Notre Dame Law Review

Volume 75 | Issue 1 Article 4

10-1-1999

Bonus Questions--Executive Compensation in the Era of Pay for Performance

Charles M. Yablon

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr

Recommended Citation

Charles M. Yablon, *Bonus Questions--Executive Compensation in the Era of Pay for Performance*, 75 Notre Dame L. Rev. 271 (1999).
Available at: http://scholarship.law.nd.edu/ndlr/vol75/iss1/4

This Essay is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

ESSAY

BONUS QUESTIONS—EXECUTIVE COMPENSATION IN THE ERA OF PAY FOR PERFORMANCE

*Charles M. Yablon**

I. Introduction

Thanks to the stringent disclosure regulations concerning executive compensation promulgated by the Securities and Exchange Commission (SEC), I now know exactly how much more money Michael Eisner, Chief Executive Officer of the Walt Disney Company, makes than I do. The wide dissemination of this information has not proven particularly beneficial either to Mr. Eisner or myself. Published reports of Eisner's bloated pay package have prompted renewed controversy concerning the burgeoning income of top executives in publicly traded American corporations and made him a sort of poster boy for greedy CEOs. Contemplation of my meager salary in relation to Mr. Eisner's paycheck has also had an unfortunate result. It has produced this Essay.

Executive compensation traditionally has been a matter of concern to corporate law policy makers. It has long been recognized that the intimate ties between top executives and the directors who set their salaries create an inherent conflict of interest, a tendency toward

* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.
Earlier versions of this Essay were presented at conferences sponsored by the law faculties of the University of Sydney and the University of Melbourne. I would like to thank Professor Jennifer Hill of the University of Sydney for making it possible for me to spread these ideas in Australia and for her comments and encouragement in connection with this Essay and issues of executive remuneration generally. Thanks also to Professor Hill and Professor Ian Ramsay of the University of Melbourne for organizing their respective conferences and to all the participants in those events. Finally, thanks to the Samuel and Ronnie Heyman Center for Corporate Governance at Cardozo Law School for supporting this research.

overgenerosity exacerbated, in the case of publicly held companies, by the fact that the money the directors are paying the CEOs is not their own. However, given judicial reluctance to second guess corporate decision making or judge any particular level of executive pay to be unreasonable,[1] the problem was also understood to be pretty much insoluble through traditional legal means.

In the early 1990s, however, a new view of both the problem of executive compensation and its appropriate solution took hold. The problem was now seen not as management's ability to award themselves excessive compensation, but rather the failure of many compensation packages to give management appropriate incentives to maximize shareholder value. The obvious solution was for corporate boards to change the form of compensation paid to top executives, making it more performance-based through the use of such vehicles as stock options, restricted stock, and performance-based bonus plans.

The new gospel of pay for performance was heartily embraced by shareholder activists, regulators, and corporate management themselves. New SEC regulations, adopted in 1992, provided shareholders with significantly increased disclosure about the compensation practices of their companies. New tax laws, passed in 1993, provided strong incentives for such companies to link executive pay to corporate performance. The result has been a substantial increase in the information about the pay of individual CEOs that is publicly available, a substantial increase in the use of stock options, performance-based bonuses and other forms of pay for performance, and an enormous increase in the amount of compensation actually paid to the CEOs of public corporations.

Less concrete, but no less significant, has been the accompanying change in public attitude toward CEO compensation. These days, corporate CEOs are routinely lumped with other exemplars of the celebrity superrich such as bankable movie stars, franchise players in major sports, and lawyers with their own talk shows. The business pages

1 *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998) ("[I]n the absence of fraud, this Court's deference to directors' business judgment is particularly broad in matters of executive compensation."). *See generally* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1896–98 (1992). This reluctance to rule on the reasonableness of compensation is far less prevalent in cases involving closely held companies, where the executive/shareholder is essentially paying the compensation to himself and the one challenging the reasonableness of the compensation (and therefore its deductibility) is the Internal Revenue Service. *See* ROBERT C. CLARK, CORPORATE LAW 199–200 (1986); Detlev C. Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 257–61 (1983).

are full of profiles of superstar CEOs, reported with the same contemporary mix of adulation, intrusiveness, and malice that can be found in the sports and entertainment sections. Moreover, a combination of legally required disclosure (with respect to CEOs), a vigorous and inquisitive press, and sheer braggadocio (by both the recipients of such pay and their agents) has largely erased any reluctance the very rich might once have had to show us their money.

Accordingly, those writing about executive compensation today must deal with a problem that is perceived quite differently from the traditional problem of executive compensation. In the good old days, circa 1990 or so, the problem of executive compensation was that greedy CEOs were receiving outrageous levels of compensation they did not deserve. These days, the problem is that greedy CEOs are receiving even more outrageous levels of compensation, which they may very well deserve. The trend towards performance-based pay means that some (although far from all) of the highest paid CEOs are those that have obtained extremely good results for their shareholders, making their multi-million dollar bonuses seem like justifiable rewards for a job well done and making plausible (although hardly proving) the proposition that such CEOs are being appropriately compensated for their unique managerial skills.

But it would really be rather surprising if these highly skilled corporate executives, whose talents, after all, consist primarily of their ability to utilize corporate resources in the manner most likely to maximize the value of the firm, would not use those same talents to utilize the corporate governance mechanisms in the manner most likely to maximize the value of their own compensation packages. That is precisely what many have done. Far from erasing the fiduciary problems inherent in executive compensation, the pay for performance trend has opened new potential conflicts between shareholders, the compensation-setting boards that shareholders increasingly view as their surrogates, and the CEOs.

The theory of pay for performance is that shareholders benefit when management compensation is significantly at risk, so that a high level of compensation is dependent on a high level of corporate performance. What most pay for performance fans tend to forget, however, is that it is not in management's interest to have a substantial portion of their potential remuneration at risk. All other things being equal, a CEO would much rather have the same levels of compensation at little or no risk. Accordingly, while CEOs and their compensation consultants often use the rhetoric of pay for performance to justify higher amounts of compensation, they may also seek to reduce

the risk attached by increasing the number of options granted, setting easy performance goals, or repricing underwater options.

