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Ryan Miske

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## Note

### **Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code**

*Ryan Miske\**

Richard Grasso, former chairman and chief executive of the New York Stock Exchange (NYSE), is just the latest example of corporate greed. In fall 2003, Grasso resigned after several weeks of “blistering criticism” regarding his compensation.<sup>1</sup> While Grasso served as chairman and chief executive, the NYSE’s directors gave him a pay package totaling \$188 million.<sup>2</sup> Eighty million dollars of the pay package represented pension benefits that a consultant advised the directors were six times more generous than those at similar financial services companies.<sup>3</sup> In addition, some of the directors who approved Grasso’s compensation were executives of Wall Street firms that Grasso was responsible for regulating.<sup>4</sup> After Grasso withdrew \$139.5 million in deferred savings and retirement benefits, his total compensation was disclosed to the public and a firestorm of criticism ensued.<sup>5</sup>

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\* J.D. Candidate 2005, University of Minnesota Law School; B.A. 1999, Carleton College. The Author would like to thank Emily Pruisner, Eliot Wrenn, Alyn Bedford, John Stern, and Jeffrey DeBruin for their editorial assistance. The Author would also like to thank Professor Gregg Polsky, Thomas Morgan, Michael Stanchfield, and Justice Russell Anderson for their advice. This article is dedicated to David Garrett and Meghan Ryan for their unwavering support.

1. Gretchen Morgenson & Landon Thomas, Jr., *Chairman Quits Stock Exchange in Furor over Pay: But Grasso Departure Is Unlikely to End Scrutiny of Big Board*, N.Y. TIMES, Sept. 18, 2003, at A1.

2. Landon Thomas, Jr., *Officials in 2 States Urge Big Board Chief to Quit*, N.Y. TIMES, Sept. 17, 2003, at A1.

3. Floyd Norris, *More Changes in Store for the Big Board*, N.Y. TIMES, Sept. 18, 2003, at C1.

4. Landon Thomas, Jr., *Grasso's Fate Is in Hands of Undecided: Some Directors Remain in Wait-and-See Mode*, N.Y. TIMES, Sept. 16, 2003, at C1.

5. Thomas, *supra* note 2. The compensation scandal was recently cited in

The debate over executive compensation has raged for two decades.<sup>6</sup> Some commentators argue that executive compensation has become inappropriate.<sup>7</sup> Others argue that executive compensation is strongly correlated with corporate performance.<sup>8</sup> As the scholarly debate persists, some federal legislators have weighed in by proposing tax code provisions to cap executive compensation. In 1991, Representative Martin Sabo sponsored legislation that would have denied company tax deductions for executive pay in excess of twenty-five times the lowest compensation paid to any employee in that company.<sup>9</sup> In 1992, Senator Tom Harkin introduced legislation that would have capped reasonable compensation at only \$500,000.<sup>10</sup>

Although the proposals to limit executive compensation have certainly outnumbered the enactments, three sections of the tax code have been implemented within the last two decades with the intent to cap executive compensation in public corporations.<sup>11</sup> In 1984, Congress enacted § 280G, disallowing a deduction for any golden parachute<sup>12</sup> in excess of three times the executive's annual compensation during the last five years,

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a class action suit filed against the NYSE on behalf of the California Public Employees' Retirement System on December 16, 2003. Jeff Chorney, *CalPERS Taps Lerach for Suit Against NYSE*, THE RECORDER, Dec. 17, 2003, at 1. A lawyer for the plaintiff class, William Lerach of Milberg Bershad Hynes & Lerach, noted that Grasso's "obscene" compensation package provided evidence of "the exchange's inability to effectively police its members." *Id.*

6. See Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 232 (1983) (indicating that a new wave of concern about the enormity of executive compensation may be developing).

7. See *Unnecessary Business Subsidies: Hearing Before the House Comm. on the Budget*, 106th Cong. (1999) (statement of Ralph Nader, Consumer Advocate, describing executive compensation as "bloated"); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 29-31 (1991) (describing America's system of executive compensation as "rotten to the core").

8. See, e.g., Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28, 30-32; Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125, 125.

9. H.R. 3056, 102d Cong. (1991).

10. S. 2329, 102d Cong. (1992).

11. I.R.C. §§ 162(m), 280G, 4999 (2000). Section 162(a)(1) monitors reasonable compensation primarily in closely held corporations and was enacted in 1918. Revenue Act of 1918, Pub. L. No. 254, ch. 18, § 234(a)(1), 40 Stat. 1057, 1077 (1919).

12. A golden parachute is "[a]n employment-contract provision that grants an upper-level executive lucrative severance benefits—including long-term salary guarantees or bonuses—if control of the company changes hands (as by a merger)." BLACK'S LAW DICTIONARY 700 (7th ed. 1999).

and § 4999, requiring executives to pay a nondeductible 20% excise tax on any excess parachute payment.<sup>13</sup> In 1993, President Clinton signed into law § 162(m), disallowing the deductibility of certain corporate executive compensation exceeding \$1 million.<sup>14</sup> Those sections, however, have not been a panacea for capping corporate greed, and the concern over executive compensation has not waned. After the dust settles from the Sarbanes-Oxley Act,<sup>15</sup> political pressure may build and another tax provision designed to cap executive compensation may make its way through Congress. Before that happens, it is important to learn from past mistakes.

This Note investigates the effectiveness of Congress in capping executive compensation in public companies through the use of the tax code. Part I discusses the regulation of executive compensation prior to the enactment of § 280G, § 4999, and § 162(m). Part II explores the functionality, legislative history, and unintended results of § 280G and § 4999. Part III describes the functionality, legislative history, and unintended results of § 162(m). Part IV asserts that tax reform will not be effective in limiting executive compensation as long as directors *are not* independent, and tax reform will not be necessary if directors *are* independent. This Note concludes that the federal government will not be successful in capping executive compensation by providing disincentives through the tax code and suggests that director independence is the best way to ensure reasonable executive compensation.

## I. EXECUTIVE COMPENSATION PRIOR TO § 280G, § 4999, AND § 162(m)

Prior to the enactment of § 280G, § 4999, and § 162(m), golden parachute payments and executive compensation in publicly held companies were only subject to the general rule

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13. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 67, 98 Stat. 494, 585-87 (1984) (codified at I.R.C. §§ 280G, 4999). Recipients of golden parachutes are denied a deduction for the § 4999 excise tax. I.R.C. § 275(a)(6).

14. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,211(a), 107 Stat. 312, 470-71 (1993).

15. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C., 11 U.S.C., and 28 U.S.C.). This statute represents "the most sweeping revision of the securities laws since the New Deal . . . [and] the deepest incursion by the federal governance into the internal affairs of U.S. corporations." ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 716 (8th ed. 2003).

under § 162(a)(1),<sup>16</sup> which limits a company's tax deduction for employee compensation to reasonable compensation.<sup>17</sup> Courts traditionally rely on the amount test when determining the reasonableness of compensation.<sup>18</sup> The amount test, which varies by jurisdiction, analyzes whether the amount of the payment is reasonable in relation to the services performed.<sup>19</sup> The concept of reasonableness is primarily intended to stop closely held businesses from artificially increasing employee compensation in an attempt to disburse profits in a deductible form, as opposed to a nondeductible form such as gifts or dividends.<sup>20</sup> The reasonableness limitation does not police compensation in arm's length business relationships such as those that exist in large public companies.<sup>21</sup> Given the ineffectiveness of § 162(a)(1) in policing compensation in publicly held companies and the continued astronomical amounts of executive compensation,<sup>22</sup> Congress sought to further regulate executive compensation.

## II. CONGRESS'S ATTEMPT TO CAP EXECUTIVE COMPENSATION WITH § 280G AND § 4999

This part briefly describes the functionality of § 280G and § 4999 of the tax code. After explaining how these sections operate, this part will examine Congress's intentions when enacting these provisions. Finally, this part will demonstrate that § 280G and § 4999 have unintended and undesirable consequences.

### A. THE FUNCTIONALITY OF § 280G AND § 4999

Sections 280G and 4999, enacted simultaneously, apply to payments that (1) are contingent on a change in control of a corporation or change in ownership of a substantial portion of a

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16. I.R.C. § 162(a)(1) (allowing a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year, including "a reasonable allowance for salaries or other compensation for personal services actually rendered").

17. See GERALD A. KAFKA, *TAX MANAGEMENT PORTFOLIOS: REASONABLE COMPENSATION* A-3 (3d ed. 2003).

18. *Id.*

19. *Id.* at A-13.

20. *Id.* at A-3.

21. *Id.*

22. See Henry F. Johnson, *Those "Golden Parachute" Agreements: The Taxman Cuts the Ripcord*, 10 DEL. J. CORP. L. 45, 49-50 nn.25-26 (1985).

corporation's assets, and (2) have a present value equal to or in excess of the average annual compensation of the executive.<sup>23</sup> If these conditions are met, the sections provide two basic penalties: § 280G denies the employer a deduction under § 162(a) for employee compensation in the form of an "excess parachute payment,"<sup>24</sup> and under § 4999, the employee must pay a nondeductible 20% excise tax on the same parachute payment.<sup>25</sup>

A "parachute payment" is defined by the sections as a payment that (1) is within the definition of compensation, (2) is given to a "disqualified individual,"<sup>26</sup> and (3) is contingent on a change in control or ownership of either a corporation or a substantial portion of a corporation's assets.<sup>27</sup> A parachute payment is considered excessive and is subject to a 20% excise tax if it equals or exceeds three times the base amount<sup>28</sup> and it cannot be proven reasonable compensation.<sup>29</sup> Usually, the base amount is determined by considering the taxpayer's average gross income for the five years prior to the tax year at issue.<sup>30</sup>

Finally, there is a special rule of proof and a rebuttable presumption contained in the golden parachute provisions. If an employer argues that a parachute payment is reasonable, the case must be proved by clear and convincing evidence.<sup>31</sup> Absent clear and convincing evidence to the contrary, a payment made based on a contract entered into, or amended, within a year before the change in control is presumed to be a parachute payment.<sup>32</sup> Rarely will prior services for which an employee was

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23. I.R.C. §§ 280G(b)(2)(A), 4999(b) (2000). The sections also apply to payments made pursuant to an agreement that violates any generally enforced securities laws or regulations. *Id.* §§ 280G(b)(2)(B), 4999(b).

24. *Id.* § 280G(a).

25. *Id.* § 4999(a).

26. A "disqualified individual" is a person who (1) is an employee, independent contractor, or other person who performs services for a corporation, and (2) is an officer, shareholder, or highly compensated individual of the corporation. *Id.* § 280G(c). Only employees earning \$80,000, as indexed for inflation, in annualized compensation during the period in question may qualify as highly compensated. Treas. Reg. § 1.280G-1, Q/A-19(a) (2003) (cross-referencing I.R.C. § 414(q)(1)(B)(i)).

27. I.R.C. §§ 280G(b)(2)(A), 4999(b); Treas. Reg. § 1.280G-1, Q/A-2(a) (2003).

28. I.R.C. §§ 280G(b), 4999(b).

29. *Id.* § 280G(b)(4).

30. *Id.* § 280G(b)(3); see Treas. Reg. § 1.280G-1, Q/A 34, 35 (2003).

31. I.R.C. § 280G(b)(4).

32. *Id.* § 280G(b)(2)(C). In such circumstances, contracts of this kind are often viewed as "last minute appropriations of corporate assets." See *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702, 712 (Cal. Ct. App. 1989) (reversing

under-compensated be considered when determining the reasonableness of a parachute payment.<sup>33</sup> Congress made several mechanical amendments to § 280G in 1986,<sup>34</sup> and enacted additional technical amendments to § 280G in 1988.<sup>35</sup>

#### B. WHAT CONGRESS INTENDED TO ACCOMPLISH WITH § 280G AND § 4999

Sections 280G and 4999 were enacted because Congress believed that corporate decision making in takeover situations should not be critically influenced by executives' concern for their own personal benefit.<sup>36</sup> Takeover situations create an inherent conflict of interest because management may be disinclined to complete a merger or acquisition that may put their job at risk, even though the merger or acquisition would be beneficial to their shareholders.<sup>37</sup> Congress concluded that, in many circumstances, parachute agreements simply keep entrenched management in control.<sup>38</sup> Parachute agreements may do this by increasing the cost to a potential buyer, which discourages acquisitions.<sup>39</sup> Excessive parachute payments may

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summary judgment in favor of board members who had approved golden parachute contracts for certain top executives in the midst of a hostile takeover battle).

33. H.R. CONF. REP. NO. 98-861, at 852 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1540.

34. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(j), 100 Stat. 2085, 2807-09. The amendments created exemptions for "payments relating to small businesses; [payments in] corporations without readily tradable stock, if shareholder approval is obtained; and payments to or from qualified pension, annuity, and simplified employee pension plans." KAFKA, *supra* note 17, at A-37 (footnotes omitted) (citing I.R.C. §§ 280G(b)(5)(A)(i)-(ii), (b)(5)(B), (b)(6)).

35. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1018(d)(6)-(8), 102 Stat. 3342, 3581 (1988). These amendments gave the Internal Revenue Service (IRS) the authority to institute shareholder approval requirements for corporations without readily tradable stock. *See* I.R.C. § 280G(b)(5)(B). The IRS proposed regulations to § 280G in both 1989 and 2002. *See* Golden Parachute Payments, 54 Fed. Reg. 19,390 (proposed May 5, 1989) (to be codified at 26 C.F.R. pt. 1); Golden Parachute Payments, 67 Fed. Reg. 7630 (proposed Feb. 20, 2002) (to be codified at 26 C.F.R. pt. 1). Final golden parachute regulations were not issued until 2003. *See* Golden Parachute Payments, 68 Fed. Reg. 45,745. The final regulations apply to any parachute payment that occurred on or after January 1, 2004. *Id.*

36. *See* KAFKA, *supra* note 17, at A-37.

