includes a compensation consultant.

When a committee convenes, it sets compensation for the company's top executives. In doing so, committees often use "benchmarking," a process that includes creating peer groups of comparable companies and using those companies' compensation figures as a standard for comparison.⁵⁶ Thus, in reality, although CEOs do not set their own compensation, their compensation is set by other "independent" CEOs who are comparing each others' pay checks.⁵⁷

The author believes this setup also explains the growing "pay gap at the top,"⁵⁸ meaning the pay gap between the chief executives and their top subordinates. Over the last two decades the compensation of number three executives has decreased from around fifty percent to about twenty-five percent of the CEO's pay.⁵⁹ Similar trends are also in effect for other top subordinates. Could it be because the number of CEOs on corporate boards exceeds the number of CFOs? Or could it be because the CEOs have joined a covert union?⁶⁰

⁵³ *Id.*

⁵⁴ See ROBERT A.G. MONKS, ET AL., CORPORATE GOVERNANCE 261 (2008).

⁵⁵ See REDA, ET AL., *supra* note 44 at 24.

⁵⁶ See *id.* at 24.

⁵⁷ See *id.*

⁵⁸ See The Pay Gap at the Top, N.Y. TIMES, May 25, 2007, http://www.nytimes.com/imagepages/2007/05/25/business/20070525_EXECS_GRAPHIC.html.

⁵⁹ See *id.*

⁶⁰ See Joseph Kahn, Former Treasury Secretary Joins Leadership Triangle at Citigroup, N.Y. TIMES, Oct. 27, 1999, at A1.

Of course, the cynical view includes an entrenched committee “rubber-stamping increasingly lucrative pay programs with a wink and a nod.”⁶¹ Skeptics have good reason to argue that an “independent” compensation committee is nothing more than a thinly-veiled self-serving “union.” They insist⁶² that benchmarking benefits even “independent” directors: these directors can set a high standard against which their own companies can set a benchmark.

For example, WaMu used the following companies in its peer group when determining Killinger’s compensation: Bank of America, Bank of New York, Capital One Financial Corp., Citigroup, Countrywide Financial, Fifth Third Bancorp, JPMorgan Chase & Co., KeyCorp, National City Corp., PNC Financial Services Group, Suntrust Bank, U.S. Bancorp, Wachovia, and Wells Fargo & Co.⁶³ In 2009, JPMorgan Chase & Co. used the following companies: American Express, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, and Wells Fargo & Co.⁶⁴ Note that neither bank included their Chinese or even European colleagues in the mix.

ii. A Short Aside

A very interesting, although not directly related topic, is the spread of American compensation practices overseas. For example, when an American subsidiary conducts business in another country, the American parent typically implements American executive compensation practices within the subsidiary. Such was the case for Cassano and AIG’s London-based banking unit. This practice forces additional pressure on foreign companies, who are beginning to benchmark against their American competitors, thus increasing executive compensation worldwide.⁶⁵ With additional pressure on

⁶¹ Kevin J. Murphy, Executive Compensation, 3 HANDBOOK OF LABOR ECONOMICS 25 (1999), available at http://www-marshall2.usc.edu/ceo/publications/pubs_pdf/g98_9.PDF.

⁶² The author must add that they insist quite convincingly. But compare id. (I tend to dismiss the cynical scenario Although there are undoubtedly exceptions, outside board members approach their jobs with diligence, intelligence, and integrity, regardless of whether they have social or business ties with the CEO. However, judgment calls tend systematically to favor the CEO. Faced with a range of market data on competitive pay levels, committees tend to err on the high side.)

⁶³ See Annual Report, *supra* note 20, at 86.

⁶⁴ JPMorgan Chase, 2009 Proxy Statement, available at http://files.shareholder.com/downloads/ONE/785360220x0x283556/c5104551-d652-4e86-a894-852a4f97265a2009_Proxy_PDF_format.pdf.

⁶⁵ Fortunately for the American companies, this likely makes their foreign counterparts less competitive. For further discussion, see Goodman & Morgenson, *supra* note 11.

executive pay after the recent financial turmoil, the future undoubtedly holds intriguing developments in this area.

iii. Independence of Compensation Consultants

In 2008, ninety-two of the top-100 U.S. companies disclosed the retention of a compensation consultant.⁶⁶ The compensation consultant also participates in determination of executive pay. The present disclosure rules require the company to disclose the role played by the compensation consultant in determining or recommending executive pay.⁶⁷ However, presently, disclosure of the consultant's independence is not required, nor is the employment of an independent consultant.