The enormous earnings of contemporary CEOs also have created new issues about the social and economic effects of such pay levels. As managers become super-rich based on the appreciation of their company's stock, the distinction blurs between investors and managers, and between compensation and investment returns. Compared to other shareholders, performance-based pay seems to make corporate executives a privileged class that does not have to pay for its stock and is largely protected from downside risk. Performance-based pay may also create a disincentive toward entrepreneurship, as managers find they can make as much money running large businesses as creating new profitable ones—and with a lot less risk. A final concern is the contribution of executive compensation increases to the growing inequality of income, both within American society generally and even among those with similar educational and professional qualifications.

This Essay examines these problems of executive compensation in the era of performance-based pay. That is the era in which we find ourselves, and it is not, on the whole, a bad place to be. Over the last few years, the stock market indices have gone through the roof, corporate profits have soared, and the U.S. economy is the envy of the world. While there is no empirical evidence directly linking performance-based pay of CEOs with improved corporate results, it would take a more foolhardy liberal than me to categorically deny any possibility that these salutary trends have any connection to the fact that most corporate CEOs these days are paid mostly in stock options.

But even if paying CEOs enormous amounts for good performance is an improvement on the old system, in which CEOs received somewhat less pay for indifferent performance, that does not mean that performance-based pay has solved the problems of executive compensation. Indeed, this Essay shows that performance-based pay has exacerbated those problems in significant ways and, at the very least, has increased the need for careful board oversight of executive compensation decisions. Such oversight often seems to be lacking, with disagreeable and potentially dangerous consequences for many companies and for American society.

This Essay proposes one significant modification in the current regulatory structure to address these problems: changing the present one million dollar cap on the deductibility of nonperformance-based pay into a cap on the deductibility of *all* executive pay that exceeds a certain annual value (I suggest three million dollars), including the present risk-discounted value of any performance-based pay. By bringing the risk discounted value of performance-based pay within

the deductibility cap, such a rule would provide both an incentive and a justification for board compensation committees to use something other than the sky to limit the amount of executive pay increases. By valuing such pay on a risk-discounted basis, moreover, the proposal also seeks to curb managerial impulses to give themselves incentives with little downside risk. It may even create a healthy competition among CEOs as to who is willing to take the riskiest (and therefore potentially most lucrative) pay package.

The broader point of this Essay, however, is that neither performance-based pay nor any other change in the form of executive compensation can fully align the interests of management with shareholders. Conflicts between agents and principals are built into the structure of the public corporation. Compensation is one area where they most directly conflict, and can only be ameliorated, never solved. The elements most likely to restrain the perennial executive push for more money are (1) full public disclosure concerning the compensation of top executives; (2) institutional shareholder concern and pressure for reform, at least in the most egregious cases of abuse; (3) serious directorial attention and responsibility for justifying both the form and amount of compensation they approve; and (4) a willingness on the part of the executives themselves to accept greater risk as a price for potentially greater compensation.

As the following Essay shows, the first two elements are already largely, though not entirely, in place. The latter two, however, which are equally critical in restraining compensation abuses, still need quite a bit of work. This Essay examines the current state of executive compensation regulation and practices. Part II provides a brief history. Part III is a case study of the proxy statements of the Walt Disney Company and the recent controversies regarding its compensation practices. Part IV is a more general, abstract, and less funny analysis of the problems of performance-based pay. Part V contains some suggestions for reform that not everyone will find amusing.

II. A Short History of Executive Compensation

Up until the beginning of this century, the problem of executive compensation did not really exist. People who ran corporations made money the old fashioned Marxist way—they owned the means of production.[2] Early in this century, however, the development of large and relatively efficient capital markets, particularly in London and

2 *See* Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 237–38 (1977); William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 Stan. L. Rev. 1471, 1485 (1989).

New York, enabled budding entrepreneurs and established businessmen to raise capital through the public sale of stocks.[3] The result was the familiar separation of ownership and control in the public corporation.[4]

This separation created a very great possibility that corporate officers could, in effect, steal corporate assets by obtaining compensation packages which exceeded the fair rate that they would have been paid for their services by a single shareholder owner. The main regulatory effort to restrain such conduct has been to encourage certain procedural safeguards like the delegation of all compensation decisions to a committee composed solely of outside directors.[5]

As the corporate world changed over the last few decades, the concept of appropriate executive compensation changed as well. The sixties were the time of the great conglomerate mergers, when Harold

---

3 Stock offerings, of course, and stock fraud had been known at least since the days of the South Sea Bubble. Nonetheless, until the early twentieth century, most corporate entities were still dominated, as they are in many parts of the world today, by individual or family ownership. *See* Bratton, *supra* note 2, at 1486.

4 *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). According to Berle and Means, because of the diffusion of ownership among shareholders in the modern publicly traded corporation, nobody has the ability and inclination to exert effective control over the activities of corporate managers. This creates the grave danger that corporate assets will be used for the personal benefit of corporate managers. *See id.* at 66, 84. For Berle and Means, this established both the necessity and normative justification for regulation of managerial activity by the government and, in particular, by corporate law. The problem of executive compensation, when viewed from this fiduciary duty perspective, is that it poses the problem of managerial self-dealing in the publicly held corporation in a particularly intractable way.

5 Recommendations concerning the use of outside directors on such committees may be found in AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 3A.05(b) (1994). It has also been a major item on the agenda of American shareholder activists and is strongly encouraged by recent changes in U.S. tax law. *See* I.R.C. § 162(m)(4)(C)(i) (1994).

In practice, however, compensation committees generally rely on the expert advice of outside compensation consultants to inform them of the appropriate going rates for corporate moguls. On the role of compensation consultants generally, see GRAEF CRYSTAL, IN SEARCH OF EXCESS 215–16 (1991). These compensation consultants are knowledgeable and skilled professionals. Their opinions, like those of investment bankers with regard to fairness, or those of counsel as to the legality of proposed corporate action, are based on careful study, concern for their professional integrity, and a profound understanding of who is paying their fees. Not surprisingly, despite the existence of outside directors on compensation committees, instances of egregious overcompensation can still easily be found in corporate America. *See, e.g.*, *id.* A more up to the minute report on excessive compensation may be found on a website maintained by the AFL-CIO. *See Executive Pay Watch* (visited Sept. 2, 1999) <http://www.paywatch.org> (copy on file with author).

