NOTE

PAY FOR PERFORMANCE: CORPORATE EXECUTIVE COMPENSATION IN THE 1990s

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I. INTRODUCTION

Nearly sixty percent of America's gross domestic product is generated by its corporations.[1] Additionally, publicly held corporations represent approximately twenty percent of the total equity invested within the

[1]BUREAU OF ECONOMIC ANALYSIS, U.S. DEPT. OF COM., SURV. CURRENT BUS. (Jan. 1994). The Gross United States Domestic Product for 1992 was $6.0385 trillion. *Id.* at 8 (table 1.1). Corporate Gross Domestic Product for 1992 was $3.5717 trillion or 59.15% of the total. *Id.* at 11 (table 1.16).

United States.[2] Obviously, the efficient operational performance of public corporations and their supporting market systems is therefore critical.[3]

Economists have advanced several different theories concerning the proper role of government regulation in controlling public corporations.[4] Some economists believe that market regulation is both necessary and desirable in order to ensure free competition.[5] Interestingly, other commentators argue the opposite for similar reasons. They contend the absence of government intervention allows naturally occurring market forces to drive businesses to improve in order to remain competitive.[6] According to the latter view, government regulation in any form only hinders this desirable capitalistic outcome.[7]

In practice, however, some government regulation of public corporations has proven necessary to support orderly corporate operation

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[2]ROGER G. IBBOTSON & GARY P. BRINSON, INVESTMENT MARKETS: GAINING THE PERFORMANCE ADVANTAGE 33 (1987) (showing, at figure 3.3, the relative distribution of U.S. investment in 1984).

[3]*The SEC and the Issue of Runaway Executive Pay, Hearing Before the Subcomm. on Oversight of Government Management of the Senate Comm. on Governmental Affairs*, 102d Cong., 1st Sess. 1 (1991) [hereinafter *The Issue of Runaway Executive Pay*]. "The future of America's economy and the economic well-being of our people are directly dependent upon the competitiveness and productivity of American business." *Id.* (opening statement of Sen. Levin discussing the importance of American corporate performance to the country). *See generally* D.E. AYLING, THE INTERNATIONALISATION OF STOCKMARKETS; THE TREND TOWARDS GREATER FOREIGN BORROWING AND INVESTMENT 9,124 (1986) (discussing U.S. prominence as a leader in the development of investment market systems and the interrelationship of the U.S. market systems to foreign investment markets).

[4]*See, e.g.*, Harold Demsetz, *Perfect Competition, Regulation and the Stock Market, in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (Henry G. Manne ed., 1969) (discussing the implementation of public policy in the regulation of security markets); ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION (1992) (exploring the Securities and Exchange Commission (SEC) as a bureaucracy and its successes in protecting the public interest); SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST (Richard Schmalensee ed., 1981) (reviewing the SEC implementation of public policies).

[5]Demsetz, *supra* note 4, at 2. "Those who would like to increase the role of government believe that most important instances of imperfections [to competition] find their source in the market and that the removal of these requires much more extensive remedial action by the government." *Id.*

[6]*Id.*

> Those who feel that the role of government should be minimized stress their view that government itself is responsible for the most grievous instances of imperfections [in competition] and that economic policy in this area should consist primarily of the removal of government obstructions and the implementation of antitrust policy.

Id. at 1-2.

[7]*Id.* at 1. "There is widespread predisposition to believe that imperfections in competition are undesirable." *Id.*

and to protect the interests of the individual investor.[8] The cornerstones of federal market regulation are the Securities Act of 1933[9] and the Securities and Exchange Act of 1934.[10] Furthermore, the federal government regulates the operation of business organizations through additional methods, including the federal tax structure[11] and the issuance of accounting standards for corporate reporting.[12] Whatever the method of regulation, the federal government walks a delicate line. It must regulate enough to protect the public interest but must be careful not to overregulate and harm the capitalistic system that drives our economy.[13]

Compensation practices used by corporate directors to motivate and reward senior managers have come under scrutiny concerning their relationship with corporate performance.[14] Since early 1992, three separate federal government institutions have undertaken four different actions which have had a profound effect upon how executives are compensated in America's largest corporations.[15] Congress enacted legislation which modified the Internal Revenue Service (IRS) code by excluding the deductibility of certain amounts of executive compensation.[16] The Financial Accounting Standards Board (FASB) released proposed rule changes affecting the manner in which a corporation accounts for fixed stock option grants in its financial statements.[17] The Securities and Exchange Commission (SEC) reversed a long-standing policy when it issued ten no-action letters to corporations stating that the corporations could no longer exclude properly submitted shareholder proposals concerning executive compensation from their

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[8]KHADEMIAN, *supra* note 4, at 23. "There was a widely shared public demand for the federal government to regulate Wall Street after the stock market crash of 1929." *Id.*

[9]15 U.S.C. §§ 77a-77aa (1993).

[10]*Id.* §§ 78a-78*ll*.

[11]*See infra* Part III.C.

[12]*See infra* Part III.B.

[13]PHILLIPS & ZECHER, *supra* note 4, at 3 (discussing a needed balance which must be struck with regulation).

[14]*The Issue of Runaway Executive Pay*, *supra* note 3, at 1. The importance of American businesses "is the basis for the growing concern with what I would call runaway executive pay. . . . It is one thing to have spectacular pay increases for spectacular performance. It is another thing to have spectacular pay increases for dismal or even mediocre performance." *Id.* (opening statement of Sen. Levin).

[15]*See* discussion *infra* Part III.

[16]26 U.S.C. § 162(m) (Law. Co-op. 1993); *see infra* note 171 for the complete text.

[17]FINANCIAL ACCOUNTING STANDARDS BOARD, *Financial Accounting Foundation, Proposed Statement of Financial Accounting Standards: Accounting for Stock-Based Compensation* (Financial Accounting Series No. 127-L, 1993) [hereinafter *Accounting for Stock-Based Compensation*].

proxy material by claiming an "ordinary business operations" exemption.[18] Finally, the SEC is now requiring corporations to provide more detailed disclosure of executive compensation practices in their annual proxy material.[19]

These actions were a response to growing political pressures on and within each of the institutions to reform executive compensation practices.[20] While each action is directed at a particular problem or issue, the political pressures forcing the changes enacted by each institution have at least two common origins. First, a strong public perception exists that executive compensation has grown out of control since the early 1980s.[21] Second, shareholders today desire greater insight into and control over corporate policy, including executive compensation.[22]

The aim of this note is not to discuss the validity of government regulation. Instead, it accepts that government action has been taken and additional action is possible.[23] This note will examine the effect of actions already taken on executive compensation policies and corporate governance. Further, it will evaluate how shareholder activism is likely to be affected by these changes.

II. THE IMPETUS FOR FEDERAL ACTION

A. *The Problem with Compensation*

Executive compensation is not a new topic for either debate or regulation. The issue was discussed as early as 1939 when the SEC enacted its first regulations regarding executive compensation disclosure.[24]

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[18]*See infra* Part III.D.

[19]*See infra* Part III.A.

[20]*See, e.g.*, *Shareholder Rights, Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. 49 (1991) [hereinafter *Shareholder Rights*] (Sen. Levin, author of legislation pressuring SEC changes regarding the propriety of shareholder proposals on executive compensation, agreeing with Sen. Dodd that SEC action allowing such shareholder proposals would eliminate the need for legislation).

[21]Bevis Longstreth & Nancy Kane, *Shareholders' Growing Role in Executive Compensation* (pt. 1), N.Y. L.J., Feb. 20, 1992, at 5. "[Reports of] executive compensation of 'mind-numbing' proportions" are leading to "proposals for reform." *Id.*

[22]*Id.* (discussing the increased role of institutional investors in corporate control).

[23]The Equity Expansion Act of 1993 is currently pending in both houses of Congress. S. 1175, 103d Cong., 1st Sess. (1993); H.R. 2759, 103d Cong., 1st Sess. (1993) (proposing changes to the tax and accounting treatment of certain stock options granted as compensation); *see infra* notes 232 & 234 for portions of the bill's text.

[24]Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28-29.

At that time, the salary of $15,000 a year was considered extremely excessive for a manager of a corporation since "no one . . . could be worth [that amount of money]."[25] Today the annual median income for a chief executive officer is $1.5 million.[26]

Recently executive compensation and corporate management policies have again come under public scrutiny.[27] Two phenomena combined in the late 1980s and early 1990s to draw the attention of American governmental officials to executive compensation. First, during the late 1980s, the nature of corporate ownership changed, revising the investment goals of the "average" shareholder in an American corporation.[28] Second, during the early 1990s, the media and the recession combined to focus public attention on the salaries of America's CEOs.[29] An understanding of both phenomena is required to evaluate the necessity and desirability of the resulting federal action.

1. Changing Corporate Ownership

The first important phenomenon was the emergence of institutional investing in the late 1980s. This new force would eventually help effect changes in federal corporate governance policy.

During the 1980s, the very nature of corporate ownership underwent significant changes.[30] Early in the decade, large public corporations were bought out at a frantic pace in large stock tender deals either by private interests or by other corporations.[31] As a result, the number of

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[25] *Id.*

[26] *The Bosses' Pay*, WALL ST. J., Apr. 21, 1993, at R13. This figure is based upon a survey of 350 proxy statements. However, this amount varies and is dependent upon the group surveyed. *Fortune* reports an average pay package of $3.2 million. Andrew E. Serwer, *Payday! Payday!*, FORTUNE, June 14, 1993, at 102 (surveying 200 of America's largest corporations). *Forbes* reports an average total compensation of $2.6 million. *What 800 Companies Paid Their Bosses*, FORBES, May 24, 1993, at 124 (obtained by dividing $2.1 billion grand total by the reported number of executives polled). In 1992 the average pay of a CEO at one of America's 50 largest corporations was $3.5 million. Susan Wong, *Paychecks of the Super 50*, FORBES, May 10, 1993, at 105.

[27] *E.g.*, Brownstein & Panner, *supra* note 24, at 28.

[28] Longstreth & Kane (pt. 1), *supra* note 21, at 5. Institutional investors, which are primarily interested in long-term investments, now own a significant number of shares in public corporations. *Id.*

[29] *Id.* at 28; Bevis Longstreth, *CEO Pay: Don't Let the Government Decide*, WASH. POST, Mar. 17, 1992, at A17.

[30] Longstreth & Kane (pt. 1), *supra* note 21, at 5 (discussing the changes in corporate control brought about by institutional investors).

[31] MICHAEL USEEM, EXECUTIVE DEFENSE: SHAREHOLDER POWER AND CORPORATE

acceptable, available investment options for large institutional trusts or retirement funds dwindled.[32] The remaining trusts were, therefore, vested with ever increasing amounts of assets for investment.[33]

As a result of this shift, the institutional investors found themselves holding larger and larger blocks of stock in a given corporation.[34] This posed, and continues to pose, a serious problem for the funds.[35] Ideally, a stock trader wants the ability to make a stock trade without significantly impacting the trading price of the stock.[36] This is no longer possible for the largest institutional investors. Since liquidating an investment in a corporation would involve a large transaction of stock, it would naturally depress the stock's sale price and affect the investment's total return to the institutional investor.[37] Likewise, a significant purchase of a corporation's stock would inflate the stock's purchase price to the institutional investor.[38]

The institutional investors could no longer play the market looking for short-term gains as could the individual investor. Because the potential transactional price for buying into or liquidating a corporation's holdings was so high, institutions became long-term investors out of

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REORGANIZATION 24-25 (1993) (discussing the intensity of conversions of public corporations into private companies in the mid-1980s).

[32]*Id.* at 28. During the 1980s, $217 billion in corporate assets were taken private and were no longer available for institutional investors. *Id.* "Few untapped domestic [investment] opportunities remained." *Id.*

[33]*Id.* Total holding of institutional investors rose an average 14% annually from 1981 to 1988. *Id.* at 29 (table 2.1). In 1988, total holdings equaled over $5.2 trillion. *Id.*

[34]Longstreth & Kane (pt. 1), *supra* note 21, at 5. "In 1990 total equities held by public and private pension funds amounted to 32.4 percent of the New York Stock Exchange's total dollar value." *Id.* (citing Victor F. Zonana, *Pension Funds Flex Muscles*, LA TIMES, June 21, 1991, at A1).

[35]USEEM, *supra* note 31, at 28 (discussing institutional investors' inability to easily "exit" a particular investment). Generally, when a shareholder is unhappy with a board's decision, the sole alternative for the shareholder is to "exit" the investment. *Id.* at 19.