37. *See* Edward A. Zelinsky, *Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Sections 280G, 4999 and 5881*, 35 VILL. L. REV. 131, 150 (1990).

38. S. PRT. NO. 98-169, vol. 1, at 195 (1984).

39. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985)

also encourage executives to implement a proposed takeover that would reward them handsomely, although it might not be in the best interests of shareholders.<sup>40</sup> Recognizing that such payouts were tax deductible as ordinary and necessary business expenses, the Senate Finance Committee declared its unwillingness to have the tax law subsidize golden parachute agreements, and advocated the enactment of a tax penalty for such agreements.<sup>41</sup>

### C. THE UNINTENDED RESULTS OF § 280G AND § 4999

Commentators have generally been critical of the use of the tax code to control executive compensation.<sup>42</sup> As one commentator noted soon after the provisions were passed, "Congress has, as usual, made an opening move in a corporate chess game and neglected to consider its opponents' countermoves."<sup>43</sup> Similarly, practitioners have noted that "[b]road-based legislative solutions may be good politics, but too often they result in bad policy."<sup>44</sup> Creative corporate attorneys, accountants, and businesspeople can find ways to circumvent tax disincentives. There have been three pernicious, unintended consequences of § 280G and § 4999: (1) setting parachute payments at three times base salary has become the congressionally sanctioned standard of reasonableness for such payments; (2) some companies willingly exceed the standard and grant gross ups which provide an additional payment to the executive, such that after taxes the executive receives the same pay he would have had the excise tax not existed;<sup>45</sup> and (3) other companies include provisions providing either the full severance payment (without a gross up) or the capped payment, whichever results in the executive receiving the greater amount.

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(noting that golden parachutes may be used as a defense against takeovers).

40. See Philip L. Cochran & Steven L. Wartick, "Golden Parachutes": A Closer Look, CAL. MGMT. REV., Summer 1984, at 111, 123.

41. S. PRT. NO. 98-169, vol. 1, at 195.

42. See, e.g., Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 94-100 (1998); Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 128-29 (2001); Zelinsky, *supra* note 37, at 187-92.

43. Graef S. Crystal, *Congress Thinks It Knows Best About Executive Compensation*, WALL ST. J., July 30, 1984, at 16.

44. Brownstein & Panner, *supra* note 8, at 32.

45. See Wolk, *supra* note 42, at 139-40.



## 1. Congressionally Sanctioned Standard of Reasonableness

After the enactment of § 280G and § 4999, golden parachutes “rapidly spread” to boardrooms representing many industries.<sup>46</sup> By codifying a salary multiple, § 280G created a floor on parachute benefits that directors and executives could point to as a congressionally sanctioned standard of reasonableness.<sup>47</sup> As a result, companies are more likely to set the payouts to at least 299% of the executives’ base compensation.<sup>48</sup> Shareholders have also become accustomed to this baseline. In 2003, eighteen companies voted on shareholder proposals asking for shareholder approval of future executive severance agreements exceeding 299% of base compensation.<sup>49</sup> Fourteen of the proposals received a majority vote, with 56.9% being the average vote in support of the proposals.<sup>50</sup> In comparison, only two such proposals received a majority vote in 2002, and no such proposal received a majority vote in 2000 or 2001.<sup>51</sup> The average vote in support of such proposals during 2000–2002 never exceeded 35%.<sup>52</sup>

The establishment of a congressional standard complicates the purpose of parachute payments and is detrimental to shareholders. Golden parachutes are intended to compensate executives for the risks of being discharged due to a takeover.<sup>53</sup> They are adopted in the hopes of attracting talented leaders to organizations prone to takeover.<sup>54</sup> Without appropriate golden

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46. Carol Bowie & Judy Fischer, *Have Parachutes Become More Than Security Blankets?*, MERGERS & ACQUISITIONS, Nov.–Dec. 1996, at 17, 18. According to an annual summary by Executive Compensation Reports of change-in-control provisions at more than 1000 corporations, the number of companies with golden parachutes climbed 63% between 1987 and 1995. *Id.*

47. Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 963 n.38 (1987).

48. See Bowie & Fischer, *supra* note 46, at 18.

49. See HEWITT ASSOCS., LLC, EXECOMP MARKETRENDS: 2003 GOLDEN PARACHUTE SHAREHOLDER PROPOSALS 1 (2004) (on file with author).

50. *Id.* Nowhere is the success of shareholder proposals more pronounced than in the context of limiting severance payments for executives. *Id.*

51. *Id.* at 2.

52. *Id.*

53. “Academic studies have verified that CEOs encourage value-creating mergers and takeovers when they are protected, and fight them when they are not.” Carl R. Weinberg, *CEO Compensation: How Much Is Enough?*, CHIEF EXECUTIVE (presenting the results of its 2000 Annual CEO Compensation Review), at <http://www.chiefexecutive.net/bench/compensa/ceocomp2000.htm> (last visited Feb. 12, 2004). According to Weinberg, “change-of-control severance protection is a shareholder-friendly program.” *Id.*

54. Bress, *supra* note 47, at 958. Golden parachutes also deter takeovers

parachutes, companies and industries at risk of takeover must use other incentives to lure managerial talent.<sup>55</sup> To do so, they may increase annual compensation, cash bonuses, or stock options to provide the same expected benefit as a golden parachute.<sup>56</sup> This is even more detrimental to shareholders because the risk of a potential takeover is paid upfront on an annual basis rather than deferred until the actual change in control occurs. A higher annual salary also makes it more difficult for existing managers to objectively evaluate tender offers or potential mergers.<sup>57</sup> Golden parachutes create indifference when they offset what the executive would expect to lose by being severed.<sup>58</sup> It is not possible for Congress to estimate this equilibrium point for all companies and industries. Instead, it must be left to the individual companies. Therefore, the congressionally sanctioned standard of reasonableness established by § 280G has a negative effect unintended by Congress.

## 2. Gross Ups

Another unintended result of § 280G and § 4999 that is detrimental to shareholders is the emergence of gross ups.<sup>59</sup> A gross up gives the executive an additional payment to cover the excise tax and any income and employment taxes resulting from the additional payment.<sup>60</sup> Based on a 1999 Hewitt Associates survey, gross ups were employed by 64% of Fortune 200

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by increasing the cost of an acquisition. See *supra* note 39 and accompanying text (noting that golden parachutes are one of many defensive tactics used by management to deter or defeat tender offers).

55. See John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1236 (1984) ("[T]o the extent that job security is reduced, the executive should demand much higher compensation for his services."); Ann M. Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 82, 83 (reporting that golden parachutes are often necessary to retain high-level employees).

56. The expected value of a conditional payment is determined by multiplying the amount of the conditional payment by the probability of its receipt. A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 27 (1983).