Geneen at ITT and Charles Bluhdorn at Gulf & Western created vast corporate empires based on friendly acquisitions of disparate companies to create an impressive but frequently unmanageable whole. Not coincidentally, the captains of these corporate Titanics also led the way in compensation packages. In *Forbes'* first survey of the highest paid corporate executives in 1971, Harold Geneen of ITT finished first, earning what now seems a measly $767,000 ($3,221,400 in current dollars).[6]

After a major recession in the U.S. in the early 1970s, the era of conglomerate mergers was replaced in the late 1970s and early 1980s by the era of hostile takeovers. Executives might wake up and read in the morning paper that some very rich but often vaguely disreputable corporate raider was making a tender offer for control of their company (note the possessive). The price being offered to shareholders through the tender offer was invariably at a premium well above the stock's prevailing market price.

In addition to posing a major practical problem for corporate managers, the growth and apparent success of many hostile takeovers posed an interesting theoretical problem for corporate academics: If, as is generally assumed, the capital markets are reasonably efficient,[7] how was it possible for corporate raiders to make money by purchasing stock at well above market prices? The consensus answer, first expressed in the work of Professors Michael Jensen and William Meckling, was that hostile takeovers allowed vigilant corporate raiders to identify good companies with underperforming managers and replace them with stronger managers more responsive to shareholder concerns.[8] The increase in value created by such managerial changes could cause an increase in corporate value sufficient not only to justify the takeover premium, but to provide handsome profits for the raider as well. An underlying premise of this argument, you will note, was

6 *See* Lawrence Minard, *Executive Compensation—A Long Look Back*, FORBES, May 19, 1997, at 12.

7 Market efficiency is a large and complex topic well beyond the scope of this paper. *See generally* Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). I am speaking here of the so-called "semi-strong" version of the claim that U.S. capital markets are informationally efficient, that the price of stocks on such markets fully reflects all available public information about the company such that it is not possible consistently to earn above average returns by trading on the basis of such public information.

8 *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). These ideas were popularized among lawyers by Frank H. Easterbrook & Daniel R. Fischel in *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

that before hostile takeovers became popular, there were a lot of underperforming corporate managers out there.[9]

In the 1980s an even more theoretically puzzling phenomenon emerged: the MBO, or management buyout. Some officers of publicly held corporations, sometimes in response to or in anticipation of a hostile takeover bid, would make their own offer to shareholders. They sought to take their companies private by purchasing all the publicly traded stock, using borrowed funds which would later become corporate debt secured against the assets of the company. The MBO, if successful, would leave the management group as the sole equity holders and the company with very large debt obligations. Like the hostile raiders, these management groups also offered to buy out existing shareholders at a substantial premium above market price.[10]

The MBO phenomenon seemed to pose a major problem for the theoretical understanding of control transactions. If the value created by hostile takeovers was primarily due to the raider's ability to replace underperforming managers, were managers who sponsored an MBO paying a premium to, in effect, replace themselves? Perhaps surprisingly, that was indeed what the theoreticians argued. Executives of publicly traded companies might well be underperforming, said the academics, not because they were lazy or lacked management skills, but simply because, as unmonitored agents, they lacked incentives to maximize shareholder value to the utmost. Quite the contrary, being rational profit maximizers, managers would have powerful incentives to utilize corporate cash flows in ways that would be most personally beneficial, like well furnished offices and corporate jets. Once an MBO occurs, however, that same management must generate sufficient corporate cash flows to pay the whopping interest bills on the debt it incurred to buy the company. Indeed, to make any money out of an MBO, management must generate cash flow that exceeds both operating costs and interest charges to create a profit. All the profit that gets created, however, goes into the pockets of the new owner managers.[11] Many MBOs did succeed in creating such profits

9 Despite the growth of the takeover phenomenon, there still seems to be quite a few underperforming corporate managers. For stories about some, see Joseph Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 873–901 (1993).

10 For an excellent general discussion of the MBO phenomenon and the theoretical issues it raised, see RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 398–453 (2d ed. 1995).

11 For the most extreme version of this view, predicting the demise of the public company as the dominant form of business enterprise, see Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61.

(although many also failed).[12] The lesson to corporate academics, however, was that incentives were the crucial variable in managerial performance.

The stage was now set for a fundamental reconceptualization of the problem of executive compensation. Its popular expression came in a 1990 article in the *Harvard Business Review* titled *CEO Incentives—It's Not How Much You Pay, But How.*[13] In that article, Professors Jensen and Murphy argued that the problem of CEO compensation was not a matter of excess compensation over some fair or reasonable rate, but rather a misalignment of incentives. In a study of CEO pay over an extended period, Jensen and Murphy showed that there had been little correlation over the last thirty years between executive compensation and corporate performance. Rather, the primary determinant of the size of the executive's compensation was the size of the corporation, not its profitability. They argued that appropriate regulation of executive compensation would not involve reducing total pay or curbing specific abuses, but encouraging performance-based forms of compensation, like options and restricted stock, which more closely aligned the executive's interests with those of shareholders.

Jensen and Murphy's article was extremely influential. It fit well with both current theories of corporate governance and the prior experience of American business. It helped explain the empire building of the conglomerate mergers of the 1960s, since in making their companies bigger, even at the expense of profitability, those CEOs had been able to justify ever greater compensation. It explained why hostile takeovers, by replacing such managers and dismantling their corporate empires, could increase shareholder returns and profitability. It suggested that investors in all companies should do what managers of MBOs had already done for themselves—align the interests of management and shareholders so as to maximize profitability.[14]

---

12 *See* GILSON & BLACK, *supra* note 10, at 433–38.

13 Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How,* HARV. BUS. REV., May–June 1990, at 138.

14 It is not a coincidence that Professor Jensen, a strong advocate of the efficiency gains of MBOs, was also a major proponent of the move to performance-based compensation.

As a theoretical matter, Jensen and Murphy brought compensation concerns into the dominant conceptual model for contemporary corporate law theorizing, the agency cost model. Whereas under legal concepts of fiduciary duty, the corporate executive who feathers his own nest at the expense of the corporation is acting aberrantly and improperly, under the economic concept of agency costs, that same behavior is simply the expected utility maximizing action of a poorly monitored agent. The executive who owns only a small amount of stock in a publicly held company derives only a minuscule portion of the benefit generated by an increase in the stock price.