An issue with the independence of compensation consultants arises when the consultant, in addition to providing compensation consulting, also provides other consulting services to the company.⁶⁸ Compensation consulting usually represents only a small fraction of the total consulting bill. Therefore, non-compensation consulting, which is contractually secured by the management, represents the consultant's livelihood. The consultant thus has few incentives to be the shareholders' watchdog on the compensation committee.

For the 2009 proxy season, fifty-four of the top-100 U.S. companies voluntarily disclosed that their compensation consultant was independent and twenty-nine acknowledged that their compensation consultant provided other services to the company.⁶⁹ In light of the growing concern over independence of compensation consultants, additional disclosure rules have been proposed. They are discussed *infra*.

iv. The Difficulty of Formulating Meaningful Long-Term Incentives

The premise that corporations exist to create shareholder wealth is rarely questioned, and the creation of this wealth typically results from payment of dividends and appreciation of the company's stock. Theoretically, there could be nothing easier than to tie these objectives

⁶⁶ See Shearman & Sterling, 2009 Trends in Corporate Governance of the Largest U.S. Public Companies 13, <http://info-shearman.com/vf/7430r9691V7164G68k> (registration required).

⁶⁷ See *id.*

⁶⁸ See *id.*

⁶⁹ See *id.*

to executive compensation. In practice, however, determination of meaningful long-term incentives requires profound knowledge of the company's core business.

For instance, in the previously discussed WaMu example, WaMu's compensation committee connected the following objectives to the level of executive pay: "(i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty."⁷⁰ These objectives stated nothing about "upside potential" or "downside risk," the two maxims at the center of the Business Roundtable's principles. In fact, within just a few months, WaMu crashed into the downside territory under the risk which its management flagrantly ignored. On the other hand, risky lending indisputably increased WaMu's net operating profit, banking fees, and customer loyalty—at least in the short run. Killinger himself, assumingly the best CEO WaMu could find and afford at the time, did not foresee this risk. The only people who foresaw the imminent burst of the bubble were marginalized economists that now stand in line for the Nobel Prize.⁷¹ Unfortunately for WaMu, none of them were sitting on WaMu's compensation committee.

Herein lies the extreme difficulty of determining meaningful long-term incentives. The task is particularly complicated in the financial world, where banking and finance companies engage, *inter alia*, in highly sophisticated derivative trading. Consider, for example, the sheer size of the components of the derivative trading industry: credit default swaps now account for \$45 trillion; interest rate derivatives stack up at \$500 trillion.⁷² Faulty and near-sighted incentives laid out by inadequate compensation committees can be the first causal "trigger" of the next meltdown.⁷³ Therefore, if shareholders are serious about creating long-term value, they must insist that executives' incentives are thoroughly analyzed and determined by highly competent and truly independent compensation committees.

⁷⁰ Annual Report, *supra* note 20, at 84

⁷¹ For an example, see Stephen Mihm, *Dr. Doom*, N.Y. TIMES, Aug. 17, 2008, <http://www.nytimes.com/2008/08/17/magazine/17pessimist-t.html>.

⁷² See Paul B. Farrell, *Derivatives the New "Ticking Bomb": Buffet and Gross warn: \$516 Trillion Bubble Is a Disaster Waiting to Happen*, MARKET WATCH (Mar. 10, 2008, 7:31 PM), <http://www.marketwatch.com/Story/derivatives-are-the-new-ticking-time-bomb>.

⁷³ See, e.g., Paul De Grauwe, Op-Ed., *Central Banks Should Prick Asset Bubbles*, FIN. TIMES (Nov. 2, 2007, 5:58 PM), <http://www.ft.com/cms/s/0/479f24ba-8892-11dc-84c9-0000779fd2ac.html>.

D. Conclusion

So, how consistent with reality are the Business Roundtable's maxims on executive compensation? Again, Business Roundtable calls for executive compensation that is "closely aligned with the long-term interests of shareholders and with corporate goals and strategies."⁷⁴ Executive compensation "should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk."⁷⁵ Compensation should be determined "entirely by independent directors" who understand all of its aspects and who oversee compensation consultants to ensure their independence.⁷⁶

The author's research and analysis reveals that for the most part the trends in executive compensation are consistent with the Business Roundtable principles. At the same time, the principles themselves reflect an imperfect system: independence and competence of directors and consultants can be reasonably questioned. Can the proposed legislative efforts provide a fix?

IV. Legislative Proposals on Executive Compensation

What would be the scope and the efficacy of any proposed legislative check on executive compensation?

A. Introduction

Since the passage of the Troubled Assets Relief Program ("TARP"), there have been several legislative proposals that could significantly impact U.S. compensation practices.⁷⁷ The reality of a legislative intervention is more likely than ever. Of course, few management teams will welcome the new rules, which will abridge the management's authority and potentially limit or reduce executive paychecks.