[36]Similarly, an institutional investor would like the ability to walk away from poor performers without affecting the market. *See* Longstreth & Kane (pt. 1), *supra* note 21, at 5 (noting institutional investors can no longer easily walk away).

[37]*Id.* For example, the California Public Employees Retirement System (CALPERS) cannot easily walk away since it owns nearly one percent of every major stock. *Id. See also* CLIFF PRATTEN, THE STOCK MARKET 116 (1993) (stating "[a] large fund cannot unload or acquire substantial holdings with a single sale or purchase").

[38]Longstreth & Kane (pt. 1), *supra* note 21, at 5. "Due to the nature of shareholding and corporate ownership, the shareholder/owners would tend to take a short-term profit maximizing view, with emphasis on the largest possible immediate returns on their (possibly brief) investments." *Id.* (citation omitted).

necessity.[39] This change in investment strategy resulted in each institutional investor taking a greater interest in the long-term management policies and practices of the corporation.[40] Naturally, along with an increased focus on management policies went a desire on the part of the institutional investors to influence or control those policies.[41]

2. Public Opinion

Executive compensation levels rose steadily during the 1980s.[42] During that same period, the rate of executive compensation growth greatly exceeded the rate of growth of the average American's salary.[43] By the early 1990s, the average CEO's salary was prodigious under any standard,[44] and such enormity was compounded by exercised stock options and other additional performance based compensation.[45] Quite

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[39]*Id.* "[S]ome institutional investors have begun to think of themselves as 'owners' for the very long term." *Id. See also* USEEM, *supra* note 31, at 28 (noting that the College Retirement and Equities Fund (CREF) does not believe it is "in a position to divest itself of a company's stock when it disagrees with the action of that company's management"). *Id.*

[40]Longstreth & Kane (pt. 1), *supra* note 21, at 5. "If they are locked into ownership, [the institutional investors] had best rediscover the voice of ownership in order to protect the value of their investments." *Id.*

[41]USEEM, *supra* note 31, at 28. "'We [institutional investors] want to break up the concentration of power at the top, create more accountability, and provide checks and balances.'" *Id.* (quoting an investment advisor to the New York City Employees' Retirement System). By the early 1990s, at least one institutional investor had become particularly interested in the selection and compensation of senior management because of its perceived direct effect upon corporate performance. Richard W. Stevenson, *Huge Fund Turns Up Proxy Heat*, N.Y. TIMES, Mar. 21, 1992, at 37 (discussing CALPERS threatened proxy action against several corporations should they fail to adopt more shareholder friendly policies including, in some cases, modified executive compensation policies).

[42]*Shareholder Rights*, *supra* note 20, at 16 (graph showing executive compensation). *See also* DEREK BOK, THE COST OF TALENT; HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 78 (1993) (graph comparing the top salaries for CEOs).

[43]*Shareholder Rights*, *supra* note 20, at 16. Recent studies indicate the ratio between the highest paid employee and the lowest paid employee is 160 to 1 or more. Longstreth, *supra* note 29, at A17. Also, the average CEO is "about 70 times that of the average factory worker." ROBERT B. REICH, THE WORK OF NATIONS: PREPARING OURSELVES FOR 21ST-CENTURY CAPITALISM 7 (1991).

[44]This average has been referred to as "mind-numbing." Longstreth & Kane (pt. 1), *supra* note 21, at 5.

[45]Joann S. Lublin, *Higher Profits Fatten CEO Bonuses*, WALL ST. J., Apr. 21, 1993, at R1. "Last year's strong 22.8% rebound in profits at surveyed companies resulted in generous annual bonuses for numerous corporate leaders." *Id.*; *see also* Serwer, *supra* note 26, at 102 (showing stock option compensation along with salaries of CEOs).

simply, the sheer magnitude of executive compensation was difficult for the average American to comprehend.[46]

During the same time period, America was suffering through a moderate recession.[47] In the face of increasing economic hardships, the unemployed were confronted with stories of multi-million dollar salaries paid to CEOs.[48] The gap between what CEOs were earning and what they were perceived to be worth[49] seemed gigantic, especially to an average employee whose wage increase barely exceeded the inflation rate.[50]

In early 1992, excessive executive compensation was publicly targeted. American corporations and their workers were suffering from a widely held "perception of America's declining competitiveness, particularly in comparison with the Japanese."[51] In an attempt to open foreign markets and to win public relations points during an election year, President Bush traveled to Japan with several American CEOs to discuss trade issues with the Japanese.[52] The Japanese, resisting the contention that Japanese performance was due to trade restrictions at home, quickly turned the issue of competition into one of excessive compensation paid to American CEOs.[53] As a result, executive compensation became a widely discussed populist topic during the 1992 election year.[54] When the populist opposition candidate prevailed, it became a topic destined for federal government action.[55]

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[46]Robert A. Rosenblatt, *Firms Must Fully Report Officers Pay*, L.A. TIMES, Oct. 16, 1992, at A1, A34. "Sometimes, corporate chieftains' pay is so big that 'you are not able to square it with a normal person's idea of what is right and wrong.'" *Id.* (quoting SEC Chairman Breeden).

[47]Brownstein & Panner, *supra* note 24, at 28.

[48]*Id.*

[49]*Id.* at 29. "Most people believe the rich have gotten richer and the poor poorer and that CEOs are now lining their pockets at the expense of everyone else." *Id.*

[50]The median increase in CEO pay was 8.1% in 1992 compared to a 4.9% increase for white collar employees in the same year. *The Bosses' Pay*, *supra* note 26, at R13. The inflation rate in 1992 was 2.9%. Steven Pearlstein, *Reform's Economic Side Effects*, WASH. POST, May 2, 1993, at A1, A22.

[51]Brownstein & Panner, *supra* note 24, at 28. *See also* Longstreth, *supra* note 29, at A17 (discussing the public relations effect of the trade visit on executive compensation).

[52]Rosenblatt, *supra* note 46, at A34. "The issue became a hot political issue this year when President Bush was visiting Japan on a trade mission." *Id.*

[53]*Id.* "When [President Bush] complained about unfair trade, Japanese officials pointed to excessive U.S. executive salaries as a reason for the lack of U.S. competitiveness." *Id.*

[54]Brownstein & Panner, *supra* note 24, at 28.

[55]For example, Arthur Levitt (President Clinton's appointee as SEC chairman) acted swiftly to affirm, extend, and report on the SEC's changes in executive compensation disclosure requirements. Jonathan E. Gottlieb & Diana R. de Brito, *New Disclosure, Taxation*

B. *A Purpose for Regulation*

By the beginning of this decade, it was clear that something would be done to control the growth of executive compensation.[56] The high levels of executive compensation in America had been a major campaign issue for the newly elected president.[57] Public opinion was strongly against the inequity in the current compensation structure.[58] Institutional investors were bringing increasing pressure to bear on the regulatory agencies to support mechanisms which would increase institutional investor influence on the corporations.[59] As a result, Congress and the SEC conducted hearings addressing executive compensation and its perceived excesses.[60]

Three major arguments were forwarded supporting the contention that something was wrong with executive compensation policies in America.[61] First, executive compensation was disproportionate when compared with the salaries paid to the senior executives of foreign corporations.[62] Second, the level of executive compensation had increased much more rapidly than salaries of the remainder of the American work force.[63]

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and Accounting Treatments for Executive Compensation, 7 INSIGHTS (P-H) No. 9, at 28 (Sept. 1993).

[56]*See* BOK, *supra* note 42, at 116-18 (discussing the concept of federal action to help control compensation practices); *see also* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 241-52 (1992).

[57]Brownstein & Panner, *supra* note 24, at 28.

[58]*See* Rosenblatt, *supra* note 46, at A1.

[59]*See, e.g.*, MARK A. SARGENT, PROXY CONTESTS HANDBOOK Doc. 1-1 (Sec. Law Series) (1992) (showing copy of letter from CALPERS to the SEC proposing revisions to the SEC's proxy rules to allow greater communication between shareholders).

[60]*See, e.g.*, *The Issue of Runaway Executive Pay*, *supra* note 3 (example of Congressional hearing on the topic of excessive executive compensation involving the chairman of the SEC); *see also Shareholder Rights*, *supra* note 20.

[61]*Shareholder Rights*, *supra* note 20, at 8.

[62]*Id.* It is undeniably true that the cash compensation in salary and bonuses granted American CEOs generally exceeds that given to similarly situated CEOs in foreign countries. *Id.* However, the contrasting argument is that foreign compensation cannot and should not be directly compared to American compensation because foreign compensation includes perks which are difficult to value and are generally not granted their American counterpart. Brownstein & Panner, *supra* note 24, at 32. *See also* Richard Morris et al., *The Global Boss' Pay: Where (And How) The Money Is*, FORBES, June 7, 1993, at 90 (comparing United States, Japanese, and German executive compensation).

[63]*Shareholder Rights*, *supra* note 20, at 8. Statistical data since the beginning of the 1980s clearly supports this contention. *Id.* *See also* BOK, *supra* note 42, at 78 (graph comparing the top salaries for CEOs). However, the counterpoint is that the rate of growth of executive compensation has recently decreased. *See The Bosses' Pay*, *supra* note 26 (graph showing lower growth rate during the period from 1989 to 1991). Further, executive compensation

Third, executive compensation was not related to corporate performance.[64]

These arguments supported the contention that executive compensation practices were inconsistent with the apparent best interests of the corporation, its shareholders, and, therefore, of the general public.[65] True or not, these arguments proved to be persuasive to a dissatisfied public.[66] As a result of ensuing pressure, members of Congress threatened to enact legislation which would have made significant changes to the Securities and Exchange Act.[67] Thereafter, the focus of inquiry, within and outside of the government, turned to defining the proper goal for any subsequent government action.[68]

While dissatisfied, Congress appeared hesitant to act so drastically as to set explicit limits on executive compensation.[69] However, Congress was willing to influence executive compensation levels through alternative means.[70] The majority of commentators, including those stridently opposed to the current compensation practices, agree that the desired solution should be to increase the natural market forces which normally serve to keep executive compensation levels in line with the value obtained for the services.[71] The normal market forces controlling

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should be measured against the overall performance of the organization and not against the rate of increase in others' salaries. Lublin, *supra* note 45, at R2 (asserting that it does not matter how much an executive is paid provided it is tied to performance).

[64]*Shareholder Rights*, *supra* note 20, at 8. Some statistics indicate that the compensation paid to several chief executive officers bore little, if any, relationship to the success of the corporation. *Id.* However, the truth of the assertion is hotly debated and very difficult to prove conclusively because of the large number of intervening factors which must be analyzed for each individual case. *Compare* CRYSTAL, *supra* note 56, at 253-76 *with* Brownstein & Panner, *supra* note 24, at 29-32 (attacking each other's analysis of the issue).

[65]*The Issue of Runaway Executive Pay*, *supra* note 3, at 1 (arguing that poor compensation policies adversely affect the performance of public corporations and, therefore, work against the public good).

[66]*See supra* Part II.A.1.

[67]*Corporate Pay Responsibility Act*, S. 1198, 102d Cong., 1st Sess. (1991), and H.R. 2522, 102d Cong., 1st Sess. (1991). *See infra* note 77 (providing a portion of the text).

[68]*Shareholder Rights*, *supra* note 20, at 1.

[69]*Id.* at 2. Senator Dodd stated, "But we are not about to pass a law, nor would I support one, even coming close to placing a cap on chief executive officer pay." *Id.*

[70]For example, the Congress passed new restrictions on the amount of executive compensation which corporations can deduct from their income. 26 U.S.C. § 162(m) (Law. Co-op. 1993). *See infra* note 171 for the complete text.

[71]For example, one commentator stated:

> In the perfectly competitive world . . . all chief executives would receive amounts approximating what they added to the net profits of their compan[y]. Firms that could benefit the most from inspired leadership would pay the most money to the CEO of their choice. Because everyone in this world is perfectly informed, such companies would proceed unerringly to identify the best chief executives and offer

executive compensation are adversely influenced by a lack of knowledge on the part of both concerned executives[72] and boards of directors[73] regarding the actual worth of a chief executive. Add to this ignorance the amount of influence the CEO naturally exerts over a board of directors and it is clear that a CEO will generally get paid what s/he desires.[74] From the shareholder's perspective, the worth of a CEO or any senior manager depends upon corporate performance.[75] Therefore, an ideal goal for government action should be restoring, as much as possible, a natural market balance which would tie executive compensation more closely to an executive's worth as measured by the corporation's performance.[76]

> them more than they were currently earning. The latter, being motivated primarily by love of money, would happily agree to serve. In this way, the greatest talent would move automatically to the firms in which it could do the most good, resources would be utilized more productively, and everyone would benefit as a result.