As a public policy matter, viewing executive compensation as an incentive alignment problem rather than as a breach of fiduciary duty had major advantages. It avoided having to ask courts, compensation committees, or anyone else to answer the difficult questions of how much compensation was reasonable for a CEO, or whether the process by which the compensation was set was fair. It substituted the far easier question of whether the form of the compensation was structured so as to provide incentives for shareholder wealth maximization. To the extent they did not, the solution was also easy—simply add such incentives as additional compensation above the executive's basic salary.

Accordingly, by the early 1990s the old concern about compensation as a breach of fiduciary duty had been largely replaced by the concern about compensation as a misalignment of incentives. This reconceptualization was embraced by virtually all the participants in the process. For institutional investors, it offered the prospect of increased managerial incentives to boost shareholder returns. For policy makers, it offered a tractable definition of the problem, clear policy objectives, and a viable regulatory program. For corporate executives and compensation consultants, it offered a powerful new set of arguments to justify increases in executive compensation.

Not surprisingly, the two major changes in U.S. legal regulation of executive compensation in the 1990s reflect this new emphasis on performance-based compensation. The first change was the adoption by the SEC of expanded disclosure rules regarding executive compensation.[15] The disclosure required of public companies concerning the compensation paid to their directors and most highly compensated corporate officers was made much more detailed and specific. Compensation committees were required to set forth the basis on which their compensation decisions had been made, and comparative data was required relating the company's stock performance to that of other companies in its industry and to the market as a whole. The second major change was tax legislation prohibiting corporations from deducting any compensation paid to a corporate officer in ex-

---

Jensen and Murphy calculated that the average CEO of a public company received $3.25 for every $1000 increase in shareholder value. *See* Jensen & Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). In contrast, he derives 100% of the benefit from a corporate jet, an elaborately furnished office, or Wednesdays at the golf course. On this view, increased monitoring of managerial behavior by outside directors, increased threats of hostile takeovers, and increases in the use of performance-based executive compensation were all beneficial to shareholders in essentially the same way—as devices which reduced agency costs.

15 *See* 17 C.F.R. § 229.402 (1992).

cess of $1 million unless the additional compensation was performance-based.[16] When Bill Clinton ran for the Presidency in 1992, he pledged to limit corporate deductibility of "excessive executive pay," which many interpreted as a cap on total pay. The legislation that actually passed, however, instead creates strong incentives for incentive-based pay. In the Section that follows, we will see these new rules in action.

III. Disney Dollars: A Case Study of Compensation Issues in Recent Disney Proxy Statements

Proxy statements rarely make compelling literature. Characterizations are weak, even though we get lots of information about the leading players. Conflict is kept to a minimum, and plots are dull. The recent proxy statements of the Walt Disney Company would seem to suffer from these defects. Disney had a well-regarded management that provided good, although not spectacular results in recent years and a staggered board of directors running unopposed for reelection. Nonetheless, the Disney proxies, and the shareholders meetings they portended, have been subjects of major media attention. Like all the best media stories, the Disney saga implicates serious policy concerns while providing a vivid cast of characters and a direct connection to show business.

The focus of the story is Michael D. Eisner, Chairman of the Board and CEO of Walt Disney Company.[17] Eisner, who had previously been President of Paramount Pictures, was recruited in 1984 to be Disney's CEO.[18] He is one of the most highly paid chief executives of a publicly traded company.[19] Between 1993 and 1996 he received $228 million in compensation as the CEO of Disney.[20] In 1997, he negotiated a new employment contract.

Also making a significant appearance in the 1997 Disney Proxy Statement was Michael Ovitz. Ovitz had been a leading Hollywood agent and entertainment business entrepreneur.[21] In 1995, when Jerry Katzenberg (the President and number two man at Disney) re-

16 *See* I.R.C. § 162(m) (1994).

17 *See* Walt Disney Co., Notice of Annual Meeting of Stockholders 4 (1997) [hereinafter 1997 Disney Proxy Statement].

18 *See id.* at 4–5.

19 In the Wall Street Journal's 1997 CEO compensation survey, Eisner's "total direct potential compensation" of $601 million (which included $590 million in unrealized option gains) far exceeded that of any other CEO. *See The Boss's Pay*, Wall St. J., Apr. 9, 1998, at R13.

20 *See* 1997 Disney Proxy Statement, *supra* note 17, at 28–29.

21 *See id.* at 15.

signed after a falling out with Eisner, Ovitz was recruited to take his place. Ovitz negotiated a five-year employment contract for himself, which included one million dollars in base salary, discretionary bonuses, and five million dollars in stock options exercisable at market price on the date of issuance. The agreement also provided that, if Ovitz's employment with the company was terminated, most of these payment provisions would accelerate, giving him a hefty severance bonus. Ovitz also seems to have had a falling out with Mr. Eisner, and his employment was terminated by mutual agreement as of December 31, 1996.[22] He received termination benefits valued at up to $140 million for slightly over one year of work.[23] By January 6, 1997, derivative suits had been filed in California and Delaware state courts challenging the payments to Ovitz as a breach of fiduciary duty.[24]

There was also an intriguing cast of supporting characters, including Roy Disney, nephew of founder Walt Disney, who is the largest shareholder on the Disney board, owning 1.4% of the outstanding shares,[25] Sidney Poitier, the actor, who sits on Disney's board and its compensation committee,[26] and Reveta F. Bowers, Disney board member and principal of the private elementary school that Eisner's children once attended.[27]

The major theme of the 1997 Disney Proxy Statement is, without a doubt, executive compensation. Of its thirty-five pages, twenty-one are devoted directly to the subject. These include a four page report of the Compensation Committee, another two pages summarizing the employment agreements of Eisner and Ovitz, and six more pages of summary charts and graphs relating to executive compensation. Although these sections might have been a little shorter in proxy statements for companies with less compensation to report, all of this information is basically required by the current rules of the SEC governing executive compensation.[28] The heart of those rules are summary charts and graphs delineating and analyzing the compensation of the five most highly compensated corporate officers.[29]

---

22 *See id.*

23 *See In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998).