57. See Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1217 n.60 (1984).

58. Bress, *supra* note 47, at 972 (analyzing golden parachutes within an insurance law framework).

59. According to a 1991 study of golden parachute agreements by Executive Compensation Reports, 38% promised to pay a gross up. Bowie & Fischer, *supra* note 46, at 19. A similar study, conducted in 1996, showed an increase to 45%. *Id.*

60. Wolk, *supra* note 42, at 139-40.

companies with change-in-control provisions for senior executives.<sup>61</sup> In addition, a follow-up survey by Hewitt Associates completed in the first quarter of 2004 found that 68% of Fortune 200 companies with change-in-control provisions now employ gross ups.<sup>62</sup> Apparently, even the corporate scandals at Enron, Global Crossing, and Tyco International have not caused directors to reconsider the continued use of gross ups.

This practice is extremely expensive and often unknown to shareholders because it is buried in individual executive employment agreements.<sup>63</sup> “[T]he gross-up payments must also be grossed up, and these gross-ups must also be grossed up, and so on.”<sup>64</sup> Each incremental gross up is treated as another excess parachute payment, which makes the gross up subject to the § 4999 excise tax and prevents the company from deducting the payment as an ordinary and necessary business expense.<sup>65</sup> Shareholders suffer extraordinarily because gross ups “cost a company several dollars after taxes for every \$1 of after-tax payments” received by the executive.<sup>66</sup>

The current prevalence and intricacies of golden parachute agreements may be explored by researching executive employment agreements at some of the largest public corporations in the United States.<sup>67</sup> There were twenty new and amended employment agreements containing change-in-control provisions filed with the SEC in 2003 by the twenty-five largest U.S. pub-

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61. HEWITT ASSOCS., LLC, SURVEY FINDINGS: EXECUTIVE CHANGE-IN-CONTROL ARRANGEMENTS AT FORTUNE 200 COMPANIES 17 (1999) [hereinafter 1999 HEWITT SURVEY] (on file with author); see also George B. Paulin, *Executive Compensation and Changes in Control: A Search for Fairness*, COMPENSATION & BENEFITS REV., Mar.-Apr. 1997, at 30, 33 (noting that most surveys conclude that almost half of large and midsize companies provide gross ups to their executives).

62. HEWITT ASSOCS., LLC, SURVEY FINDINGS: EXECUTIVE CHANGE-IN-CONTROL ARRANGEMENTS AMONG FORTUNE 200 COMPANIES 16 (2003/2004) [hereinafter 2003/2004 HEWITT SURVEY] (on file with author).

63. Gross ups have been labeled a form of “stealth compensation.” *CEO Compensation: Hearing Before the Senate Comm. on Commerce, Sci. & Transp.*, 108th Cong. (2003) [hereinafter *Compensation Hearing*] (testimony of Sean Harrigan, President, California Public Employees’ Retirement System), at <http://commerce.senate.gov/hearings/witnesslist.cfm?id=767>.

64. Paulin, *supra* note 61, at 33.

65. *Id.*

66. *Id.* at 37.

67. The Securities and Exchange Commission (SEC) requires disclosure of plans or arrangements for additional compensation to a firm’s top five managers that will be triggered by a change in control of the issuer. 17 C.F.R. § 229.402(a)(3), (b)(2)(v)(A)(2) (2003).

lic companies (based on revenue).<sup>68</sup> Of those twenty agreements, half had gross-up provisions.<sup>69</sup> The high percentage of companies with change-in-control provisions that also provide gross ups implies that § 280G and § 4999 are not having their intended effect of reducing executive compensation. Instead, these sections of the tax code have instigated the practice of using gross ups, which is even more costly to shareholders.

### 3. Best-Net Provisions

One way in which § 280G and § 4999 have been partially, but not entirely, circumvented is with best-net provisions. Best-net provisions grant the executive either the entire payment without a gross up or a reduced payment, whichever provides the executive with more money after considering the impact of taxes.<sup>70</sup> Best-net provisions are obviously less generous than gross-up provisions, but more lucrative for executives than having no additional protection. The effect of the congressionally sanctioned standard of reasonableness is still felt because companies automatically go up to the 299% cap.<sup>71</sup> The cap is only exceeded, however, if it is more lucrative for the executive even without a gross up being paid. In the 1999 Hewitt Associates survey, best-net provisions were employed by only seven percent of Fortune 200 companies with change-in-control provi-

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68. See *Search the EDGAR Database: Companies and Other Filers*, SEC, at <http://www.sec.gov/edgar/searchedgar/webusers.htm> (last visited Mar. 21, 2004). The twenty-five largest revenue-producing public companies in the United States were determined by *Fortune's* annual survey. *Fortune 500 Largest U.S. Corporations*, FORTUNE, Apr. 14, 2003, at F-1. Employment agreements are listed as exhibits in the annual Form 10-K filed by each corporation. The following employment agreements were included in the study: Robert E. Rubin, Citigroup, Inc.; John A. Graf, American International Group, Inc.; Rodney O. Martin, American International Group, Inc.; Charles R. Lee, Verizon Communications, Inc.; Mary Beth Bardin, Verizon Communications, Inc.; David Benson, Verizon Communications, Inc.; Ezra D. Singer, Verizon Communications, Inc.; Doreen A. Toben, Verizon Communications, Inc.; Franklin D. Raines, Federal National Mortgage Association; James S. Gorelick, Federal National Mortgage Association; Daniel H. Mudd, Federal National Mortgage Association; Michael S. Heschel, Kroger Co.; George L. Fotiades, Cardinal Health, Inc.; James F. Millar, Cardinal Health, Inc.; Stephen S. Thomas, Cardinal Health, Inc.; Betsy J. Bernard, AT&T Corp.; David Yost, AmerisourceBergen Corp.; Kurt J. Hilzinger, AmerisourceBergen Corp.; Michael D. DiCandilo, AmerisourceBergen Corp.; Terrance P. Haas, AmerisourceBergen Corp.

69. See *supra* note 68.

70. See *Wolk*, *supra* note 42, at 138.

71. See *supra* Part II.C.1.

sions for senior executives.<sup>72</sup> In Hewitt's most recent survey, prevalence fell to three percent.<sup>73</sup> Given this statistic, it is not surprising that none of the twenty employment agreements investigated under Part II.C.2 included best-net provisions.<sup>74</sup> Although not popular at this time, best-net provisions are yet another example of how corporate attorneys, accountants, and businesspeople find ways to minimize the impact of tax disincentives.

Ultimately, the negative effects of § 280G and § 4999 are felt primarily in two ways: (1) companies set parachute payments at the 299% cap regardless of their specific situations (which may command a less generous payout); and (2) a majority of companies provide costly gross ups to their executives. Given these negative effects, Congress's attempts to curb executive compensation through § 280G and § 4999 have proved not only ineffective, but counterproductive.<sup>75</sup>

### III. CONGRESS'S ATTEMPT TO CAP EXECUTIVE COMPENSATION WITH § 162(m)

Almost a decade after adding § 280G and § 4999 to the tax code, Congress enacted § 162(m).<sup>76</sup> The following subparts describe § 162(m)'s functionality, discuss Congress's intentions when enacting § 162(m), and analyze the unintended consequences of § 162(m).