BOK, *supra* note 42, at 96.

[72]*Id.* "Executives rarely know what opportunities exist for them in other companies or what such jobs might pay." *Id.*

[73]Bok continues:

> [D]irectors do not have perfect knowledge even about their own CEO. If the firm is prospering, no one can be sure how much of the credit belongs to the leadership and how much to favorable economic conditions, changes in tax laws or government regulations, outstanding subordinates, or wise investments made in some earlier regime. If the company is performing sluggishly, directors cannot always know how much blame should be heaped upon the current CEO and how much belongs to onerous government regulations, bad luck, or mistakes of a previous chief executive.

Id.

[74]Bok concluded:

> [M]ost top executives are in an unusually strong position to strike a favorable bargain, because they exert such influence over the process [of fixing executive compensation]. CEOs almost always serve as chairman of the board. They typically have a good deal to say about the choice of new board members. They are the key people who decide on the fees paid to the directors, fees that average over $40,000 for only a few days of work each year. They often choose the consultant who presents recommendations on their next pay increase to the board — and most consultants are only too aware that candor, restraint, frugality, and other Puritan virtues may not be warmly remembered when it comes to picking a successor for the following year. In this environment, the task of fixing the compensation of top executives is hardly an arm[']s-length transaction . . . .

Id. at 98.

[75]Lublin, *supra* note 45, at R2. "'[Institutional investors] don't care if [CEOs] are paid $75 million as long as it is tied to performance.'" *Id.* (quoting Sarah Teslik, executive director of the Council of Institutional Investors).

[76]Longstreth, *supra* note 29, at A17 (noting that the federal actions regarding excessive executive compensation favor the operation of market forces and the private sector must now move to make the market forces work).

III. FEDERAL ACTION

This note is concerned primarily with four actions taken by three government agencies in the area of executive compensation. Not all of the actions were directed specifically at restoring or inducing market forces to act to restrain executive compensation. However, each of these actions directly affects how executive compensation practices are modified in the future and are, therefore, central to an analysis of how executive compensation policies will change.

A. *Compensation Disclosure*

Faced with the threat of impending Congressional action,[77] the SEC moved,[78] under its own authority, to change the executive compensation

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[77]*Corporate Pay Responsibility Act*, S. 1198, 102d Cong., 1st Sess. (1991) and H.R. 2522, 102d Cong., 1st Sess. (1991). Section 2 of the House bill would have amended § 14 of the Securities Exchange Act of 1934, 15 U.S.C. § 78(n), by adding language including:

> (2) DISCLOSURE INFORMATION. — Pursuant to the rules and regulations of the Commission, an issuer shall include in its proxy statement, clear and comprehensive information concerning the compensation paid to each director and senior executive, including —
>
> (A) a single dollar figure representing the total compensation paid to such person, including deferred, future, or contingent compensation, by the issuer during the year to which such proxy statement pertains;
>
> (B) the estimated present value, represented by a dollar figure, of any forms of deferred, future, or contingent compensation provided during such year; and
>
> (C) a graphic representation of —
>
> (i) the compensation referred to in subparagraph (A);
>
> (ii) comparable figures for the total compensation paid to such person by the issuer during each of the 2 years prior to the year to which such proxy statement pertains; and
>
> (iii) comparable figures for the estimated total compensation to be paid to such person by the issuer in each of the succeeding 5 years.
>
> (3) PRESENT VALUE CALCULATIONS. — For purposes of paragraph (2) of this subsection, the Commission shall —
>
> (A) specify the method for estimating the present value of stock options and other forms of deferred, future, or contingent compensation paid to the directors and senior executives of an issuer; and
>
> (B) require the issuer to reduce its earnings, as reflected in its earning statements to its security holders, by the estimated present value of such compensation.

H.R. 2522, 102d Cong., 1st Sess. § 2 (1991).

[78]The SEC Annual Report states:

> On June 4, 1992, Chairman Breeden testified before the Subcommittee on

disclosure requirements of Regulation S-K.[79] It also made further associated changes to Schedule 14A[80] and Form 10K.[81] These reporting requirements apply to most large United States corporations, including all publicly traded entities.[82] The SEC adopted the initial regulation changes in late 1992[83] following the dissemination of a set of proposed changes[84] and a short comment period. The regulations were refined by a second set of changes adopted near the end of 1993.[85] The 1993 modifications

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Taxation of the Senate Committee on Finance and stated that the Commission opposed direct government regulation of compensation and the indirect use of the tax code or legislatively mandated accounting rules to try to accomplish the same objective.

Shortly after Chairman Breeden's June 4, 1992 testimony, the Commission proposed new rules designed to improve the public disclosure of information concerning executive compensation [referring to Securities Act Release No. 6940 (June 23, 1992)].

1992 SEC ANN. REP. 143-44.

[79]17 C.F.R. § 229 (1993).

[80]*Id.* § 240.14a.

[81]*Id.* § 249.310.

[82]All companies are required to file information statements, registration statements, and periodic reports under the Securities and Exchange Act of 1934 (codified at 15 U.S.C. § 78m (1993)), and registration statements under the Securities Act of 1933 (codified at 15 U.S.C. § 77g (1993)). Similar but less extensive reporting requirements were also adopted for corporations electing to report as small business issuers. *See* 17 C.F.R. § 228 (1994) (Regulation S-B requirements); 17 C.F.R. § 249.310(b) (1993) (Form 10KSB requirements). "A small business issuer is defined as . . . (i) [having] revenues of less than $25,000,000; (ii) is a U.S. or Canadian issuer; (iii) is not an investment company; and (iv) if a majority owned subsidiary, the parent corporation is also a small business issuer." 17 C.F.R. § 228.10(a) (1994).

[83]Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,126 (1992) (to be codified at 17 C.F.R. §§ 228, 229, 240, 249) [hereinafter Securities Act Release No. 6962], *as corrected in* Executive Compensation Disclosure, Correction, Securities Act Release No. 6966, Exchange Act Release No. 31,420, Investment Company Act Release No. 19,085, 57 Fed. Reg. 53,985 (1992) (to be codified at 17 C.F.R. § 228) [hereinafter Securities Act Release No. 6966].

[84]Executive Compensation Disclosure, Securities Act Release No. 6940, Exchange Act Release No. 30,851, 57 Fed. Reg. 29,582 (1992) (to be codified at 17 C.F.R. §§ 229, 240) [hereinafter Securities Act Release No. 6940].

[85]The second set of proposed changes were issued in August of 1993. Executive Compensation Disclosure; Securityholder List and Mailing Requests, Securities Act Release No. 7009, Exchange Act Release No. 32,723, 58 Fed. Reg. 42,882 (1993) (to be codified at 17 C.F.R. §§ 228, 229, 240 [hereinafter Securities Act Release No. 7009]. The second set of changes were enacted in November of 1993. Executive Compensation Disclosure; Securityholder List and Mailing Requests, Securities Act Release No. 7032, Exchange Act Release No. 33,229, 58 Fed. Reg. 63,010 (1993) (to be codified at 17 C.F.R. §§ 228, 229, 240) [hereinafter Securities Act Release No. 7032].

were adopted largely to correct problems which arose in the application and administration of the initial regulation changes and to clarify questions of interpretation faced by the SEC during its first year of enforcement.[86]

So significant were the changes to the disclosure requirements that their enactment caused Ralph V. Whitworth, president of the United Shareholders Association, to comment, "These sweeping reforms pave the way for shareholders to take back their companies."[87] The revised SEC disclosure regulations drastically alter the amount and nature of executive compensation information required to be disclosed under securities laws.[88] Specifically, three of the rule changes encourage corporate directors to adopt compensation policies tying pay to performance. First, the compensation committee must disclose its compensation policy to the shareholders in order to permit shareholders to evaluate how well it furthers their interests.[89] Second, the total compensation of several senior executives, including the CEO, must be disclosed using a standard format.[90] Finally, the corporation must provide a "performance graph" comparing the shareholders' returns to the market as a whole and to the corporation's specific industry.[91]

1. The Compensation Committee and its Policy Statement

The SEC action is directed at informing shareholders and increasing their decision-making authority.[92] Many corporations have formed compensation committees comprised of directors with the responsibility for establishing and implementing the corporation's compensation policy.[93] The new SEC rules require disclosure of relationships that could

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[86]Securities Act Release No. 7032, *supra* note 85, at 63,010.

[87]Rosenblatt, *supra* note 46, at A1, A34.

[88]*See generally* Michael E. Ragsdale, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 538 (1993) (discussing the initial SEC rules changes and their potential effects on executive pay practices).

[89]*See infra* Part III.A.1.

[90]*See infra* Part III.A.2.

[91]Ragsdale, *supra* note 88, at 538; *see infra* Part III.A.3.

[92]Securities Act Release No. 6940, *supra* note 84, at 29,583. "The goals of the Commission initiative are to assure that shareholders are well informed and that all the facts regarding the compensation that the shareholders are paying are out in the open, and to foster better accountability of the board of directors to the shareholders." *Id.*

[93]*See* Andrew R. Brownstein, *Compensation Committees Face New Rules*, N.Y. L.J., Dec. 7, 1992, at 7 (discussing recommended rules for the composition and operation of compensation committees).

potentially influence the decisions of members of this committee.[94] Also, the revised rules require the compensation committee to disclose to the shareholders the basis for the compensation granted to senior executives.[95]

Under the revised disclosure rules, the corporation is required to disclose any "interlocks" or other conflicts of interest which exist for any member of the compensation committee.[96] In adopting this change, the

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[94]*See infra* notes 96-99 and accompanying text.

[95]*See infra* notes 100-10 and accompanying text.

[96]Securities Act Release No. 6962, *supra* note 83, at 48,156-48,157 (to be codified at 17 C.F.R. § 229.402(j) (1992)). The rules are as follows:

(j) *Additional Information with Respect to Compensation Committee Interlocks and Insider Participation in Compensation Decisions.* Under the caption "Compensation Committee Interlocks and Insider Participation,"

(1) The registrant shall identify each person who served as a member of the compensation committee of the registrant's board of directors (or board committee performing equivalent functions) during the last completed fiscal year, indicating each committee member who:

(i) was, during the fiscal year, an officer or employee of the registrant or any of its subsidiaries;

(ii) was formerly an officer of the registrant or any of its subsidiaries; or

(iii) had any relationship requiring disclosure by the registrant under any paragraph of Item 404 of regulation S-K (§ 229.404). In this event, the disclosure required by Item 404 shall accompany such identification.

(2) If the registrant has no compensation committee (or other board committee performing equivalent functions) the registrant shall identify each officer and employee of the registrant or any of its subsidiaries, who, during the last completed fiscal year, participated in deliberations of the registrant's board of directors concerning executive officer compensation.

(3) The registrant shall describe any of the following relationships that existed during the last completed fiscal year:

(i) an executive officer of the registrant served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant;

(ii) an executive officer of the registrant served as a director of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant; and

(iii) an executive officer of the registrant served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served as a director of the registrant.

SEC noted that these situations may cause "shareholders [to] have greater concerns regarding the independence of board compensation decisionmaking."[97] While the proposed changes would have required disclosure of the specific financial details of some interlocks, the regulations as adopted eliminate much of this requirement.[98] Also excluded from the reporting requirement are interlocks involving non-profit organizations.[99]

Also under the revised rules, the corporation's compensation committee must report their policies governing the last year's executive compensation.[100] A general statement of compensation policies is

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(4) Disclosure required under paragraph (j)(3) of this item regarding any compensation committee member or other director of the registrant who also served as an executive officer of another entity shall be accompanied by the disclosure called for by Item 404 (§ 229.404) with respect to that person.

Id.

Item 404 of Regulation S-K states:

(a) *Transactions with management and others.* Describe briefly any transaction, or series of similar transactions, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, or series of similar transactions, to which the registrant or any of its subsidiaries was or is to be a party, in which the amount involved exceeds $60,000 and in which any of the following persons had, or will have, a direct or indirect material interest, naming such person and indicating the person's relationship to the registrant, the nature of such person's interest in the transaction(s), the amount of such transaction(s) and, where practicable, the amount of such person's interest in the transaction(s):

(1) Any director or executive officer of the registrant;

(2) Any nominee for election as a director;

(3) Any security holder who is known to the registrant to own of record or beneficially more than five percent of any class of the registrant's voting securities; and

(4) Any member of the immediate family of any of the foregoing persons.

17 C.F.R. § 229.404 (1993).

[97]Securities Act Release No. 6962, *supra* note 83, at 48,142.