24 *See* 1997 DISNEY PROXY STATEMENT, *supra* note 17, at 9.

25 *See id.* at 2, 4.

26 *See id.* at 8.

27 *See* Anita M. Busch, *Pond Crowd Pummels Eisner's Mighty Bucks*, VARIETY, Mar. 3, 1997, at 9.

28 *See generally* 17 C.F.R. § 229.402 (1992).

29 *See id.* "The Summary Compensation Table was praised by shareholder commenters as the linchpin of the Commission's revised executive compensation disclosure scheme." Executive Compensation Disclosure, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056, at 83,414 (Oct. 16, 1992).

The Summary Compensation Table in the 1997 Disney Proxy succeeds (mostly) in giving us a pretty good idea of what is going on with Disney's compensation practices. Clearly Eisner is first among equals. Although his $750,000 base salary doesn't seem far beyond that of his colleagues, the seven to eight million dollar annual bonus he received during each of the three prior years clearly puts him in a different category from the rest.[30] Even these amounts, however, were dwarfed by the eight million stock options Eisner received in 1996 in connection with his new employment agreement. That is eight million *options*, not eight million *dollars*.

This is a good place for a short discussion of the critical question of valuation disclosure. Obviously, when disclosing executive compensation, a highly material fact to be revealed is the value of the compensation received. For salaries and bonuses paid in cash, that is simple enough. A dollar is worth a dollar. Restricted stock can also generally

---

The disclosures in the Disney Summary Compensation Table are far more detailed than those required by the SEC prior to the 1992 revisions of the proxy rules. Prior to that time, compensation could be aggregated for the top executives as a group, but now it must be specified for each officer for each year. The amount of compensation per individual must be reported separately for each of three columns relating to annual compensation: (1) salary, (2) bonus, and (3) other annual; and three others relating to long term compensation: (1) stock options, (2) restricted stock, and (3) other. *See generally* 17 C.F.R. § 229.402(b)(2). Actually, the Long Term Compensation side of the Summary Compensation Table also has a separate column for payouts made pursuant to a long term incentive plan (LTIP), but Disney, pursuant to the Rules, left out that column—presumably because it had no such payouts in that category. *See* § 229.402(b)(2)(iv).

30 These bonuses were not discretionary, but were bargained for as part of Eisner's prior employment agreement. That agreement provided for a nondiscretionary annual bonus equal to 2% of the amount by which the Company's net income for the fiscal year exceeded the amount representing a return on stockholder's equity of 11%. *See* 1997 DISNEY PROXY STATEMENT, *supra* note 17, at 13. Although the note relating to Eisner's long term compensation on the summary compensation table states that Eisner's bonuses for all three of the years 1996, 1995 and 1994 were "calculated pursuant to the bonus formula in his 1989 employment agreement," the Compensation Committee Report indicates that is not quite the case. *Id.* at 11, 16.

While the 1994 and 1995 bonuses did indeed follow the formula, in 1996 Disney negotiated the acquisition of the American Broadcasting Company (ABC), which resulted in Disney acquiring an additional $12 million in debt and apparently throwing off the old formula. Under the 1989 Employment Agreement, if the bonus formula is significantly affected by a merger, the Compensation Committee can adjust it to yield "an equitable and comparable result." *Id.* at 10. Accordingly, the 1996 bonus was computed using pro forma accounting statements that reported Disney results for 1996 as if the ABC merger had not taken place. This may be particularly significant in light of the subsequent controversy regarding a $2.5 billion reserve Disney took in connection with the merger, a charge which allegedly enabled Disney to overstate its earnings in subsequent years.

be valued with reference to its market price on the date of issuance.[31] The more difficult valuation issue is posed by stock options, stock appreciation rights (SARs), and their phantom counterparts.[32]

At the time a stock option is granted, assuming that its exercise price is at or above fair market value on the date of issuance, it can be argued that the option has no value whatsoever. After all, such options only confer on their owner a right which everyone else already has with respect to a publicly traded security—the right to purchase it at the market price. The appropriate answer to this line of argument is, "If you think stock options have no value on their date of issuance, please give me all of yours." The point is that stock options and their equivalents confer on their owners the right to benefit from future stock increases with no additional investment and no downside risk. Accordingly, the right provided by the typical option—to purchase company shares at a fixed price for an extended period (generally five to ten years)—is a valuable right, even on the day it is granted. How valuable, however, depends on the future performance of the company's stock, and that is a notoriously difficult thing to predict.

Because of these difficulties in valuation, the American accounting profession does not require companies to take any charge to earnings when they issue options as executive compensation. In a recent change, however, the accountants now require companies which do not take such a charge to disclose the dilutive effect such option grants would have on earnings per share if the options had been exercised.[33] By the same token, options are not taxed as income at the time they are granted. Those that do not qualify for special tax treat-

31 Many companies offer their executives the right to buy stock at a discount from market, often in connection with obligatory stock purchase requirements. *See* Adam Bryant, *Earning It: How Companies Make the Boss Buy Stock, but Soften the Pinch*, N.Y. TIMES, Feb. 1, 1998, § 3, at 1. In such cases, the value of the discount is the reduction from the market price. In some cases, the stock is provided free as, in essence, additional compensation. *See id.* In some cases, the restrictions on transferability of such stock or the possibility of its being forfeited if the executive is fired or leaves, might warrant a diminution in valuation relative to the price of fully vested and freely transferable shares. Under § 83 of the Internal Revenue Code and applicable regulations, stock received subject to a substantial risk of forfeiture is not taxable income until it can be freely transferred. *See* I.R.C. § 83 (1999).

32 For an extremely comprehensive, if now slightly dated account of the various forms of stock-related long-term incentives programs, including stock options, both qualified and non-qualified, SARs, and phantom stock plans, see generally Subcommittee on Executive Compensation of the Comm. on Employee Benefits and Executive Compensation, *Executive Compensation: A 1987 Road Map for the Corporate Advisor*, 43 BUS. LAW. 187 (1987).