#### A. THE FUNCTIONALITY OF § 162(m)

Under § 162(m), a public corporation can only deduct \$1 million of annual compensation for the Chief Executive Officer (CEO) and each of the four most highly compensated employees, unless the compensation that is in excess of \$1 million is part of a performance-based plan that meets certain criteria.<sup>77</sup>

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72. See 1999 HEWITT SURVEY, *supra* note 61, at 17.

73. 2003/2004 HEWITT SURVEY, *supra* note 62, at 16.

74. See *supra* note 68.

75. Based on a June 2002 poll of "217 executives of Fortune 1000 and leading industry companies" conducted by Christian & Timbers, an international executive search firm, 69% of respondents felt that executive severance packages are still excessive. Press Release, Christian & Timbers, 69 Percent of Executives Surveyed Think Severance Packages Are Out of Hand (Aug. 13, 2002), at <http://www.ctnet.com/pr/releaseDetails.asp?prid=164>.

76. See Omnibus Budget Reconciliation Act of 1993 § 13211, Pub. L. No. 103-66, 107 Stat. 312 (codified as amended at I.R.C. § 162(m) (2000)).

77. See I.R.C. § 162(m).

To be fully deductible, performance-based compensation must be based on the attainment of preestablished and objective performance goals designated by a compensation committee "comprised solely of [two] or more outside directors" and approved by a majority vote of shareholders before payment.<sup>78</sup> In addition, the compensation committee must certify that the performance goals were met before payment is granted.<sup>79</sup>

Generally speaking, stock options are inherently performance based.<sup>80</sup> In fact, certification that the performance goals have been met is generally unnecessary for stock options because any money earned by the executive on the options is generated by an increase in the stock's price, which is theoretically attributable to corporate performance.<sup>81</sup> As long as directors predetermine the maximum number of stock options that an executive may receive during a specified period, directors may adjust the number of options they eventually grant to an executive.<sup>82</sup> If the stock-based compensation is not fully dependent on corporate performance, then it is not considered performance based.<sup>83</sup> If a stock option's exercise price is less than the stock's value when the option is granted, or "if the executive is otherwise protected from decreases in the stock's value (such as through automatic repricing), [then] the compensation is not performance-based" and may not be deducted under § 162(m) if total compensation exceeds \$1 million.<sup>84</sup>

Restricted shares, however, are not necessarily performance based because, under most restricted-share agreements, the grantee receives value regardless of whether the share price increases.<sup>85</sup> Unless the grant or vesting of restricted

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78. *Id.* § 162(m)(4)(C)(i)-(ii).

79. *Id.* § 162(m)(4)(C)(iii).

80. See KAFKA, *supra* note 17, at A-56.

81. *Id.*

82. See H.R. CONF. REP. NO. 103-213, at 587 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1276.

83. See KAFKA, *supra* note 17, at A-56.

84. *Id.*; see also H.R. CONF. REP. NO. 103-213, at 587.

85. KAFKA, *supra* note 17, at A-56. Restricted shares are "common stock shares released under an agreement whereby they do not [receive] dividends [and effectively cannot be sold] until some event has taken place—usually the attainment of certain levels of earnings" or the passage of time. JERRY M. ROSENBERG, *DICTIONARY OF BANKING AND FINANCIAL SERVICES* 573 (2d ed. 1985). From a shareholder's perspective, payment in restricted shares is preferable to stock options because restricted shares encourage "executives to focus on long-term growth and profitability." Ben White, *Stock Options Becoming Pay-Plan Dinosaurs? Image-Sensitive Firms Get Creative with Perks*,

shares is contingent on meeting specific performance objectives and fulfills the other criteria for performance-based compensation, the restricted shares will be subject to the \$1 million cap.<sup>86</sup> On the other hand, compensation in the form of contributions to, or payments from, qualified retirement plans or nontaxable fringe benefits are not subject to the deduction limitation.<sup>87</sup> Finally, § 162(m) also provides that any amount denied deductibility under § 280G will reduce the \$1 million cap under § 162(m) on a dollar-for-dollar basis.<sup>88</sup>

#### B. WHAT CONGRESS INTENDED TO ACCOMPLISH WITH § 162(m)

Congress enacted § 162(m) after the populist outrage over executive compensation reached a high during the 1992 presidential race. During that race, Governor Bill Clinton stated: "It's wrong for executives to do what so many did in the 1980s. The biggest companies raised their [CEOs'] pay by four times the percentage their workers' pay went up and three times the percentage their profits went up."<sup>89</sup> A year later in 1993, with Clinton as President, Congress amended the tax code to add § 162(m), a compensation-capping measure.<sup>90</sup> According to the Senate Finance Committee, Congress added § 162(m) because "the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced [by the \$1 million cap]."<sup>91</sup>

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WASH. POST, Jan. 31, 2003, at E1. If the stock price declines while an executive holds restricted shares, the executive still has a "strong incentive to perform" because the shares retain some value until the stock price goes to zero. Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 219 (1996); see also F. John Reh, *Restricted Stock Is Better Than Stock Options*, at <http://management.about.com/cs/adminaccounting/a/restrictedstock.htm> (last visited Dec. 22, 2003).

86. KAFKA, *supra* note 17, at A-56.

87. I.R.C. § 162(m)(4)(E) (2000).

88. *Id.* § 162(m)(4)(F). For example, suppose an executive earned \$1 million in base compensation for each of the last five years. In year six, he receives a golden parachute worth \$3.5 million. Because the golden parachute exceeds 300% of his historic base compensation by \$500,000, the \$500,000 that is not deductible under § 280G would reduce the \$1 million cap imposed by § 162(m) by \$500,000 for that year.

89. *Presidential Candidates Divide on Executive Compensation Caps*, 24 Sec. Reg. & L. Rep. (BNA) No. 42, at 1634 (Oct. 23, 1992).

90. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,211, 107 Stat. 312, 469-71 (1993).

91. *Id.*; H.R. Rep. No. 103-11, at 646 (1993), *reprinted in* 1993

### C. UNINTENDED CONSEQUENCES OF § 162(m)

After the enactment of § 162(m), many commentators quickly condemned the \$1 million cap.<sup>92</sup> According to one commentator, the provision may cause companies to restructure, but not necessarily reduce, compensation packages.<sup>93</sup> Based on a 2003 research study conducted by *Corporate Board Member* magazine and Towers Perrin, 36.2% of responding directors believed § 162(m) would have *some* impact on executive compensation policies and practices at their company, while 49.3% believed that the regulation would have *no* impact.<sup>94</sup> Since enactment in 1994, there have been three unintended consequences of § 162(m): (1) \$1 million immediately became the standard executive base salary; (2) there was a shift towards stock options to compensate executives; and (3) performance-based pay essentially encouraged executives to focus on and manipulate short-term earnings at the expense of long-term value creation.