[98]Securities Act Release No. 6940, *supra* note 84, at 82,884 (proposing a change to Item 402(j)(2)(ii) to require disclosure of financial interests between a director and the corporation in excess of $60,000 under certain circumstances or disclosure of any method a director could benefit from the actions of the corporation or one of its officers).

[99]Securities Act Release No. 6962, *supra* note 83, at 48,157. The instruction states: "For purposes of this paragraph, the term entity shall not include any entity exempt from tax under Section 501(c)(3) of the Internal Revenue Code [26 U.S.C. 501(c)(3)]." *Id.* "Interlocks involving not-for-profit entities have been excluded in response to public comment that such relationships do not raise the same level of concern with respect to the independence of the compensation-setting process." *Id.* at 48,143.

[100]Securities Act Release No. 6962, *supra* note 83, at 48,157. The text provides:

(k) *Board Compensation Committee Report on Executive Compensation.*

(1) Disclosure of the compensation committee's compensation policies applicable to the registrant's executive officers (including the named executive

required for most of the senior executives.[101] However, for the CEO, a specific statement relating compensation to the corporation's performance must be made.[102] In reviewing a number of compensation committee reports prepared by corporations during the first year, the SEC noted that "[t]he quality of the disclosure linking pay and performance varied."[103] The SEC expressed concern over the general lack of specificity in these discussions.[104] In the release, the Commission outlined the level of

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officers), including the specific relationship of corporate performance to executive compensation, is required with respect to compensation reported for the last completed fiscal year.

(2) Discussion is required of the compensation committee's bases for the CEO's compensation reported for the last completed fiscal year, including the factors and criteria upon which the CEO's compensation was based. The committee shall include a specific discussion of the relationship of the registrant's performance to the CEO's compensation for the last completed fiscal year, describing each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based.

(3) The required disclosure shall be made over the name of each member of the registrant's compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors). If the board of directors modified or rejected in any material way any action or recommendation by such committee with respect to such decisions in the last completed fiscal year, the disclosure must so indicate and explain the reasons for the board's actions, and be made over the names of all members of the board.

Id.

[101]The SEC noted in the introduction to the initially adopted regulations:

In place of the [specific] discussion of the compensation of each of the other named executives and its relationship to registrant performance, a discussion is required of the compensation policies with respect to the registrant's executive officers, including the extent to which such compensation (in the aggregate) is performance-related, and the performance measures that are considered (*e.g.*, sales, earnings, return on assets, return on equity or market share).

Id. at 48,138.

[102]After a review of the first year's compensation report submissions, the SEC stated:

The [Compensation Committee's] report is to set out . . . the specific relationship of *corporate performance to that of compensation*. . . . [T]he report must discuss specifically the Compensation Committee's bases for the compensation reported for the CEO in the past year. The discussion of CEO compensation must include the criteria upon which the CEO's compensation was based, as well as a specific discussion of the *relationship of the registrant's performance to the CEO's compensation*, with a description of each measure of the registrant's performance, qualitative or quantitative, on which the CEO's compensation is based.

Securities Act Release No. 7009, *supra* note 85, at 42,887 (emphasis added).

[103]*Id.*

[104]*Id.* at 42,887-42,888. "[T]he principle recurring problem [in the reports reviewed] was a lack of specificity." *Id.*

specificity[105] necessary to satisfy the report requirements.[106]

The SEC views the compensation committee report requirement as "central" to its overhaul of compensation disclosure requirements.[107] It is intended to "enhance [the] shareholders' ability to assess how well directors are representing their interests."[108] In order to ensure that the shareholders know which directors are to be credited or blamed for compensation policies, the SEC requires the report be made over the names of the directors serving on the committee.[109] Finally, the SEC encourages dissatisfied shareholders to take internal action through the normal director elective process instead of immediately involving the legal system.[110]

2. Standardized Compensation Disclosure Tables

A meaningful review of the implementation of a given compensation policy requires a review of the pay that it grants and the performance it

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[105]*Id.* "While noting the 'simplicity' and 'generality' of the disclosure provisions, the Release made clear that specificity is required not only in the discussion of CEO compensation but also with respect to the policies applicable to all executive officers and the relationship of the registrant's performance to the compensation for the last year." Gottlieb & de Brito, *supra* note 55, at 29.

[106]Securities Act Release No. 7009, *supra* note 85, at 42,887-42,888.

The SEC provided examples of different approaches to the report. *Id.* at 42,888. The Commission also noted that the "length of the report was not a measure of its informativeness." *Id.* Furthermore, one commentator believes that starting with the current proxy season, the SEC will begin rejecting compensation committee reports which do not meet these standards. Emanuel D. Strauss, *The Honeymoon is Over for Compensation Committee Reports*, INSIGHTS (P-H) No. 10, at 5 (Oct. 1993) (noting the SEC's priority on the issue and the risk of proxy rejection).

[107]Securities Act Release No. 7009, *supra* note 85, at 42,887.

[108]Securities Act Release No. 6962, *supra* note 83, at 48,138.

[109]Securities Act Release No. 6940, *supra* note 84, at 29,593. The initially proposed regulation changes would have required that the statement be made over the signatures of the directors involved. *Id.* This "requirement was intended simply to increase the Committee members' focus on the specific disclosure obligation." Securities Act Release No. 6962, *supra* note 83, at 48,139. However, in the regulation changes as adopted, this requirement was removed in response to comments received governing its practical difficulties and because the mere statement of the names was felt to serve the same purpose. *Id.* The adopted rules also contain provisions governing whose names must appear below the report should no compensation committee exist or should the decisions of that committee be materially altered by the full board of directors. *Id.* at 48,157. *See supra* note 100 for the complete text.

[110]Securities Act Release No. 6962, *supra* note 83, at 48,138. "If shareholders are not satisfied with the decisions reflected in the report, the proper response is the ballot, not to resort to the courts to challenge the disclosure." *Id.*

elicits.[111] The first part of the pay for performance equation is compensation. Under the revised regulations, corporations must detail total executive compensation in a series of four tables.[112] Completing the tables requires compensation information for the current fiscal year and the two immediately preceding years.[113] The new rules require compensation disclosure regarding the CEO and the four highest paid executives with total compensation in excess of $100,000 in the most recent fiscal year.[114] Additionally, disclosure of the compensation of certain senior executives retiring during the past year may be required.[115]

The primary purpose of the disclosure requirements is to grant shareholders the ability to compare compensation practices between reporting corporations.[116] The difficulty in correctly ascertaining an executive's actual compensation from all sources had been a common complaint of industry observers.[117] In order to provide for complete compensation disclosure and to facilitate comparison,[118] the format for the presentation of information is very precise.[119] For example, the total compensation table ideally sets forth an executive's complete compensation from all sources in a single easily accessible place.[120] The

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[111]Securities Act Release No. 6940, *supra* note 84, at 29,594 (stating the purpose of the performance graph is to complement the compensation committee report).

[112]Securities Act Release No. 6962, *supra* note 83, at 48,150-48,158 *as amended by* Securities Act Release 7032, *supra* note 85, at 63,013-63,015. *See generally* Joann S. Lublin, *Then and Now; Shareholders Gain Much From New Pay-Disclosure Rules.* WALL ST. J., Apr. 21, 1993, at R2 (comparing disclosures under the old and revised rules); Gottlieb & de Brito, *supra* note 55, at 31 (detailing how the tables were filled out during the initial year).

[113]Securities Act Release No. 6962, *supra* note 83, at 48,151 (stating the requirement for the summary compensation table).

[114]*Id.* at 48,150.

[115]Securities Act Release No. 7032, *supra* note 85, at 63,014. The revised rules add a requirement to include a retiring CEO and up to two additional executives if the executives would have qualified as being in the top four most highly compensated. *Id.*

[116]Securities Act Release No. 7009, *supra* note 85, at 42,884. The SEC cautions that "variations to the prescribed format hinder comparative analysis" and, therefore, would thwart this goal. *Id.*

[117]*See supra* note 26 (noting how executive compensation values differ depending upon data used).

[118]Securities Act Release No. 6940, *supra* note 84, at 29,583. "The proposed amendments are intended to provide shareholders with a clear and concise presentation of compensation paid or awarded to executive officers, and the director's bases for making such compensation decisions." *Id.*

[119]*Id.* at 29,584. "[T]o provide shareholders a concise, comprehensive overview of compensation awarded, earned or paid in the reporting period, registrants will be required to present a summary of all such compensation in tabular form." *Id.*

[120]*Id.*

additional tables are intended to supplement the total compensation table to provide detailed information on some of the more variable compensation components.[121] As previously noted, the SEC permits no deviation from its specified formats because such deviation would hamper the regulation's primary purpose of providing clear information to shareholders.[122]

One aspect of the revised compensation disclosure rules is the requirement to report the estimated present value of stock option grants.[123] The intent of this requirement is to assist shareholders in recognizing the value of such options as compensation to the recipient.[124] Under the initially proposed rules, a corporation would have been required to show potential values realized by an executive exercising a stock option based upon 50%, 100%, and 200% appreciation of the stock's value.[125] However, the rules as adopted allow the corporation to choose to either calculate a present value for the stock option using a standard pricing model[126] or construct a table showing the future value of the stock options at the maturity date of the option, assuming the stock value appreciates 5% and 10% annually.[127]

3. Performance Comparison

The second part of the pay for performance equation is performance. The newly adopted SEC rules require a corporation to graphically present the corporation's performance measured by total shareholder return.[128]

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[121]*See id.* at 29,588-29,593 (describing the purposes of and data in the additional tables). The first additional table contains information on stock options and stock appreciation rights (SARs) granted in the past year. *Id.* The second table contains information on currently held stock options and SARs including exercise information from the past year. *Id.* The third table contains information on other long term incentive plan awards granted during the past year. *Id. See generally* Ragsdale, *supra* note 88, at 553-54 (discussing the three disclosure tables).

[122]*See supra* note 116.

[123]Securities Act Release No. 6962, *supra* note 83, at 48,153.

[124]Securities Act Release No. 6940, *supra* note 84, at 29,587. "While the Commission has considered requiring valuation of options granted for purposes of reporting in the Summary [Compensation] Table, shareholders may be better served by disclosure of a range of potential realizable values . . . ." *Id.*

[125]*Id.*

[126]Securities Act Release No. 6962, *supra* note 83, at 48,153. *See infra* notes 157-59 (discussing option pricing models).

[127]*Id.* Additionally, the SEC will require corporations to add a column showing the stock's value assuming no appreciation if the grant is made at below market price. *Id.*

[128]Security Act Release No. 6940, *supra* note 84, at 29,594 n.45. "Total shareholder return in a given year equals total dividends paid out and the year-end stock price less the

This figure must then be compared to both a broad equity market index and an industry or peer group index.[129] The intent of the new requirement is "[t]o complement the discussion by the compensation committee . . . of the relationship of executive compensation to corporate performance in a given fiscal year."[130] To achieve this end, the graph must accompany the discussion of executive compensation and may not be "buried" elsewhere within the proxy statement.[131] The base year for graphical comparison must be one of the preceding five years, and the graph must show data for a minimum of five years.[132]

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previous year-end stock price (adjusted as necessary for stock dividends and splits) divided by the previous year-end stock price." *Id.*

[129]Securities Act Release No. 6962, *supra* note 83, at 48,157-48,158. It reads in part:

> (*l*) Performance Graph
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> (1) Provide a line graph comparing the yearly percentage change in the registrant's cumulative total shareholder return on a class of common stock registered under Section 12 of the Exchange Act (as measured by dividing (i) the sum of (A) the cumulative amount of dividends for the measurement period, assuming reinvestment, and (B) the difference between the registrant's share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period) with
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> (i) the cumulative total return of a broad equity market index assuming reinvestment of dividends, that includes companies whose equity securities are traded on the same exchange or NASDAQ market or are of comparable market capitalization; *provided, however,* [t]hat if the registrant is a company within the Standard & Poor's 500 Stock Index, the registrant must use that index; and
>
> (ii) The cumulative total return, assuming reinvestment of dividends, of:
>
> (A) A published industry or line-of-business index;
>
> (B) Peer issuer(s) selected in good faith. If the registrant does not select its peer issuer(s) on an industry or line-of-business basis, the registrant shall disclose the basis for its selection; or
>
> (C) Issuer(s) with similar market capitalization(s), but only if the registrant does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group. If the registrant uses this alternative, the graph shall be accompanied by a statement of the reasons for this selection.

Id. at 48,157.

[130]Securities Act Release No. 6940, *supra* note 84, at 29,594.