Moving in the same direction, but using a different mechanism, are the proposals of shareholders. Within the recent year alone, there was a total of seventy-seven compensation-related shareholder proposals at

⁷⁴ *Executive Compensation*, *supra* note 14.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ For background on the compensation regulations under the TARP, see Linda E. Rappaport et al., *Treasury Releases Executive Compensation Regulations for TARP Recipients*, SHEARMAN & STERLING LLP (June 22, 2009), <http://www.shearman.com/treasury-releases-executive-compensation-regulations-for-tarp-recipients>.

the top-100 U.S. companies.⁷⁸ This section examines the convergence of two fundamentally different influences on corporate law: the external governmental intercession and the internal shareholder pressure.

B. Shareholder Initiatives

Shareholders' authority is derived from their ownership of the corporation. It is only natural that shareholders would desire to do everything within their power to ensure efficient operation of the enterprise. This subsection reviews the following shareholder initiatives as they relate to executive pay: say-on-pay provisions, clawback provisions, and risk assessment.

i. Say-on-Pay Provisions

Say-on-pay provisions allow shareholders to influence remuneration of executives. In a typical say-on-pay scenario, shareholders do not directly determine executive pay; rather, they have an opportunity to vote on the numbers prepared by the compensation committee.⁷⁹ The vote is usually advisory—that is, non-binding—or, less frequently, shareholders may insist on a binding vote. Those companies that have adopted say-on-pay proposals most commonly give the shareholders a non-binding vote.⁸⁰ The vote serves a purpose similar to the compensation disclosure rules. In essence, the shareholders are timely informed on the issue of executive pay and, at a minimum, are able to voice their support or opposition to the compensation figures.

Although say-on-pay votes are most often advisory, they can, nevertheless, serve an important purpose. Compensation committees become more aware of the scrutiny given by the shareholders to the committees' proposals. Timely disclosure and the feedback process also allow for greater accountability. Caution, on the other hand, should be taken with binding shareholder votes. In certain scenarios, disagreements and standoffs are possible between shareholders and management. The current administration is a big proponent of say-on-

⁷⁸ *Corporate Governance of the Largest U.S. Public Companies: Directors and Executive Compensation*, SHEARMAN & STERLING LLP, 11, available at https://reaction.shearman.com/reaction/pdf/Eighth_Annual_Director_&_Executive_Compensation_Survey.pdf.

⁷⁹ See ALAN PALMITER & FRANK PARTNOY, *CORPORATIONS: A CONTEMPORARY APPROACH* 689 (2010).

⁸⁰ *See id.*

pay provisions. The governmental efforts in this area are discussed *infra*.

ii. Clawback Provisions

Clawback provisions are after-the-fact confiscatory measures. Clawback provisions are not particularly novel. For example, the Sarbanes-Oxley Act of 2002 provides for recoupment of certain executive compensation in the event of material noncompliance with financial reporting.⁸¹ Similarly, shareholders may include clawback provisions that are triggered by certain threshold performance figures. Arguably, such provisions have some merit for a company with a very predictable business model where meaningful incentives can be set with certainty. However, clawback provisions will do very little to help compensation committees set incentives within sophisticated industries, such as the financial industry. In short, clawback provisions do not offer a remedy for a lack of foresight; instead, they merely offer token assurance that “bad-boy” executives will not collect a windfall at the expense of shareholders.

iii. Risk Assessment

Risk assessment attempts to tackle head-on one of the recurring themes of this paper: the difficulty of setting meaningful long-term incentives for executives. Risk is the new “buzzword” in the executive pay discussion.⁸² Relevant shareholder proposals call for thorough evaluation of all potentially detrimental risks and for their disclosure. Compensation incentives should then thoroughly discourage unnecessary risk taking. The author is skeptical of any potential effectiveness of broad language that discourages unnecessary risk-taking. At large, risk assessment analysis is nothing more than a reincarnation of the age-old duty of loyalty: the management is not expected to take on excessive risks for personal benefit and at the detriment of the shareholders. Because risk assessment will most likely become the task of a company’s compensation committee, the entire issue is again reduced to the competence of the committee’s members and their knowledge of the company’s core business. As long as broad admonitions are not replaced with company-specific and truly beneficial long-term incentives, the new “buzzword” will be as ineffective as any previous broadly-worded measures.

⁸¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 16 Stat. 778 (codified as amended at 15 U.S.C. § 7243 (2006)).

⁸² 2009 *Trends in Corporate Governance*, *supra* note 65, at 4.