#### 1. Ante Becomes \$1 Million

Experts predicted that “trying to micromanage the pay process or pay outcomes through federal legislation . . . is likely to be ineffective in solving the problem and may well have harmful and unintended consequences.”<sup>95</sup> Indeed, after enactment of § 162(m), \$1 million became the government-sanctioned standard for executive base salary.<sup>96</sup> To compete for managerial talent, the market forced companies to meet the \$1 million ante.<sup>97</sup> Section 162(m) is even less logical than § 280G

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U.S.C.C.A.N. 378, 877.

92. See Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 24–25 (2000) (arguing that tax “reform is unlikely to limit compensation, and it may fuel the increase of compensation”); Mark A. Salky, Comment, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?*, 49 U. MIAMI L. REV. 795, 825 (1995) (“[The] IRS approach of [capping] the deduction for excessive compensation at \$1 million is entirely unnecessary and ineffective.”).

93. Salky, *supra* note 92, at 824.

94. Directors and Executive Compensation Study, CORPORATE BOARD MEMBER & TOWERS PERRIN (question 13), at [http://www.boardmember.com/network/cbm\\_execcomp.pdf](http://www.boardmember.com/network/cbm_execcomp.pdf) (last visited Nov. 8, 2003).

95. *Compensation Hearing*, *supra* note 63 (testimony of Brian Hall, Associate Professor, Harvard Business School).

96. See *id.* (“[T]he pay trend . . . makes it look as if [§ 162(m)] were passed with the intention of accelerating, not curbing, CEO pay increases.”).

97. See John A. Byrne, *That’s Some Pay Cap, Bill*, BUS. WK., Apr. 25, 1994, at 57 (explaining that the cap has effectively established a standard for



and § 4999 in this respect because the \$1 million cap is not tailored in any way to individual public corporations that face unique circumstances and different competitive environments. The appropriate amount and method of compensation varies by corporation.<sup>98</sup> For example, a cap of \$1 million for John Coughlan, the CEO of Lawson Software, which had revenues of \$428 million in 2002, may be appropriate,<sup>99</sup> while that same cap may be unfair to H. Lee Scott, Jr., the CEO of Wal-Mart Stores, which had revenues of \$246.5 billion in the same year.<sup>100</sup> The \$1 million cap is a capricious figure.<sup>101</sup> The cap also does not take into account the effects of inflation.<sup>102</sup> If \$1 million was an appropriate cap in 1994, it is arguably inappropriate after a decade of inflation. Taking inflation into account, the \$1 million cap in 1994 should be adjusted to almost \$1.2 million in 2004.<sup>103</sup> Thus, by enacting § 162(m), Congress has unintentionally set a government-sanctioned standard for executive base salary that fails to take into account the individual circumstances of different companies and neglects to recognize the effects of inflation.

## 2. Stock Options Are Worth Even More

Another detrimental effect of § 162(m) is the increase of corporations' use of stock options to compensate their executives. In 1984, less than half of the CEOs running large U.S. corporations received compensation in the form of stock options.<sup>104</sup> Between 1992 and 2000, however, there was a shift in the composition of CEO compensation as reported by the Standard & Poor's 500 Industrials from 27% stock options to 51%

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executive pay). The section has also encouraged companies to pay their executives with stock option grants worth many times the limit because option grants are deemed performance-based compensation and are exempted from the cap. See James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 708-09 (1997) (describing the operation and ramifications of § 162(m)).

98. Brownstein & Panner, *supra* note 8, at 38.

99. Lawson Software, 2003 Form 10-K (items 1 & 6), at <http://www.sec.gov/Archives/edgar/data/1141517/000104746903025445/a2115268z10-k.htm> (last visited Feb. 22, 2004).

100. *Fortune 500 Largest U.S. Corporations*, *supra* note 68, at F-1.

101. Salky, *supra* note 92, at 825.

102. See I.R.C. § 162(m) (2000).

103. See Gross Domestic Product Deflator Inflation Calculator, at <http://www.jsc.nasa.gov/bu2/inflateGDP.html> (last visited Dec. 22, 2003).

104. *Compensation Hearing*, *supra* note 63 (testimony of Brian Hall, Associate Professor, Harvard Business School).

stock options.<sup>105</sup> Option grants have also become “about twice as large as cash-based pay,” and now represent “about two-thirds of total CEO pay.”<sup>106</sup>

At the same time, stock market valuations increased dramatically. “From the early 1980s to the end of the 1990s, the stock markets rose 1400%.”<sup>107</sup> The Conference Board reported in September 2002 that gains in stock options accounted for approximately 80% of the rise in CEO pay between 1992 and 2000.<sup>108</sup> During a congressional hearing on the topic, one executive compensation expert asserted that the public got what it asked for when it called for the use of stock options: “we tied CEO pay to increasing shareholder wealth and shareholder wealth overall increased dramatically.”<sup>109</sup> During the same congressional hearing, a business school professor commented that “[o]ptions became ‘icing on the cake’ for CEOs in the mid 1980s. Today, the icing has become the cake.”<sup>110</sup> This comment indicates the dramatic rise in the size and value of stock option grants during the last two decades.

Section 162(m) has encouraged companies to pay their executives with these stock option grants that are worth many times more than the \$1 million limit because option grants easily qualify as performance-based compensation and thus are exempted from the cap.<sup>111</sup> Since certification that the performance goals have been met is generally not necessary with stock options, such options are also easy to implement.<sup>112</sup> In addition, many boards of directors do not consider the true economic cost

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105. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 848–49 (2002). The Standard & Poor’s 500 Stock Index is the “composite of 425 industrial stocks, 25 railroad stocks, and 50 utility stocks compiled by the Standard & Poor’s Corporation.” HOWARD BRYAN BONHAM, *THE COMPLETE INVESTMENT AND FINANCE DICTIONARY* 615 (2001).

106. *Compensation Hearing*, *supra* note 63 (testimony of Brian Hall, Associate Professor, Harvard Business School).

107. *Id.* (testimony of Joseph E. Bachelder, Founder and Senior Partner, The Bachelder Firm).

108. *Id.*

109. *Id.*

110. *Id.* (testimony of Brian Hall, Associate Professor, Harvard Business School).

111. *See supra* text accompanying notes 80–84. “At best, these changes [§ 162(m)] were ineffective. At worst, they distorted pay towards options (which automatically count as performance-based pay) while contributing to CEO pay excesses.” *Compensation Hearing*, *supra* note 63 (testimony of Brian Hall, Associate Professor, Harvard Business School).