[131]Securities Act Release No. 7009, *supra* note 85, at 42,855.

[132]Securities Act Release No. 6962, *supra* note 83, at 48,157. The paragraph states:

> (2) For purposes of paragraph (*l*)(1) of this item, the term "measurement period" shall be the period beginning at the "measurement point" established by the market close on the last trading day before the beginning of the registrant's fifth preceding fiscal year, through and including the end of the registrant's last completed fiscal year. If the class of securities has been registered under Section 12 of the Exchange Act for a shorter period of time, the period covered by the compensation may

If the corporation is a part of the Standard and Poor's (S&P) 500 Stock Index, that index must be used as the broad equity index.[133] This is a change from the proposed rules which would have required all corporations to use the S&P 500 Index.[134] Under the adopted rules, however, several other indices may be used by non-S&P 500 corporations including: "the Dow Jones Equity Market Index, the American Stock Exchange Market Value Index, the Wilshire 5000 Equity Index, and the Russell 1000, 2000, or 3000."[135] Once an index is selected, the rules require the same index be used each year.[136]

In addition to the broad equity index, the corporation's performance must also be compared to similar corporations in the same industry. To fulfill this requirement, corporations can compare their performance to one of the following: a published industry or line-of-business index,[137]

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correspond to that time period.

Id. This limit was set to prevent a corporation from selecting a much earlier year in an attempt to cast "performance in an unduly favorable light." *Id.* at 48,139. Performance should be compared "assum[ing] a fixed investment, stated in dollars (*e.g.*, $100) in the stocks and the indices plotted." Securities Act Release No. 7009, *supra* note 85, at 42,891 (referencing proposed changes to Instruction 2 of 17 C.F.R. § 229.402(*l*) which were adopted in Securities Act Release No. 7032, *supra* note 85, at 63,015).

[133]Securities Act Release No. 6962, *supra* note 83, at 48,157. This requirement is based in part on increasing comparability for the shareholder between competing corporations and on the importance the S&P 500 has obtained as a "leading economic indicator" for the country. *Id.* at 48,139 n.112. *See* BUREAU OF ECONOMIC ANALYSIS, U.S. DEPT. OF COMMERCE, THE HANDBOOK OF CYCLICAL INDICATORS 5 (1984) (stating that the "Composite Index of Twelve Leading Indicators" includes series 19 which is the S&P 500 Index); ECONOMIC REPORT OF THE PRESIDENT 403 (Feb. 1992) (including the S&P 500 Index as a reported item).

[134]Securities Act Release No. 6962, *supra* note 83, at 48,139. The change was made "[i]n response to commenters' [sic] recommendations that registrants, particularly those not in the S&P 500, be given the flexibility to select another broad market index." *Id.*

[135]*Id.* at 48,139 n.112.

[136]*Id.* If a new index is to be used, both the new and old indices must be used in the year of the change. *Id.* (quoting Item 402(*l*)(4) of regulation S-K). Item 402(*l*)(4) of regulation S-K states:

> (4) If the registrant selects a different index from an index used for the immediately preceding fiscal year, explain the reason(s) for this change and also compare the registrant's total return with that of both the newly selected index and the index used in the immediately preceding fiscal year.

Id. at 48,157-48,158.

[137]Securities Act Release No. 6962, *supra* note 83, at 48,157. *See supra* note 129 for complete text. This requirement was changed from "nationally recognized index" to "published index" so as to not limit the indices available. *Id.* at 48,139. The terms are defined in paragraph (3) of the rules:

> (3) For the purposes of paragraph (*l*)(1)(ii)(A) of this item, the term "published industry or line-of-business index" means any index that is prepared by a party other than the registrant or an affiliate and is accessible to the registrant's security holders;

a self-created peer group index,[138] or issuer(s) with similar market capitalization(s).[139] As with the broad equity index, it is assumed the same index will be used each year.[140] If a non-published index is used, the corporation has broad discretion in creating its index,[141] but must fully disclose the companies comprising the index[142] and the bases for selection and comparison.[143] Further, each component company must be weighted according to its capitalization.[144] Finally, any change in the companies making up a non-published index is considered a change of indices by the corporation, thus requiring comparison to both indices in the year of the change.[145]

> provided, however, that registrants may use an index prepared by the registrant or affiliate if such index is widely recognized and used.

Id. at 48,157. Corporations in more than one industry or line-of-business may create a composite index using several published indices but must disclose which indices were used and how they were weighted. Securities Act Release No. 7009, *supra* note 85, at 42,886. Trade association indices will generally not be considered "published" by the SEC. *Id.*

[138]Securities Act Release No. 6962, *supra* note 83, at 48,157. "[P]eer issuer(s) [must be] selected in good faith. If the registrant does not select its peer issuer(s) on an industry or line-of-business basis, the registrant shall disclose the basis for its selection." *Id.*

[139]*Id.* A market capitalization index can only be used when "the registrant . . . does not believe that it can reasonably identify a peer group." *Id.*

[140]*See supra* note 138.

[141]Securities Act Release No. 6962, *supra* note 83, at 48,139.

[142]Instruction 5 to 402(*l*) states:

> 5. If the registrant uses a peer group issuer(s) comparison or comparison with issuer(s) with similar market capitalizations, the identity of those issuers must be disclosed and the returns of each component issuer of the group must be weighted according to the respective issuer's stock market capitalization at the beginning of each period for which a return is indicated.

Securities Act Release No. 7032, *supra* note 85, at 63,015.

[143]Disclosure of the selection bases is required by 402(*l*)(ii)(B) and (C). Securities Act Release No. 6962, *supra* note 83, at 48,157. *See supra* note 129 for complete text.

[144]Securities Act Release No. 7032, *supra* note 85, at 63,015; *see supra* note 142 for the complete text. Capitalization weighting was selected over equal weighting or a median percentile approach since it is used by most published indices and "consistent with the objective that the graph provide an accurate comparison of the companies in a given industry." Securities Act Release No. 7009, *supra* note 85, at 42,891.

[145]Securities Act Release No. 7009, *supra* note 85, at 42,886. If the index is based upon an objective criteria, "changes in the compensation of the peer group resulting from application of the criteria would not require presentation of the old index." *Id.* Also, deleting a company because it is no longer in the line of business or industry will not require presentation of the old index but, "a specific description of, and basis for the change must be disclosed, including the names of the companies deleted from the index." *Id.*

B. *Accounting for Stock Options*

While the SEC was putting its new disclosure requirements for executive compensation in place, the Financial Accounting Standards Board was addressing the accounting ramifications for a major component of most executive compensation packages, stock options.[146] On June 30, 1993, the FASB proposed significant changes in the accounting methods used for stock-based compensation, superseding a prior FASB opinion.[147] The previous FASB opinion[148] required the estimated cost of performance based stock options,[149] but not fixed stock options,[150] to be taken as a charge against earnings in the year of the grant.[151] In contrast, the proposed rules treat all stock options equally by recognizing both fixed and performance stock options as compensation.[152]

The board's stated rationale for pursuing the new accounting treatment is that "[t]he value of stock options issued to employees is compensation[,] . . . [c]ompensation is a cost that should be recognized in the income statement[, and an] accounting standard that requires *non*recognition of costs produces financial statements that are neither credible nor representationally faithful."[153] In order to correct this perceived problem, the proposed rules require "the fair value of an award of equity instruments to employees [be treated] as additional equity at the

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[146]In its sample of CEO compensation for 1991, *Fortune* reported that 50% of the compensation value was derived from "newly granted stock options and restricted stock." Shawn Tully, *What CEOs Really Make*, FORTUNE, June 15, 1992, at 94. For "[t]he 19 top paid CEOs . . . nearly 86% of their median total 1991 compensation [was] in stock grants." *Id.*

[147]*Accounting for Stock-Based Compensation*, *supra* note 17, at summary.

[148]APB Opinion No. 25, *Accounting for Stock Issued to Employees* (1972) (actually authored by the FASB's predecessor, the Accounting Principles Board (APB)).

[149]A performance based stock option plan is based, in part, "upon the attainment of future performance goals" for part of its eventual award. Joyce Strawser, *Accounting for Stock-Based Compensation: The FASB's Proposal*, CPA J., Oct. 1993, at 44, 44.

[150]A fixed stock option plan has its "terms fixed at the date of the grant." *Id.*

[151]*Accounting for Stock-Based Compensation*, *supra* note 17, at summary. This outcome is particularly anomalous given that performance based options are often less valuable than fixed options. *Id.*

[152]*Id.* The proposed rules will go into effect after a transition period:

> This proposed Statement has two effective dates. Its disclosure provisions would be effective for years beginning after December 31, 1993. Pro forma disclosure of the effects on net income and earnings per share of recognizing compensation cost for awards granted after December 31, 1993 would be required. The recognition provisions would be effective for awards granted after December 31, 1996.

Id.

[153]*Id.*

date the award is granted."[154] If the proposed rules are adopted, stock options will be valued on the date the option is granted to the employee, not the date it is exercised.[155]

The new rules also require a corporation to use a standard stock option pricing model to estimate the value of the stock option and to recognize it as compensation which must be deducted as an expense from corporate earnings.[156] The board presents the binomial[157] and Black-Scholes[158] models as acceptable examples.[159] These models recognize the

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[154]*Id.*

> Amounts attributed to future service would be recognized as an asset, prepaid compensation, and would be amortized ratably over the period(s) that the related employee services are rendered. If an award is for past services, the related compensation cost would be recognized in the period in which the award is granted.

Id.

[155]*Accounting for Stock-Based Compensation, supra* note 17, at summary. "Stock price changes after that date [the date the option is granted] have no effect on measuring the value of the equity instrument issued or the related compensation cost." *Id.*

[156]*Id.*

[157]*See* RICHARD M. BOOKSTABER, OPTION PRICING & INVESTMENT STRATEGIES 59-73 (1987) (providing a derivation of the binomial pricing model).

[158]Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (presenting the Black-Scholes Model). A simplified presentation of the Black-Scholes Model for a non-dividending stock is given by:

$$V_r = P_2 N(d_1) - Se^{r(o-t)} N(d_2)$$

$$d_1 = \frac{1n(P_2/S) + (r + \tfrac{1}{2}v^2)(t^* - t)}{v\sqrt{(t^* - t)}}$$

$$d_2 = \frac{1n(P_2/S) + (r - \tfrac{1}{2}v^2)(t^* - t)}{v\sqrt{(t^* - t)}}$$

V_r = *Fair value of option*
P_2 = *Stock price*
S = *Striking or exercise price*
$N(d)$ = *Cumulative normal density function*
r = *"Risk-free" interest rate*
t = *Current date*
t^* = *Maturity date of option or warrant*
v^2 = *Variance rate of return on stock*
e = *Base of natural logarithms* = 2.71828
$1n$ = *Natural logarithm*

JAMES W. YATES, THE OPTIONS STRATEGY SPECTRUM 23 (1987) (figure 2-3 restating the results of Black's and Scholes' work).

[159]*Accounting for Stock-Based Compensation, supra* note 17, at summary. However, the implication is that other models also would be acceptable. *See* OPTION PRICING; THEORY AND APPLICATION 3 (Menachem Brenner ed., 1983) (providing examples of other pricing models).

inherent additional value in a current option to purchase stock at a fixed price in the future.[160] Even if the option price is equal to the trading price on the date of the grant, the option is quite valuable because of its limited risk in comparison to its positive potential.[161] The proposed rules require this value be treated as a compensation expense to the corporation.[162] This creates a current charge against earnings for the corporation making the grant.[163]

However, estimating the value of a stock option is not an exact process. First, the models themselves are based upon certain assumptions which are inherently untrue.[164] Second, the stock option value predicted

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[160]*Accounting for Stock-Based Compensation, supra* note 17, at summary.

[161]An option for a single share of stock trading at $50 on the grant date, with an exercise price of $50 in ten years would have a minimum value of $17.98 (based upon a risk-free interest rate of seven percent and an expected dividend rate of two percent annually). *Id.* Of course, options that are bought, instead of acquired by grant, can be extremely risky. In fact, option trading is undoubtedly one of the most volatile and dangerous areas in which to speculate.

[162]This is in addition to its dilution effect on the corporation's equity which is currently recognized when a grant is made. Warren Buffet, CEO of Berkshire Hathaway, Inc., noted in a letter to shareholders, "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?" Strawser, *supra* note 149, at 44.