33 *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123, § 49 (Financial Accounting Standards Bd. 1998); EARN-

ment as "incentive stock options"[34] are generally taxable when exercised, based on the difference between the exercise price and fair market value on the date of exercise.[35]

While the valuation of such stock-based incentives may be uncertain, in recent years, financial analysts, with the aid of sophisticated financial models and some very powerful computers, have become quite adept at making reasonable estimates concerning the present value of options based on certain assumptions about the stock's volatility, dividend yield, and prevailing risk-free interest rates. The most popular and prominent of these valuation techniques is the Black-Scholes option pricing model.[36]

To get a sense of the value of the options granted to Eisner, one must turn to the table, "Option Grants During Fiscal 1996."[37] In that table, Disney used the Black-Scholes model to compute the present value for Eisner's options at over $195 million.

One final question before we leave these basic disclosures regarding executive compensation: where, on these tables, is Michael Ovitz? Ovitz, you recall, obtained cash and options worth $140 million from Disney in 1996 as a result of getting fired and triggering the severance provisions in his employment contract. That would seem to place him at least second among Disney executives for 1996 compensation. Why isn't he on any of the tables? It appears that under the SEC regulations his termination benefits do not count as "compensation." Accordingly, the 1997 Proxy Statement blandly states that Ovitz was not

---

INGS PER SHARE, Statement of Financial Accounting Standards No. 128, § 40(c) (Financial Accounting Standards Bd. 1998).

34 *See* I.R.C. § 422 (1994).

35 Options that qualify as incentive stock options are not taxable even when exercised, but only upon sale or other recognition of income, where the increase in value they represent is taxed as capital gains rather than income. By the same token, the corporation gets no deduction when such incentive stock options are exercised.

36 *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

37 The SEC has required disclosure of certain pertinent information about stock options, including disclosure of their likely value. The SEC provides two basic ways to do this. One is to compute the potential realizable value of the option at the end of the option period based on the assumption that the stock will rise at an annual rate of 5% and 10% over that period. This is not a conceptually elegant solution, both because the assumptions about stock value increases are totally arbitrary and because realizable value is expressed in future rather than present dollars. It is, however, relatively easy to compute. The second method, which Disney adopted, is to use one of the present value option pricing models, with appropriate disclosures as to the assumptions that went into the model.

in the top five because he "did not receive a bonus for fiscal 1996."[38] The failure of the SEC to require any specific disclosure concerning severance or termination benefits in connection with its executive compensation disclosure appears to be a deficiency in those rules.

Nonetheless, the 1997 Disney Proxy enables us to determine that Eisner received a great deal of compensation in 1996, and it even gives us a fair idea as to how much. Does it give us any information as to whether he was worth it? The only objective data provided on that subject are two graphs which appear on pages nineteen and twenty of the Disney Proxy Statement. These are designed to enable shareholders to evaluate Disney's corporate performance in both absolute and relative terms. The first graph shows how much $100 worth of Disney stock purchased five years ago was worth at the end of fiscal 1996. It then compares that with the performance of the shares of a group of companies Disney has selected as its "peers" and with a broader-based index, the Standard and Poor's 500 (S & P 500). Although this graph may not seem to have much to do with executive compensation, it is in fact mandated by the SEC as part of the 1992 revisions of its executive compensation disclosure rules.[39] The concept, clearly a product of the performance-based movement of the 1990s, was that if executives were being awarded above-average compensation, their companies should show above-average performance.[40] On this basis, the five-year performance graph for Disney is a bit of a disappointment. It shows Disney doing no better than its peer companies over the relevant period and only slightly better than the broad based index.

Perhaps for that reason, Disney has included a second performance graph. This provides the same information, but provides it for a twelve-year period beginning in 1984. Here Disney is clearly the leader of the pack. Someone who invested in Disney in 1984 would have earned about three times as much from this investment as someone who bought the peer companies on the S & P 500. Unlike the

38 *See* 1997 DISNEY PROXY STATEMENT, *supra* note 17, at 14 n.1. On page 14 of the Proxy Statement, however, we are told that he did receive a termination payment of $10 million. The information about Ovitz appears to have been provided out of a concern with the general SEC requirement that proxy statements disclose all material information. *See* False or Misleading Statements, 44 Fed. Reg. 38,810 (1979).

39 *See* 17 C.F.R. § 229.402 (1992).

40 "In prescribing such a comparison, the Commission recognizes that many and varied performance benchmarks other than shareholder return are used in the design of executive compensation packages. However, as reflected in many shareholder letters of comment, shareholder return is a primary benchmark for shareholders and investors in assessing corporate performance." Executive Compensation Disclosure, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056, at 83,414 (Oct. 16, 1992).

five year graph that was mandated by SEC rules, this graph is not required by the SEC, although providing such additional information is certainly not prohibited. It is also probably not a coincidence that the performance period years begin in 1984, the year Eisner became CEO. But Disney's great performance over the first seven years of Eisner's stewardship and merely average performance during the next five raises further questions about his current compensation. It could be used to argue that Eisner should not seek to be paid for recent years at the same levels he received in the eighties. The alternative argument, of course, is that his drop in performance shows that he needs more incentives.

This, in essence, is the argument of the Disney Compensation Committee, whose report is also contained in the 1997 Disney Proxy Statement.[41] There is much language in the report praising incentives generally and the performance-based nature of most of the compensation the committee has awarded. There is no attempt to justify the actual amounts being paid to Eisner.

This lack of justification was even more surprising in light of the fact that Disney shareholders were actually being asked to vote on Eisner's new compensation package. Such a vote was itself reflective of recent changes in executive compensation law. Under § 162(m) of the Internal Revenue Code, passed in the first year of the Clinton administration,[42] compensation to an executive of more than one million dollars per year is not deductible by the corporation unless it is "performance-based." The statute goes on to identify compensation as performance-based where: (i) it is based on performance goals set by a compensation committee composed solely of outside directors;

---

41 SEC rules expressly require disclosure by the Compensation Committee of the policies pursuant to which they set executive compensation for the prior year and the bases for the specific compensation awards made. *See* 17 C.F.R. § 229.402. The requirement that such information be "made over the name of each member of the registrant's compensation committee" ensures that a report much like that of the Disney Compensation Committee will be a part of every company's proxy statement. § 229.402(k)(3). The SEC rules tell committees to avoid "boilerplate language" in describing the factors and criteria underlying their compensation decisions. *Id.* This appears to be an impossibility, however, for committees containing one or more lawyers.