112. *See supra* text accompanying notes 80–84.

of stock options to shareholders.<sup>113</sup> Many directors currently “view options to be ‘free’ or ‘costless.’”<sup>114</sup> According to Professor Brian Hall, three factors have led to this incorrect view. First, the current accounting rules do not require companies to expense options on the income statement, which makes them effectively free from an accounting perspective.<sup>115</sup> Second, although option grants dilute the shares of current stockholders, options do not require companies to expend any cash.<sup>116</sup> Third, because methods for valuating stock options are murky, many businesspeople assess the costs of options by measuring the number of options granted rather than the actual value of the options at the time they are granted.<sup>117</sup> He asserts that together these three factors have caused executive compensation to burgeon.<sup>118</sup>

The requirement that compensation be performance based to be excluded from the \$1 million cap has also left directors with less discretion when doling out stock options. IRS regulations authorize directors to reduce, but not increase, a stock grant that has been approved by shareholders.<sup>119</sup> In an effort to regain the discretion they had before § 162(m), directors seek a larger bonus pool without intending to grant the entire pool when it comes time to allocate it.<sup>120</sup> Compensation committees, however, have been pressured into utilizing more of this larger pool than they would have awarded if a smaller pool existed.<sup>121</sup> Thus, compensation will likely increase because of the enactment of § 162(m), and there is some evidence that this is occurring.<sup>122</sup>

### 3. Focus on Short-Term Results

The shift toward stock options brought about by § 162(m) also had the unintentional effect of causing CEOs to focus on stock-price fluctuations and short-term results. Stock options

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113. *Compensation Hearing*, *supra* note 63 (testimony of Brian Hall, Associate Professor, Harvard Business School).

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. See I.R.C. § 162(m) (2000); see also *supra* note 82 and accompanying text.

120. Loewenstein, *supra* note 92, at 25.

121. *Id.*

122. See Loewenstein, *supra* note 85, at 218 & n.80.

“encourage excessive risk taking by executives and can prompt [them] to pursue corporate strategies designed to promote short-term stock price to the detriment of long-term corporate value.”<sup>123</sup> For some executives, because so much of their compensation was tied to stock options, “there was an irresistible impulse to cook the books.”<sup>124</sup> Executives have an incentive to adjust accounting methods to prop up their corporation’s earnings and stock price until executives sell the options and stock they receive as compensation.<sup>125</sup>

Congress recognized this temptation when crafting the Sarbanes-Oxley Act in 2002. If an issuer is required to restate its financials within one year after publication because of misconduct relating to financial reporting requirements, then the Act provides that the CEO and Chief Financial Officer must reimburse their company for any “bonus or equity compensation” they received during that time.<sup>126</sup> As one commentator noted in a congressional hearing on the topic, “in the absence of effective corporate governance, mechanical measures to rein in pay are unlikely to be successful—CEOs and their consultants can and will game these rules if they control the processes by which their pay is set.”<sup>127</sup>

#### 4. Where Is the Bite?

Not only has § 162(m) had unintended, negative consequences for executive compensation, but it never really had any bite. Well-counseled public corporations inevitably connect any

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123. *2002 Trends in Executive Pay*, AFL-CIO, at <http://www.aflcio.org/corporateamerica/paywatch/pay/index.cfm> (last visited Nov. 9, 2003). For example, Ralston Purina had an incentive plan that rewarded executives nearly 500,000 shares “if the stock closed above 100 for 10 straight days.” Dean Foust, *The SEC’s CEO-Pay Plan: No Panacea*, BUS. WK., July 16, 1992, at 37, 37. Management borrowed funds and diverted much of the company’s free cash flow to tighten the supply and increase the demand for shares by buying back nearly one-third of the company’s outstanding stock. *Id.* The stock soon drifted back down, which analysts attributed to “excessive financial engineering and a lack of attention to core businesses.” *Id.*

124. Joel Hoekstra, *Executive Privilege: Has Pay for America’s Bosses Spun Out of Control?*, CARLETON C. VOICE, Fall 2003, at 40, 44 (quoting Lawrence Perlman, former chair and CEO of Ceridian Corporation and former chair of Seagate Technology).

125. *Compensation Hearing*, *supra* note 63 (testimony of Damon Silvers, Associate General Counsel, AFL-CIO).

126. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C., 11 U.S.C., and 28 U.S.C.).

127. *Compensation Hearing*, *supra* note 63 (testimony of Damon Silvers, Associate General Counsel, AFL-CIO).

compensation in excess of the limit to executive performance and can therefore deduct the entire compensation package of the executive.<sup>128</sup> As head of the National Economic Council, former Treasury Secretary Robert Rubin helped steer § 162(m) through Congress in 1993.<sup>129</sup> Ironically, Rubin's "guaranteed" incentive compensation of \$14 million at Citigroup today is fully deductible by the company.<sup>130</sup>

Deductibility can also simply turn on when the compensation is paid because compensation that is deferred until retirement is not subject to the cap.<sup>131</sup> As a result, companies may take advantage of the deferred compensation loophole.<sup>132</sup> Finally, directors may surrender the deduction for compensation if shareholders reject the performance goals advanced by the directors, and thus increase the after-tax cost of executive compensation to the shareholders.<sup>133</sup> Directors may also be less hesitant to do so because the corporate tax base is eroding. The pervasiveness of offshore corporate tax shelters now costs the Treasury approximately \$50 billion a year and has reduced corporate tax payments by 20% annually since 2000.<sup>134</sup>

Thus, while § 162(m) has had no real bite in capping executive compensation, its negative effects ultimately have been felt in two ways: (1) companies look to the \$1 million cap regardless of the size or complexity of their organization (which may command a lower base salary); and (2) companies have doled out lucrative stock options far exceeding the \$1 million cap, causing executives to focus on short-term, accounting-based results

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128. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 233 (rev. 4th ed. 2002).

129. Carol J. Loomis, *The Larger-Than-Life Life of Robert Rubin*, *FORTUNE*, Dec. 8, 2003, at 114, 124.

130. See *id.* at 123. Rubin's contract guarantees \$14 million unless there are "extraordinary circumstances drastically negatively affecting Citigroup reported operating results" and Citigroup Chairman Sandy Weill's pay is docked as well. *Id.*

131. See I.R.C. § 162(m)(4)(E) (2000).

132. See *id.*

133. Charles C. Pak, *Toward Reasonable Executive Compensation: Outcry for Reform and Regulatory Response* 2 ANN. SURV. AM. L. 633, 662 (1995). Based on a survey of 155 major corporations in 1994, twenty-five paid their CEOs more than \$1 million in base salary. Graef Crystal, *Need a Good Laugh? Look at Caps on Executive Pay*, *L.A. TIMES*, May 21, 1995, at D2. A review of 1995 proxy statements by William M. Mercer, Inc., disclosed that of the 350 companies surveyed, thirty-eight paid base salaries in excess of \$1 million. *The Boss's Pay*, *WALL ST. J.*, Apr. 11, 1996, at R15.

134. See Press Release, Citizens for Tax Justice, *More Corporate Tax Shelters on the Way?* (Oct. 14, 2003), at <http://www.ctj.org/pdf/corp1003.pdf>.

rather than long-term value creation. Given these negative effects, Congress's attempts to curb executive compensation through § 162(m) have proved not only ineffective, but counterproductive.