[163]Robert Crane & Victor H. Boyajian, *FASB Proposal Hits Executives' Bottom Line*, CORP. COUNS., Aug. 1993, at 6. This practice will cause severe problems for small entrepreneurial corporations which rely on stock option grants to employees as a method of providing competitive compensation without adversely effecting the companies cash flow or equity for borrowing purposes. *Taking Account of Stock Options*, HARV. BUS. REV., Jan.-Feb. 1994, at 27-28.

[164]YATES, *supra* note 158, at 23 (fig. 2-3). Out of necessity, models use some assumptions. Unfortunately, these assumptions often are based on ideal conditions which do not reflect the reality of the modern marketplace. The Black-Scholes assumptions are typical:

1. The short term interest rate is known and is constant through time.
2. The stock price follows a random walk in continuous time with a variance rate proportional to the square of the stock price.
3. The distribution of possible stock prices at the end of any finite interval is lognormal.
4. The variance rate of return on stock is constant.
5. The stock pays no dividends and makes no other distributions.
6. The option can only be exercised at maturity.
7. There are no commissions or other transaction costs in buying or selling the stock or the option.
8. It is possible to borrow any fraction of the price of a security to buy it or to hold it, at the short-term interest rate.
9. A seller who does not own a security (a short seller) will simply accept the price of the security from the buyer and will agree to settle with the buyer on some future date by paying him an amount equal to the price of the security on that date. While this short sale is outstanding, the short seller will have the use of, or

by a model depends upon other values (or data) input into the model's equation.[165] Using the Black-Scholes example, some of the data, such as the fair (market) value of the stock on the date of the grant, the exercise price, and the option dates are exact values. However, data such as the "risk free" interest rate and variance rate on the return of stock are subject to estimation.[166] Since these values may be manipulated, the resulting stock option value to be charged against earnings can be slightly altered by the corporation.[167]

C. *A New Tax on Compensation*

As previously noted, in response both to public outcry about excessive executive compensation[168] and the incoming administration's need to raise federal revenues,[169] a limit was placed on the deductibility of executive compensation as a part of the Revenue Reconciliation Act of 1993 (the Act).[170] Under the new tax code,[171] a publicly held

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interest on, proceeds of the sale.

10. The tax rate, if any, is identical for all transactions and all market participants. *Id.*

[165]*See supra* note 158 (discussing the Black-Scholes equation and defining the input values required to obtain an answer).

[166]Strawser, *supra* note 149, at 46 (discussing the need to establish values for risk free interest rates and volatility (expected variance of returns on the stock) in using models to value options).

[167]*CEO Pay: Bill Hears of SEC Loophole*, FORTUNE, Dec. 14, 1992, at 16 (complaining that option pricing models can be manipulated).

[168]Brownstein & Panner, *supra* note 24, at 28 (discussing both the Republican and Democratic parties' arguments against excessive salaries during the elections).

[169]"[T]he Clinton administration estimates [the budget] will reduce federal deficits by $496 billion over five years." Joan C. Szabo, *The New Tax Law's Business Impact; 1993 Budget Effect On Business Tax*, NATION'S BUS., Oct. 1993, at 24.

[170]*See generally* Janice M. Johnson, *The Revenue Reconciliation Act of 1993: Who Wins and Who Loses?*, CPA J., Oct. 1993, at 18, 23 (discussing the tax effects of the act).

[171]The pertinent code provision effected is § 162 of the I.R.S. Code (Title 26). The Act added subsection (m) which states:

(m) Certain excessive employee remuneration . . . .

(1) In general. In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $ 1,000,000.

(2) Publicly held corporation. For purposes of this subsection, the term "publicly held corporation" means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 [15 USCS § 78l].

(3) Covered employee. For purposes of this subsection, the term "covered employee" means any employee of the taxpayer if —

(A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or

(B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 [15 USCS §§ 78a et seq.] by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

(4) Applicable employee remuneration. For purposes of this subsection —

(A) In general. Except as otherwise provided in this paragraph, the term "applicable employee remuneration" means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year (determined without regard to this subsection) for remuneration for services performed by such employee (whether or not during the taxable year).

(B) Exception for remuneration payable on commission basis. The term "applicable employee remuneration" shall not include any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual to whom such remuneration is payable.

(C) Other performance-based compensation. The term "applicable employee remuneration" shall not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if —

(i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors,

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

(D) Exception for existing binding contracts. The term "applicable employee remuneration" shall not include any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration is paid.

(E) Remuneration. For purposes of this paragraph, the term "remuneration" includes any remuneration (including benefits) in any medium other than cash, but shall not include —

(i) any payment referred to in so much of section 3121(a)(5) as precedes subparagraph (E) thereof, and

(ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter.

For purposes of clause (i), section 3121(a)(5) shall be applied without regard to section 3121(v)(1).

corporation generally cannot deduct any compensation over $1 million paid to certain executives from its gross income.[172] The effect, therefore, is an increase in the corporation's, rather than the individual employee's, tax burden.[173]

In addition to being a revenue generating tool, the new tax is intended to encourage corporations to adopt performance based compensation practices.[174] Towards that end, the corporation can avoid the $1 million limit if the compensation is characterized as performance related.[175] For the compensation to qualify as performance related, the corporation must meet three requirements.[176] First, the corporation's compensation committee must be comprised of two or more outside directors.[177] Second, the compensation plan and performance goals must be approved by a majority of the shareholders.[178] Finally, the compensation committee must "certif[y] that the performance goals and any other material terms were in fact satisfied."[179] Clearly, these requirements are intended to strengthen shareholder control and board independence in executive compensation matters.[180]

> (F) Coordination with disallowed golden parachute payments. The dollar limitation contained in paragraph (1) shall be reduced (but not below zero) by the amount (if any) which would have been included in the applicable employee remuneration of the covered employee for the taxable year but for being disallowed under section 280G.

26 U.S.C. § 162(m) (Law. Co-op. 1993) (emphasis omitted).

[172]*Id.* § 162(m)(3). *See supra* note 171 for the complete text. This requirement originally mirrored the SEC's disclosure rules but is no longer the same because of the SEC revision including retiring CEO's and possibly two additional corporate officers. *See supra* note 115.

[173]The section is specifically applicable only to publicly held corporations. *Id.* § 162 (m)(1); *see supra* note 171 for the complete text. The subsection defines the term to mean "any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934." *Id.* § 162(m)(2).

[174]*See supra* note 168 and accompanying text (discussing populist public pressure to relate pay to performance).

[175]That includes commission based pay or other performance based compensation. 26 U.S.C. § 162(m)(4)(B), (C) (Law. Co-op. 1993); *see supra* note 171 for the complete text. Also, certain existing compensation contracts are excluded as are other miscellaneous items. *Id.* § 162(m)(4)(D), (E). *See* Johnson, *supra* note 170, at 23 (discussing the application of the rule).

[176]26 U.S.C. § 162(m)(4)(C) (Law. Co-op. 1993); *see supra* note 171 for the complete text.

[177]*Id.* § 126(m)(4)(C)(i); *see supra* note 171 for the complete text.

[178]*Id.* § 126(m)(4)(C)(ii); *see supra* note 171 for the complete text.

[179]*Id.* § 126(m)(4)(C)(iii); *see supra* note 171 for the complete text.

[180]*See* Securities Act Release No. 6962, *supra* note 83, at 48,142 (discussing shareholder interest in board independence).

D. *Shareholder Proposals*

The final policy change affecting executive compensation which will be discussed concerns proposals submitted to stockholders.[181] In 1992, in response to increased Congressional[182] and shareholder pressure,[183] the SEC altered a long-standing policy and began to require shareholder proposals regarding executive compensation to be submitted to the shareholders for a vote.[184]

The SEC's previous policy was to allow corporations to exclude such proposals from shareholder balloting.[185] The SEC interpreted such proposals as intruding into the proper conduct of the corporation's business and, therefore, allowed their exclusion from shareholder consideration.[186] However, in 1992 the SEC modified its interpretation

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[181]The shareholder proposal action was actually the first to occur. It was announced on February 13, 1992. *Breeden Announces SEC Initiative on Executive Compensation Issues*, 24 Sec. Reg. & L. Rep. (BNA) 223 (Feb. 21, 1992) [hereinafter *Breeden Announces SEC Initiative*]. The SEC did not release the initial proposed draft of its revisions to the executive compensation disclosure rules until June 23, 1992. Securities Act Release No. 6940, *supra* note 84, at 29,608. The FASB exposure draft was released on June 30, 1993. *Accounting for Stock-Based Compensation*, *supra* note 17. The President did not sign the Revenue Reconciliation Act until August 10, 1993, although several of its provisions were retroactive to January 1, 1993. Johnson, *supra* note 170, at 18.

[182]The Corporate Pay Responsibility Act included provisions requiring shareholder votes on advisory proposals on executive compensation. S. 1198, 102d Cong., 1st Sess. (1991), and H.R. 2522, 102d Cong., 1st Sess. (1991). Section 2 of the house bill would have amended § 14 of the Securities Exchange Act of 1934 (15 U.S.C. § 78(n)) by adding language including:

> (1) SECURITY HOLDER PROPOSALS. — For purposes of this Act and the rules and regulations issued by the Commission under this Act, recommendations, proposals, or statements on the policies, criteria, or methods to be used in determining or providing the compensation to be paid to the directors or the chief executive officer of an issuer shall be considered proper subjects for action by its security holders. If such recommendations, proposals, or statements otherwise meet the requirements of this section and the rules and regulations of the Commission, an issuer may not omit such recommendations or proposals or any statement in support thereof otherwise required by this section from its proxy statement.

Corporate Pay Responsibility Act, H.R. 2522, 102d Cong., 1st Sess. § 2(h)(1) (1991).

[183]"[SEC Chairman] Breeden said, the 'level of public and shareholder concern over the issue of senior executive compensation has become intense and widespread,' and 'dictates a reevaluation' of SEC policy." *Breeden Announces SEC Initiative*, *supra* note 181, at 223.

[184]"[H]enceforth the SEC will construe advisory proposals on senior executive or director compensation to be includable in proxy statements." *Id.* (quoting Chairman Breeden).

[185]*Id.*

[186]Longstreth & Kane (pt. 1), *supra* note 21, at 7. Rule 14a-8 of the Securities Exchange Act of 1934 "permits a corporation to exclude a shareholder proposal for a number of reasons." *Id.* The two primary justifications for excluding executive compensation proposals were "(a) because the proposal is not a proper subject for shareholder action according to state law and

of the business conduct rule.[187] The modification required corporations to include in proxy materials properly submitted shareholder proposals governing special pay granted to departing executives.[188] A year later, the SEC publicized its policy change through ten "no-action" letters sent to various corporations.[189] The letters required the corporations to submit proposals on executive compensation to their shareholders for a vote.[190] The SEC also made it clear that such proposals had to be worded in an advisory nature in order to be acceptable for submission to the stockholders.[191]

(b) because the proposal relates to the conduct of 'ordinary business operations.'" *Id.* (quoting Securities Exchange Act of 1934, Rule 14a-8(c)(7)). "[T]he [SEC] Staff has generally found proposals relating to executive compensation to intrude into areas of ordinary business." *Id.*

[187]*Id.*

[188]*Breeden Announces SEC Initiative, supra* note 181, at 223. These pay packages are often called "golden parachutes." *Id.*

[189]Aetna Life and Casualty Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,104, at 79,217 (Feb. 13, 1992); Baltimore Gas and Electric Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,101, at 79,211 (Feb. 13, 1992); Battle Mountain Gold Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,107, at 79,224 (Feb. 13, 1992); Bell Atlantic Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,110, at 79,234 (Feb. 13, 1992); Black Hills Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,102, at 79,213 (Feb. 13, 1992); Chrysler Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,103, at 79,215 (Feb. 13, 1992); Eastman Kodak Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,109, at 79,231 (Feb. 13, 1992); Equimark Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,108, at 79,226 (Feb. 13, 1992); Grumman Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,105, at 79,218 (Feb. 13, 1992); International Business Machines Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,106, at 79,220 (Feb. 13, 1992).

[190]*Id.* The results of nine executive compensation votes required by the SEC action were:

	For	Against	Abstain
Aetna Life & Casualty Co.	7.5%	80.3%	12.2%
Baltimore Gas & Electric Co.	12.2	83.6	4.2
Bell Atlantic Corp.	10.9	74.6	14.5
Black Hills Corp.	36.9	47.6	15.5
Chrysler Corp.	5.6	79.5	14.9
Eastman Kodak Co.	15.9	67.8	16.3
Equimark Corp.	16.5	81.4	2.1
Int'l Business Machines Corp.	16.7	83.3	N/A
Reebok Inc.	19.2	51.9	28.9

Securities Act Release No. 6940, *supra* note 84, at 29,583.