42 During his 1992 Presidential campaign, Bill Clinton endorsed a plan to eliminate corporate tax deductions for "excessive executive pay." Kevin G. Salwen, *Clinton Backs Executive Pay Set by Holders*, WALL ST. J., Oct. 9, 1992, at C1. Prior to that time, a number of bills had been introduced in Congress that sought to cap the deductibility of executive compensation. One of them had been vetoed by President Bush. *See* Yablon, *supra* note 1, at 1885 n.48. Section 162(m) of the Internal Revenue Code was passed in August 1993 as part of the Omnibus Bill. *See* I.R.C. § 162(m) (1994).

(ii) the material terms, including the performance goals, have been disclosed to shareholders and "approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration"; and (iii) the committee certifies that the performance goals have in fact been met.[43]

Accordingly, in the 1997 Proxy, Disney shareholders were being asked for the first time to approve the performance-based bonus plans described in the Proxy Statement. In the absence of such approval, the future bonuses paid by Disney would not be deductible.[44] The description of the plan the shareholders were being asked to approve, however, was surprisingly short on detail.[45]

43 *See* I.R.C. § 162(m)(4)(C). Payments pursuant to employment contracts entered into before February 7, 1993 were not subject to these rules, so the impact of the tax rules has only been felt gradually. *See* § 162(m)(4)(D). As prior agreements expire, however, companies are coming to realize that if they want to continue paying bonuses of over one million dollars to corporate executives and deducting those costs from corporate income, the new agreements must have clear performance goals and be subject to prior shareholder approval.

44 Notice that, as with many shareholder voting problems, an affirmative vote of the shareholders would not necessarily have indicated that a majority of shareholders thought the levels of compensation being paid were appropriate. If shareholders believe the alternative to approving a compensation package is that the same compensation will be paid by the board but the company will receive no tax benefits from the payments, the rational response to that coercively structured voting problem is to approve all compensation packages.

45 Internal Revenue Code § 162(m) and the rules promulgated thereunder were designed to sharply limit directorial discretion in setting performance-based compensation. The agreements were expected to specify objective compensation criteria tied to objective performance goals such that "a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee." Treas. Reg. §1.162-27(e)(2)(ii) (1995). Discretion of the board to adjust compensation amounts was severely limited. They could be reduced by the board or the compensation committee, but they could not be increased. *See id.* § 1.162-27(e)(2)(iii)(A) (1995).

One might have expected, therefore, that the 1997 Cash Bonus Performance Plan that the Disney shareholders were being asked to approve would specifically identify the performance criteria the compensation committee would use in setting bonuses and the precise amounts executives would receive upon attaining those performance levels. It does not. Rather, it simply gives the newly created Executive Plan Performance Committee the power to set such objective standards year by year based on "Business Criteria," which may include any one or more of net income, return on equity, return on assets, or earnings per share. Does the 1997 Disney Proxy at least inform shareholders as to what performance the compensation committee will require of management in order to qualify for a bonus in the coming year? No again. We are told that it is based upon net income, but "the Committee believes that the specific target constitutes confidential business information the disclosure of which could adversely affect the company," and, therefore, it does not have to be disclosed.

One of the few poignant moments in the 1997 Disney Proxy Statement appears in the shareholders proposals section, where a proposal submitted by a number of Roman Catholic organizations contrasts the pay scales of Michael Eisner with both those of the average U.S. worker and the reported wages of Haitian apparel workers who make clothes for Disney and asks the Board to consider "whether a cap should be placed on compensation packages for officers to prevent our company from paying excessive compensation."[46] The Disney board recommends a vote "against." Its rationale, which somewhat misses the point of the critique, is that Eisner's compensation is justified because nearly ninety-eight percent of it is performance-based. The issue of income inequality raised by the proposal is left unaddressed.

The Disney shareholder meeting to which this proxy statement was addressed was held on February 25, 1997 in Anaheim, California, the home of Disneyland. Despite the fact that the meeting was held at a freezing cold ice hockey rink and that the stockholders who attended had all received free passes to Disneyland, the meeting lasted over four hours. Eisner, who attended, received a substantial amount of criticism from shareholders about his pay package as well as the Ovitz termination. (He publicly admitted that the Ovitz agreement had been a "mistake."[47]) Nonetheless, even before he went into the

---

See id. § 1.162-27(e)(4)(iii). How about telling us how much the Disney executives will actually receive next year if they meet these secret performance criteria? Fat chance. Remember that under the rules, compensation committees have no discretion to raise compensation from pre-established levels, but they are given negative discretion to lower it even if the performance criteria have been met. Accordingly, the 1997 Performance Plan sets maximum bonus amounts at extremely high levels. *See* 1997 DISNEY PROXY STATEMENT, *supra* note 17, at Annex 1, ¶¶2.2, 4.3. Not to worry, however, the company informs us it is unlikely to actually pay bonuses of those amounts but is merely preserving its discretion to "lower" the bonuses to any amount it chooses. *See id.* at 29. Accordingly, the shareholders were asked to approve a performance-based compensation plan which will pay its executives some amount of bonus based on some kind of performance criteria which have something to do with net income. The proposal passed overwhelmingly.

46 1997 DISNEY PROXY STATEMENT, supra note 17, at 28–29. According to their statement, Eisner in 1995 made 183 times more per hour than the average American worker. Disney's response did not seek to refute this. *See id.*

47 Eisner is quoted as saying,

> In our quest for the best, we make it clear we expect risk-taking, which may sometimes lead to failure. I'd like to think this mistake thing doesn't apply to me. And at home I make that clear to my children. But in the office, it happens, as in the Michael Ovitz situation. Not good. A mistake. Won't happen again. But my intentions and those of our board were appropriate and, we thought, wise.

meeting, Eisner knew he had more than enough votes to approve the compensation agreements. The eight percent of the voting shares that were voted against approval of Eisner's employment agreement, however, and the additional three percent who abstained were considered an "unusually strong rebuke" of the company's compensation practices.[48] Of course, the fact that approval of an executive compensation agreement by slightly less than ninety percent of the voting shares is considered a "rebuke" may also tell us something about the effectiveness of shareholder voting as a curb on excessive compensation.