C. Governmental Efforts

Unlike the shareholders, who derive their authority to influence corporate decisions from their ownership of the corporation, the government contends that it vicariously represents the host of other legitimately interested parties such as employees, labor unions, citizens, and consumers. The government is particularly watchful of companies receiving federal aid.⁸³ Following the recent bailout and in response to populist outrage, the Obama administration took several steps to limit executive compensation at these companies.

To a large extent, the current administration's efforts have paralleled those of the shareholders. Specifically, President Obama and his advisors have issued strong backing for say-on-pay provisions, risk assessment and disclosure, and clawback provisions.⁸⁴ The Securities and Exchange Commission ("SEC") is preparing a series of rules aimed at introducing these principles.⁸⁵ At this time, the rules extend only to companies receiving government aid, but the administration has not been apologetic about the possibility of these rules applying to a broader mix of companies.⁸⁶ Predictably, such propositions are likely to cause near-hysteria in certain corporate circles.

In addition to the present TARP and SEC rules, Congress is working on the Corporate and Financial Institution Compensation Fairness Act of 2009.⁸⁷ This Act would codify non-binding say-on-pay shareholder votes, require the SEC to develop an additional set of executive pay regulations, and introduce "sound risk management" within executive pay.⁸⁸

In the interim, the administration has appointed a well-known Washington lawyer, Kenneth Feinberg, to the position frequently dubbed as "pay czar."⁸⁹ This development is entirely unique and unprecedented. Feinberg wields wide discretion, and he has not been

⁸³ See Bloomberg News, *Geithner Criticizes Wall St. Pay*, N.Y. TIMES, Dec. 5, 2009, at B2.

⁸⁴ See, e.g., Edmund L. Andrews & Louise Story, *New Rules Seek to Force Banks to Restrict Pay*, N.Y. TIMES, Sept. 19, 2009, at A1.

⁸⁵ See Press Release TG-15, U.S. Dep't of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at <http://www.treas.gov/press/releases/tg15.htm>.

⁸⁶ See *id.*

⁸⁷ Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009).

⁸⁸ *Id.*

⁸⁹ See Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A2.

afraid to use it. As of October 2009, he had cut total compensation by about fifty percent for the top twenty-five earners at seven companies that receive “exceptional help.”⁹⁰ Most recently, he left Kenneth Lewis of Bank of America without a salary or bonus for 2009.⁹¹

Unfortunately, Feinberg’s efforts are likely to be as effective as clawback provisions: they provide a measure of consolation but do not reverse the past or create shareholder value for the future. Arguably, Feinberg’s efforts may even have an opposite effect—that of discouraging top executives from working at already struggling “bailed out” companies.⁹² Moreover, if Feinberg alone determines future incentives for executives at a broad range of industries and does so without appropriate knowledge or expertise, he may repeat the mistakes of WaMu’s and AIG’s compensation committees.

D. Conclusion

So, what is the scope and efficacy of any proposed legislative check on executive compensation? The proposed scope of governmental action is largely parallel to already existing internal initiatives of the shareholders, and legislation will only make mandatory what many companies have adopted voluntarily. Of course, if any legislation codifies or extends the position of the “pay czar,” it may not be long before American executives are “benchmarking” against their Chinese counterparts. As to the efficacy of the proposed rules, it will be marginal at best. Voluntary compliance has stolen much of legislators’ “thunder,” and none of the proposals are revolutionary or particularly innovative. The legislation does, however, send an important signal to the corporate world: the government is not afraid to challenge the existing *status quo* in executive pay and beyond. If the present administration continues until 2016, the country will undoubtedly face additional changes.

V. Afterword

This paper has presented a short legal survey of today’s state of executive compensation. Presently, this field is evolving at a rapid pace, and many of the overarching issues within this debate are truly interdisciplinary and of significant societal importance. The author

⁹⁰ Stephen Labaton, *U.S. Will Order Pay Cuts at Firms with Bailout Aid*, N.Y. TIMES, Oct. 22, 2009, at A1.

⁹¹ Louise Story & Eric Dash, *Bank Chief Forgoes Pay for 2009*, N.Y. TIMES, Oct. 16, 2009, at B1.

⁹² See, e.g., Bill Vlasic, *Pay Limit May Hinder Search for a G.M. Chief*, N.Y. TIMES, Dec. 3, 2009, at B3.

believes the scrutiny awarded to this subject by the general public, the press, and the academic community is fully justified. Our joint discussion elicits recurrent, critical, and indispensable themes of just societal construction. Many of the questions presented by this dialogue—wealth, its generation and distribution within a society, incentives and their effect on human behavior, efficiency and the formative power of law—are all long-stranding and recurring human concerns. Hopefully, our efforts will foster a realization that maximum overlap of seemingly diverging interests is possible. However, that is the subject of a different intellectual journey.