#### IV. COMPENSATION CAPS ARE NOT EFFECTIVE WITHOUT OR NECESSARY WITH INDEPENDENT DIRECTORS

The disincentives provided by § 280G, § 4999, and § 162(m) have not been successful in curbing corporate greed. Similar future tax reform will not be effective unless all directors on the compensation committee are independent, and compensation caps will not be necessary if such directors *are* truly independent.<sup>135</sup> As we have seen with § 280G and § 4999, compensation caps are often circumvented by directors. They work around caps by providing gross ups to absorb any would-be penalty to the executive or by incorporating a best-net provision to give the executive the best alternative.<sup>136</sup> Either way, the shareholders that Congress was trying to protect lose.

Enacting new rules or regulations will not prevent excessive executive compensation. To truly protect shareholders, directors on the compensation committee must be independent and engage in arm's length bargaining with managers when setting executive compensation.<sup>137</sup> According to corporate governance experts, to be completely independent, directors should not have "inter-locking directorships with other companies," and independent directors should not draw "consulting, legal, or other fees from the company."<sup>138</sup> Another commentator suggests that outside directors be paid with company stock rather than cash and that their terms be lengthened so they do not become puppets controlled by entrenched management.<sup>139</sup>

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135. Cf. *supra* note 127 and accompanying text (noting that mechanical measures to rein in pay are unlikely to be successful in the absence of effective corporate governance).

136. See *supra* Part II.C.

137. "[A]t least a majority of members' of a board of directors should be 'independent of management,' and the critical oversight committees—audit, compensation, and nominating—should be staffed entirely by 'independent' or 'nonmanagement' directors." HAMILTON & MACEY, *supra* note 15, at 699–700 (quoting COMM. ON CORPORATE LAWS, SECTIONS OF BUS. LAW, AM. BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 16–17 (2d ed. 1994)).

138. *Id.* at 712.

139. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 939 (1993).

Since the federal government traditionally has left corporate law to the states,<sup>140</sup> states should enact a statute requiring executive compensation to be determined only by a committee composed *entirely* of independent directors. Alternatively, if states refuse to enact such legislation, shareholders could submit a proposal to amend the company's articles to include a provision requiring that all executive compensation be determined only by a committee of independent directors. In the heightened corporate governance climate, an increasing number of shareholder proposals are receiving a majority of shareholder votes.<sup>141</sup>

Once the compensation committee is composed solely of independent directors, compensation caps no longer become necessary. In practice, compensation caps are detrimental because they create congressionally sanctioned standards of reasonableness.<sup>142</sup> Regardless of the size, complexity, or risk of a business, Congress has applied a one-size-fits-all standard. In some cases, this standard will encourage small businesses to unnecessarily raise their executives' compensation or raise the benchmark for executive pay in nonpublic corporations, while, in other cases, this standard will unnecessarily restrain large, risky, complex businesses from appropriately rewarding their executives.<sup>143</sup>

Section 162(m), for example, strongly discourages companies from paying executives exactly what they believe they are worth.<sup>144</sup> Instead, to be fully deductible, independent directors must preestablish objective performance goals and put them in writing before the service commences.<sup>145</sup> Such goals are inherently inexact. Sometimes they are set too high, while other times they are set too low.

In addition, objective, measurable goals do not assess all aspects of an executive's performance. There may be components beyond stock price or net profit, such as employee retention or public relations, that are intangible or immeasurable

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140. See HAMILTON & MACEY, *supra* note 15, at 716. *But see id.* (noting that the Sarbanes-Oxley Act is "the deepest incursion by the federal government into the internal affairs of U.S. corporations").

141. See *supra* Part II.C.1.

142. See *supra* Parts II.C.1, III.C.1.

143. See *supra* Parts II.C.1, III.C.1.

144. See *supra* Part III.C.1.

145. See *supra* note 78 and accompanying text; Inez H. Friedman, Note, *The Deductibility of Executive Compensation: Automotive Investment, Pulsar Components, and New Section 162(m)*, 48 TAX LAW. 255, 263 (1994).

components of an executive's performance.<sup>146</sup> Under § 162(m), it becomes more difficult or costly for directors to single out these aspects of an executive's performance because it is difficult to preestablish objective goals for such performance factors. As a result, directors primarily use stock price as a scorecard for performance. This causes executives to focus primarily on short-term earnings rather than long-term corporate value because they have so much riding on the stock options.<sup>147</sup>

The move towards stock options is yet another example of the inexactness of preestablished performance goals.<sup>148</sup> In the case of stock options, even *independent* directors lose control over executive compensation.<sup>149</sup> The options granted to the executive may double or triple in value in a short amount of time. Indeed, directors could not have predicted that the stock market would rise by 1400% between the early 1980s to the end of the 1990s.<sup>150</sup>

As long as the directors on the compensation committee are independent, it would be better to allow directors total discretion to reward executives with the exact compensation they deserve rather than subject them to ineffective regulation under the tax code. They should be able to easily set goals with respect to any aspect of the executive's performance. They should be able to control exactly how much they are compensating the executive rather than waiting to see how the stock market performs, which may be dependent on many factors other than executive performance. Without exactness, directors are inclined to award too much or to focus exclusively on such aspects as stock price. As long as they are independent, directors should be given the freedom to craft goals as they wish and should not be discouraged from using compensation tools other than stock options that allow directors to more accurately predict how much compensation their executives will realize.

## CONCLUSION

Congressional attempts to cap executive compensation through the tax code have caused unintended consequences

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146. See Friedman, *supra* note 145, at 267.

147. See *supra* Part III.C.3.

148. See *supra* Part III.C.2.

149. See *supra* notes 108–10 and accompanying text (noting the unexpected and unpredictable rise in the value of stock options since the 1980s).

150. See *supra* note 107 and accompanying text.



that outweigh any benefit they may have created. As a result of § 280G and § 4999, companies gravitate to the 299% cap regardless of their specific situation, and a majority of companies provide costly gross ups to their executives. As a result of § 162(m), \$1 million has become the government-sanctioned standard for executive base salary, and companies are pushed to use lucrative stock options that have caused executives to focus on short-term, accounting-based results to the detriment of shareholders. Further attempts to cap executive compensation by providing disincentives through the tax code will not be effective. Without compensation committees composed solely of independent directors who assess the worth of the company's executives at arm's length, compensation caps will simply be circumvented with the assistance of creative lawyers, accountants, and compensation experts. Sadly, indirect routes to generous executive compensation are usually even more costly to shareholders than if the executives were paid directly. Executives remain generously compensated while shareholders suffer as their companies are compelled to pay additional taxes for nondeductible compensation and grant stock options that create perverse incentives. If executives' compensation is determined by an independent compensation committee, then compensation caps implemented through the tax code simply inhibit a board's ability to determine exactly the amount of compensation that its executives merit and the caps should thus not be applicable.