[191]*Breeden Announces SEC Initiative, supra* note 181, at 223. This action was taken in part to enable some communication to occur between shareholders on executive compensation issues. Later that same year the SEC adopted changes to the rules governing proxy solicitations

IV. THE RESULTS

As noted, the primary complaint against large executive salaries has been that executive pay in many cases did not correlate with performance.[192] With the adoption of the previously discussed changes, new market forces will hopefully be in place to regulate the magnitude of executive pay.[193] The required disclosure of executive compensation and its comparison to corporate performance will enable interested shareholders to evaluate the allocation of corporate assets.[194] Furthermore, the FASB action complements the new SEC disclosure requirements by forcing a major form of executive compensation, stock options, to be accounted for in a manner accurately depicting their "bottom-line" effect.[195] Taken together, these actions will provide a detailed description of how the corporate directors have balanced the trade-offs between corporate performance, compensation, and shareholder return on investment.

If after evaluating this information a shareholder is unhappy, what options are available? The SEC suggests that disgruntled shareholders demonstrate their concern at the ballot box.[196] While theoretically a sound idea, in practice, proxy battles waged by shareholders for control of a corporation are rarely won.[197] Admittedly, the option to use

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to facilitate additional shareholder communication. Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276 (1992) (to be codified at 17 C.F.R. § 240.249), *reprinted in* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051, at 83,353 (Oct. 16, 1992).

[192]*See supra* note 64 for discussion of the relationship between executive compensation and corporate success.

[193]"'Boards are extremely conscious of what they are paying a CEO'. . . . 'It is a different era'." Lublin, *supra* note 45, at R2 (quoting L. Dennis Kozlowski, chairman and chief executive of Tyco Laboratories). "'Better disclosure has helped shareholders monitor pay and hold boards accountable for their decisions.'" John A. Byrne et al., *That Eye-Popping Executive Pay: Is Anybody Worth this Much?*, BUS. WK., Apr. 25, 1994, at 52 (quoting James E. Heard, chief executive of Institutional Shareholder Services, Inc.).

[194]Lublin, *supra* note 112, at R2. "As a result [of the SEC disclosure rule changes], investors can better grasp whether a company's performance justifies rich pay packages for senior management." *Id. See also* Byrne et al., *supra* note 193, at 52 (discussing how SEC action has led to better informed shareholders).

[195]"[I]f the [FASB] has its way, in 1997 stock options . . . will . . . be charged against earnings in annual [financial] reports." Pam Black, *Getting Options? Consider Your Options*, BUS. WK., Jan. 24, 1994, at 108, 109.

[196]*See supra* note 110.

[197]Stevenson, *supra* note 41, at 43 (presenting the mixed results of shareholder efforts); *see also* Longstreth & Kane (pt. 1), *supra* note 21, at 7 (discussing the failure of an activist to gain a seat on Sear's board).

shareholder proposals to address executive compensation issues may facilitate some shareholder communication.[198] Still, removal of a director over an executive compensation issue remains unlikely.[199]

However, outright success in a proxy battle against a director is not required to influence compensation policy decisions. The changes in the tax code now force directors to seek shareholder approval of certain compensation plans.[200] CEOs are forced to contend with shareholders' objections and, therefore, are seeking approval or support from larger shareholders for pay policies in advance.[201] Institutional shareholder support may not be required for shareholder approval of these compensation plans, but a fight can be embarrassing for the corporation.[202]

It is unclear whether federal actions will actually restrain or reduce executive compensation. As noted, the goal is not to minimize pay, but to equate it with performance.[203] It is currently unclear whether this end has been achieved.[204] Further, there is some evidence that the changes to the tax code intended to restrain executive pay have instead established a new $1 million minimum compensation level for CEOs.[205] Still, by one account, executive compensation did not rise in 1993 after significant rises in the preceding two years.[206]

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[198]*See* Michael W. Armstrong & William L. Roberts, *Activist Shareholders Rattle Cages at 3 Firms*, PHILA. BUS. J., Apr. 13, 1992, at 1 (discussing how shareholder proposals are being increasingly used).

[199]*Id.* "'We feel it's definitely an uphill battle to win anything like this.'" *Id.* (quoting head of a dissident shareholder group trying to remove directors).

[200]*See* 26 U.S.C. § 162(4)(c)(ii); *see also supra* note 171 for the complete text. If the compensation is in excess of $1 million and is to be treated as a corporate expense to avoid taxation, the code requires shareholder approval. *Id.* § 162(4)(c)(ii).

[201]John A. Byrne, *Oh, That 80,000 Shares*, BUS. WK., May 2, 1994, at 4 (reporting Westinghouse CEO Michael Jordan's attempt to win the support of CALPERS for a pay plan).

[202]*Id.* Obviously, such embarrassment may lessen the interest of institutional investors considering future investment in the corporation.

[203]*See supra* note 193.

[204]Byrne et al., *supra* note 193, at 52-53 (noting that pay consultants believe that pay has been tied to performance and pay critics still believe the salaries are excessive).

[205]John A. Byrne, *That's Some Pay Cap, Bill*, BUS. WK., Apr. 25, 1994, at 57. "'President Clinton has created a minimum wage for CEOs,' declare[d] Arnold S. Ross, a New York consultant who designs pay packages for executives. 'A $1 million base salary is now the gold standard.'" *Id.* For example, in 1992 the salaries of the CEOs of Compaq Computer Associates International, Oracle Systems, Marsh & McLennon, and Phillip Morris, were all between $750,000 and $950,000. *Id.* In 1993, all five made exactly $1 million. *Id.*

[206]Byrne et al., *supra* note 193, at 55. "[A]verage total compensation last year for the chief executive of a major corporation remained static, after a 56% jump in 1992 and a 26% rise in 1991." *Id.*

Regardless of how these newly created forces eventually balance out the total compensation granted to CEOs, they have had two fairly immediate effects on executive compensation. First, the components making up the total compensation packages for senior executives are changing.[207] Second, compensation committees are approaching the issue of executive compensation with more care and concern than in the past.[208] Unfortunately, however, the combination of federal actions may lead to increased litigation concerning executive compensation practices.[209]

A. *Stock Options, Stock Ownership*

Whether a direct result of the aforementioned regulatory actions, the changing priorities in corporate investment,[210] or both, the nature of executive compensation packages is changing.[211] There has long been a debate over the desirability of senior management holding large equity stakes in the corporation. Some commentators have argued that such a policy was dangerous because management would hesitate to take risks if they had a long-term financial interest in the corporation.[212] However, today, many commentators believe that senior management, the CEO in

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[207]*See generally* Lublin, *supra* note 45, at R2 (discussing the changes in stock option repricing).

[208]*See supra* note 193.

[209]Jonathan M. Moses, *Defending Their Dollars*, WALL ST. J., Apr. 21, 1993, at R8. "'Someone will always find some way to get somebody into court,' . . . ." *Id.* (quoting Richard A. Steinwurtzel, an attorney with Fried, Frank, Harris, Shriver & Jacobson, in Washington D.C.).

[210]Longstreth & Kane (pt. 1), *supra* note 21, at 5.

[211]Lublin, *supra* note 45, at R1. "[M]ore boards are linking a chief executive's rewards more closely to shareholders' rewards — by shrinking salary raises, curbing 'give-away' deals and tying strings around potentially lucrative stock packages." *Id.*

[212]Alfred Rappaport, *Executive Incentives vs. Corporate Growth*, HARV. BUS. REV. July-Aug. 1978, at 84; EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990'S 101, 103 (Fred K. Foulkes ed., 1991). Whatever the reasons, stock ownership by CEOs in the top 120 corporations has declined by nearly a factor of 10 between 1938 and 1988. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives — It's Not How Much You Pay, But How*, HARV. BUS. REV. May-June 1990, at 141, 144. "[Nine] out of 10 CEOs own less than 1% of their company's stock, while fewer than 1 in 20 owns more than 5% of the company's outstanding shares." *Id.* at 141. One possible explanation for the decline in CEO stock ownership is that most shareholders in the 1970s and 1980s were themselves only short-term investors. BOK, *supra* note 42, at 111. Some commentators believe that CEOs are merely modifying their behavior accordingly, looking for short-term gains. Longstreth & Kane (pt. 1), *supra* note 21, at 5. CEOs holding large equity stakes would not be motivated to maximize short-term gains. *See infra* notes 213 & 224.

particular, should be a large equity holder.[213] Such a policy favors long-term performance and is easier to explain under the new disclosure rules.[214]

Historically, stock options have not led to senior executives developing large equity stakes in their corporations.[215] Instead, managers tended to exercise their options as soon as possible and immediately re-sell the holdings to convert the value to cash.[216] As a result, management's equity interest in the corporation was generally limited to ensuring that the corporation's stock price exceeded the exercise price of any outstanding stock option.[217] This interest was often diluted by board action which would reduce the option's exercise price if the stock's market value declined, thus, placing management in a no lose position regarding equity.[218]

Recently, however, "[o]ption repricing has virtually disappeared . . . as a result of investor furor and the [SEC's] new proxy-statement rules for executive pay."[219] Many corporations are now requiring their CEOs and other senior managers to obtain targeted equity stakes in their corporations.[220] The equity stakes may be obtained through either direct stock purchases on the open market[221] or through stock options granted by the corporation as part of the executive's compensation package.[222]

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[213]*See* Joann S. Lublin, *Buy or Bye*, WALL ST. J., Apr. 21, 1993, at R9 (discussing the institution of long-term CEO stock ownership plans at several corporations).

[214]*Id.*

[215]*Id.* "The granting of stock options — once seen as a way to increase stock ownership among executives — hasn't been much help. The problem: Most managers sell their stocks a few years after exercising the options." *Id.*

[216]*Id.*

[217]BOK, *supra* note 42, at 111-12.

[218]Lublin, *supra* note 45, at R2. When the market price of a stock is below the exercise price of the option on the stock, the option is referred to as being "underwater." *Id.* The new SEC disclosure rules require detailed disclosure when "underwater" options are repriced. *Id.* Institutional investors are pressuring corporations to stop the practice of repricing underwater options. *Id.*

[219]*Id.*

[220]Lublin, *supra* note 213, at R9. "In 1992, 4.3% of U.S. businesses — and nearly 10% of those with sales exceeding $5 billion — required senior executives to hold stock . . . ." *Id.* The prediction is for that number to increase to nearly 50% in five years. *Id.* "Typically, the guidelines require or strongly encourage chief executives and other senior managers to invest between one and 10 times their annual salaries in stock. Executives get up to eight years to reach ownership targets." *Id.*

[221]*Id.*

[222]*Id. See, e.g.*, *Following a Trend, R.R. Donnelley Requires Executives to Own Stock*, WILMINGTON NEWS J., Mar. 15, 1994, at B7 (reporting on R.R. Donnelley's stock ownership incentive plan).

Also, with the new ownership requirements, senior managers are more likely to retain for long periods stock acquired through the exercise of options.[223]

Proponents of the new ownership policies argue that once management also has an ownership stake, they are more likely to act with the corporation's long-term interest in mind.[224] Moreover, they claim shareholders will be less suspicious of management's true motives and will be less critical of board oversight of management.[225]

The structure of stock option packages will also change under the new rules. As noted, stock options currently comprise a large portion of the average executive's compensation package.[226] To avoid the corporate tax penalty, performance based compensation plans, including performance based stock grants, will now be favored.[227] Previously, most stock option grants to executives, and to most employees, were made under fixed benefit plans to avoid the immediate accounting charge against earnings and improve the corporation's bottom-line.[228] With the implementation of the FASB action, this advantage of fixed option plans is eliminated.[229] Also, because performance based and fixed stock option plans will receive similar accounting treatment, an increase in the use of performance based stock option plans is surely inevitable.[230]

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[223]Lublin, *supra* note 213, at R9. However, such a result has not been without criticism. "Several of those guys will go bankrupt," said Wilma J. Smelcer, a senior vice president of Continental, describing what would happen to her and the 23 other Continental executives holding a large amount of Continental stock. *Id.* at R9, R12.

[224]*Id.* "'There is a difference in how you look at costs' when much of your net worth is tied up in your employer's stock . . . ." *Id.* (quoting Gary Valade, vice-president at Chrysler).

[225]"'I think my chances are better with [senior management] owning [considerable] stock' because then 'your life is in fact wrapped up in the company . . . .'" *Id.* (quoting Sarah Teslik, executive director of the Council of Institutional Investors).

[226]*See supra* note 146.

[227]Black, *supra* note 195, at 109. "If the FASB's ruling goes through, performance shares will make more sense for companies to use than options because they will be less dilutive and less expensive . . . ." *Id.*

[228]*Id.* "Until now, most companies have shied away from [performance based stock options] because they create a charge to earnings." *Id.*

[229]*Id.*

[230]For example, Boeing Co. has already executed what is termed a "multi-million-dollar incentive program for its top two executives" based upon a performance stock option plan. Anthony L. Velocci, *Market Focus*, AVIATION WK. & SPACE TECH. 17 (Apr. 4, 1994). Under the plan, the CEO can earn a target option of 200,000 shares, a gain of $5.8 million, if the stock price goals are met. *Id.* The number of shares awarded decreases if lower goals are achieved. *Id.*

Controversy surrounds the potential effect of the FASB's action on fledgling enterprises,[231] and Congressional action may be forthcoming to stop its implementation.[232] However, the contemplated Congressional action would still place performance based and fixed stock option plans under the same accounting rules.[233] Further, the proposed Congressional action would add an additional incentive for the use of performance based stock options in the form of a reduction in the recipient's tax burden.[234] Therefore, whether or not Congress acts to stop the FASB action, performance based option plans will assuredly grow in popularity.

B. *The Compensation Committee*

There is no doubt that the new rules will directly affect the decisions of compensation committees.[235] Under the SEC disclosure rules, any director interlocks (conflicts of interest) must be fully disclosed.[236] Interlocks lead immediately to an appearance of impropriety; therefore,

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[231] *Taking Account of Stock Options*, *supra* note 163, at 27-28 (discussing the use of stock options by entrepreneurs to attract workers and how the rule change may effect those enterprises).

[232] The Equity Expansion Act of 1993 is currently pending in both houses of Congress. S. 1175, 103d Cong., 1st Sess. (1993); H.R. 2759, 103d Cong., 1st Sess. (1993). Section 4 of the Senate bill provides in pertinent part:

> (h) STOCK OPTION COMPENSATION. — The Commission shall not require or permit an issuer to recognize any expense or other charge in financial statements furnished to its security holders resulting from, or attributable to, either the grant, vesting, or exercise of any option or other right to acquire any equity security of such issuer (even if the right to exercise such option or right is subject to any conditions, contingencies or other criteria, including, without limitation, the continued performance of services, achievement of performance objectives, or the occurrence of any event) which is granted to its directors, officers, employees, or other persons in connection with the performance of services, where the exercise price of such option or right is not less than the fair market value of the underlying security at the time such option or right is granted.

The Equity Expansion Act of 1993, S. 1175, 103d Cong., 1st Sess. § 4 (1993).

[233] *Id.* Section 4 of the bill prohibits the SEC from requiring the use of differing accounting treatments for performance based and fixed stock options. *Id.*

[234] Section 3 of the bill states in pertinent part:

> (a) GENERAL RULE. — Gross income shall not include 50 percent of the gain from the disposition of any stock acquired pursuant to the exercise of a performance stock option if such disposition occurs more than 2 years after the date on which such option was exercised with respect to such stock.

Id. § 3.

[235] *See generally* Brownstein, *supra* note 93, at 7 (discussing the new rules and proposing new guidelines for operation).

[236] Securities Act Release No. 6962, *supra* note 83, at 48,156-48,157.

in most cases, the committees will naturally move to eliminate them by changing their membership.[237] Further, the new tax provisions may necessitate an immediate change in membership of some compensation committees. If a performance based compensation plan is to be successful in avoiding the additional corporate tax on compensation over the $1 million limit, it must be administered by "outside" directors.[238] Therefore, any sensible corporation facing the prospect of such a tax will move to replace corporate employee directors currently sitting on their compensation committees.

The new SEC compensation committee report requirement is also affecting compensation committees themselves.[239] Most compensation committees have now completed one proxy cycle with the new compensation committee report requirement in place.[240] Many commentators believe that the reporting requirement is actually assisting compensation committees in meeting their fiduciary obligations regarding compensation plans.[241] The increased responsibility inherent in the increased reporting requirement is also driving corporations to hire outside consultants to insure complete compliance with the new rules.[242]

C. *A New Shareholder Cause of Action?*

Shareholder derivative suits concerning excessive executive compensation have historically been unsuccessful.[243] Most states,

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[237]Brownstein, *supra* note 93, at 11.

> [T]he potential for fiduciary duty lawsuits against directors with respect to executive compensation continues. . . . Compensation committees should be composed of independent, outside directors. . . . The new rules require special disclosure [of interlocking relationships.] Compensation committees should be restructured when necessary to avoid these interlocking relationships.

Id.

[238]26 U.S.C. § 162(m)(4)(C)(i) (Law. Co-op. 1993); *see supra* note 171 for the complete text.

[239]*See generally* Brownstein, *supra* note 93, at 7 (discussing changes in committee operating guidelines necessary to protect the integrity of their decisions).

[240]Emanuel D. Strauss, *The Honeymoon Is Over for Compensation Committee Reports*, 7 INSIGHTS (P-H) No. 10, at 3 (Oct. 1993) (explaining that the SEC has completed one full proxy season).

[241]Moses, *supra* note 209, at R8. "If handled correctly, though, the compensation committees' report should actually prevent lawsuits, says Fred Kanner, a lawyer in the New York office of Dewey Ballantine." *Id.*

[242]Brownstein, *supra* note 93, at 11 (recommending the action). "Directors are hiring their own pay consultants, demanding more information and analysis on proposed pay plans, and asking tougher questions." Byrne et al., *supra* note 193, at 52.

[243]"State corporate law governs the matter of executive compensation. Generally state law

including Delaware,[244] have resisted shareholder attempts to question compensation decisions' holding that such decisions are a proper exercise of a board of director's business judgment.[245] In Delaware, such suits

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has put executive compensation under the authority of the corporation's board of directors as part of ordinary corporate business." Longstreth & Kane (pt. 1), *supra* note 21, at 5. *See generally* Paul K. Rowe, *Defending Executive Compensation in the Courts: Substance and Strategy*, 6 INSIGHTS (P-H), No. 4, at 12 (Apr. 1992) (discussing the latitude granted corporations by state courts to corporate boards in setting executive compensation).

[244]Specific authorization is derived from § 122 of the Delaware General Corporation Law which states in pertinent part:

> Every corporation created under this chapter shall have the power to:
>
> . . . .
>
> (5) Appoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation;
>
> . . . .
>
> (15) Pay pensions and establish and carry out pension, profit sharing, stock option, stock purchase, stock bonus, retirement, benefit, incentive and compensation plans, trusts and provisions for any or all of its directors, officers and employees, and for any or all of the directors, officers and employees of its subsidiaries . . . .

DEL. CODE ANN. tit. 8, § 122(5) (1974 & Supp. 1993). The board of director's power to act for the corporation is contained in § 141. DEL. CODE ANN. tit. 8, § 141 (1974 & Supp. 1993). The Model Business Corporation Act contains similar provisions in § 4:

> Each corporation shall have power:
>
> . . . .
>
> (k) To elect or appoint officers and agents of the corporation, and define their duties and fix their compensation.
>
> . . . .
>
> (o) To pay pensions and establish pension plans, pension trusts, profit sharing plans, stock bonus plans, stock option plans and other incentive plans for any or all of its directors, officers and employees."

MODEL BUSINESS CORP. ACT § 4 (1971). The Revised Model Business Corporation Act contains similar provisions in § 3.02:

> Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:
>
> . . . .
>
> (11) to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;
>
> (12) to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents . . . .

REVISED MODEL BUSINESS CORP. ACT § 3.02 (1984).

[245]*See* Harber v. Bell, 465 A.2d 353 (Del. Ch. 1983) (holding that the business judgment rule generally protects compensation decisions by the board of directors); Pogostin v. Rice, No. 6235, 1983 WL 17985, at *5 (Del. Ch. Aug. 12, 1983) (holding executive compensation plan

will generally be successful only if the compensation is unreasonable in comparison to the services provided.[246] In such a case, the court in equity will intervene to "prevent a waste of the corporation's assets."[247]

As with the adoption of any new government regulations, the new SEC disclosure requirements may, at first, result in increased litigation.[248] In adopting its new rules, the SEC moved to minimize this natural occurrence by making it clear that the compensation committee report does not fall within the definition of solicitation materials.[249] Therefore, the compensation committee report would not be subject to shareholder litigation regarding content.

Again, it is the SEC's view that disgruntled shareholders should use the ballot box instead of litigation to affect change in compensation policies.[250] Both the FASB and Congressional action may have created an opportunity for a successful shareholder suit in some cases. As noted, shareholder derivative suits challenging compensation absent fraud have been successful when corporate waste is demonstrated.[251] In the Delaware courts, an IRS denial of a tax deduction for an executive's compensation is a factor in determining whether the compensation amounts to waste.[252] Under the new tax code, compensation in excess of $1 million and not meeting specific code requirements, is no longer

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supporting a legitimate business purpose is covered by the business judgment rule), *aff'd*, 480 A.2d 619 (Del. 1984).

[246]Rogers v. Hill, 289 U.S. 582, 591-92 (1933). Although decided over 60 years ago, the rule of *Rogers v. Hill* is still a prominent part of Delaware law. 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.11, at 4-251 (2d ed. 1993).

[247]BALOTTI & FINKELSTEIN, *supra* note 246, § 4.11, at 4-263. Balotti also refers to Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974) (discussing criteria a court will consider in determining whether executive compensation is excessive.) BALOTTI & FINKELSTEIN, *supra* note 246, § 4.11, at 4-262.

[248]Moses, *supra* note 209, at R8.

[249]Brownstein, *supra* note 93, at 11. The SEC took the following action:

> Responding to concerns about enhanced liability, the SEC provided in the new rules that the Compensation Committee Report is to be treated for liability purposes like an annual report. Thus it is not "soliciting materials" under the proxy rules, not subject to §18 liability under the Securities Exchange Act of 1933 or Securities Exchange Act registration statement for filing.

Id.

[250]*See supra* note 110.

[251]*See* BALOTTI & FINKELSTEIN, *supra* note 246, § 4.11, at 4-263.

[252]*Wilderman*, 315 A.2d at 615. "Other factors [governing the reasonableness of compensation] which have been judicially recognized elsewhere are whether or not the Internal Revenue Service has allowed the corporation to deduct the amount of salary alleged to be unreasonable." *Id.* (noting the factor with approval).

deductible for publicly held corporations.[253] Admittedly, such compensation violates only one of several factors used by the court to determine waste.[254] However, it is difficult to see how incurring the additional tax burden on the corporation would not be considered a waste of corporate assets when a mechanism exists to avoid the additional tax (should a corporation determine the compensation is actually warranted).[255]

V. CONCLUSION

Whether necessary or desirable, the rule changes will have a significant effect on executive compensation. The effective motivation of a corporate executive is crucial to that corporation's success. It is true that the compensation policies of the 1980s arose in part because of the belief that management should not always act as owners. It was thought managers should be greater risk takers than owners. Such a philosophy rewarded short term gains but was probably consistent with the existing investment mentality of shareholders.

Increased public and shareholder concern over the apparent excesses of executive compensation during the 1980s has resulted in the rule and regulation changes discussed. Most of the changes are directed at increasing the shareholder's access to accurate compensation information and improving their ability to control some decisions of the corporate boards. In this way, market forces act to keep executive compensation in check.

Response to these new changes has been quick. Corporate boards are already moving to make senior managers share in the ownership of their corporations by tying compensation policies to ownership. Interestingly, the public outcry is accelerating or facilitating the shareholders' ability to change this compensation philosophy. The new philosophy rewards long term gains and is, therefore, consistent with the investment philosophy of today's investor.

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[253]26 U.S.C. § 162(m) (Law. Co-op. 1993). *See supra* note 171 for the complete text.

[254]Other factors include: what similarly situated executives earn, the executive's ability, whether there is a reasonable relationship to the corporation's success, previous salary, whether salary increases are geared to increases in service value, and comparable salaries paid by the employer. *Wilderman*, 315 A.2d at 615.

[255]However, The American Law Institute's Principles of Corporate Governance specifically rejects the idea that executive compensation should be limited by the tax code's treatment of compensation. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION § 5.03 cmt. e (Proposed Final Draft Mar. 31, 1992).

When new regulations are enacted, there is always a fear that they will stimulate litigation. The SEC has moved effectively to minimize this risk. Nonetheless, these actions enhance the possibility of successful shareholder litigation over excessive compensation packages. This is particularly true when these packages are not submitted for shareholder concurrence, thus, placing a glaring new limit on board independence.

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