The 1998 Disney Proxy Statement and Annual Meeting were a bit of a letdown after the fireworks of the prior year.[49] Eisner did not receive any more options, although his $9.9 million performance-based bonus on top of his $750,000 salary represented an increase in cash compensation of twenty-three percent.[50] Certain efforts appear to have been taken to avoid some of the criticism Disney had received the previous year, particularly from its institutional shareholders. For one thing, the site of the meeting was changed from Anaheim to Kansas City (no more free tickets to Disneyland), and space limitations permitted shareholders to bring only one guest. More substantively, the 1998 Proxy Statement sought authority to abolish the classified nature of Disney's board and have each member stand for reelection each year.[51]

Christopher Parkes, *Eisner's Princely Ways Cut No Ice with Shareholders*, FIN. TIMES, Mar. 3, 1997, at 17.

48 *Id.*

49 There was more media attention in December, 1997 when Eisner realized a nice profit on some of the options he had been granted in 1989. By cashing in those options and selling some more Disney stock, Eisner reduced his holdings in Walt Disney by about two-thirds. At the time Eisner sold, Disney stock was near its all time high, and the options did not expire until January 11, 1999, more than a year later. Did Eisner see a correction coming? The justification for his timing was that Eisner "felt he had a rare window of opportunity in which the company [was] experiencing relative calm." James Bates, *Company Town: Getting to the Bottom of Michael Eisner's $565-Million Payday*, L.A. TIMES, Dec. 5, 1997, at D4. He apparently did not want to sell shortly before the release of news that could trigger a major sell-off, which might open him to charges of insider trading. *See id.* As it happened, Disney stock hit a record high in May 1998 but took a sharp drop later in that year.

50 *See 23% Rise in Pay for Disney Chief*, N.Y. TIMES, Dec. 23, 1997, at D2.

51 *See* WALT DISNEY CO., NOTICE OF ANNUAL MEETING OF STOCKHOLDERS 21 (1998) [hereinafter 1998 DISNEY PROXY STATEMENT]. Such changes are generally favored by institutional investors because classified boards are seen as an obstacle to potential takeovers. Given Disney's size and the fact that it has other takeover defenses, like a poison pill, one may wonder if the change to annual election of all directors may actually give Eisner even greater influence over incumbent board members.

In any event, institutional investors were clearly not placated. The College Retirement Equities Fund (CREF), an institutional investor which often takes public stands on corporate governance issues, submitted a shareholder proposal which, in effect, attacked the Disney board for not being sufficiently independent of management. It proposed that a majority of the board and all members of the Audit, Compensation, and Nominating Committees consist of directors with no "significant personal or financial ties" to the company or its management.[52] While never mentioning Eisner or compensation issues expressly, there is little doubt that the CREF proposal was a reaction to Disney's problems of the previous year and reflected the view of many observers that the Disney board has been a little lax in exercising managerial oversight.[53]

The CREF proposal received over thirty-five percent of the vote, an extremely strong showing for a proposal opposed by management, and appeared to have received support from almost all of Disney's institutional shareholders.[54] To be sure, the proposal was not a direct attack on Eisner or his compensation, but rather a vote in favor of greater board independence.[55] Nonetheless, the vote on the CREF

---

52 *Id.* at 23. Disney management opposed the proposal, not, of course, because they disagreed with the principle of board independence, but with CREF's "excessively restrictive" definition of independence. *Id.*

53 The CREF press release announcing its shareholder proposal specifically mentioned Eisner's stock options and the Ovitz matter. *See CREF Shareholder Resolution Urges Disney Board Restructure*, PR NEWSWIRE, Jan. 14, 1998 [hereinafter *Shareholder Resolution*].

54 *See* Christopher Parkes, *Disney Shake-Up Urged by Institutions: Campaign Seeks a More Independent Board and Improved Corporate Governance*, FIN. TIMES, Feb. 25, 1998, at 17.

55 Board independence is for institutional investors what tax reduction is for Republicans, an issue on which their philosophical predilections and pecuniary interests perfectly converge. The question is what kind of relationships with the company or its top management impair a board's independence? Disney has many board members who, while not currently employed by Disney, have personal or financial ties to Eisner or the company. These include former Disney executives (E. Cardon Walker, Gary L. Wilson), Father Leo J. Donovan, the President of Gerogetown University, which one of Eisner's sons attended and to which he has donated over one million dollars, Reveta Bowers, principal of a private school previously attended by Eisner's children, George Mitchell, former Senator and special counsel to a law firm that has done work for Disney and has also consulted personally for the company, and Robert A.M. Stern, an architect, whose firm has completed multi-million dollar projects for Disney and one for Eisner himself. The CREF proposal, which would have defined as "independent directors" only as those with "no business or personal ties to management or the Company that could interfere with or appear to interfere with the director's loyalty to shareholders" would appear to exclude all these people. *See Shareholder Resolution*, *supra* note 53.

resolution does seem to reflect a growing unease in many parts of the business community over the failure of boards or anyone else to impose effective limits on executive compensation. As Graef Crystal, a compensation consultant to the Disney board put it, in discussing compensation trends generally, "[I]t can't go on like this forever."[56]

IV. WEIGHING OPTIONS: THE POLICY IMPLICATIONS OF PERFORMANCE-BASED PAY

The foibles and excesses of the rich are always amusing, but the big policy question raised by these proxies is whether they actually raise a big policy question. Are current corporate remuneration prac-

---

In 1998, the Delaware Chancery Court was also required to make a determination of the Disney board's independence in connection with the derivative suit regarding the Ovitz payments. In determining whether demand on the board could be excused in that case, the Court had to determine whether plaintiffs had shown a reasonable doubt as to the disinterest of at least half of the directors. *See* Steiner v. Meyerson, No. CIV.A.13139, 1995 Del. Ch. LEXIS 95, at *26–27 (Del. Ch. July 18, 1995); Aronson v. Lewis, 473 A.2d 805, 814 (Del. Supr. 1984). It found such reasonable doubt only with respect to Eisner and Stern. Of course, the Court was applying the concept of "interest" under Delaware law, which is far narrower and more formalistic than the CREF concept. When urged to rule that people like Bowers were in reality under the influence of Eisner, the Court stated that "to discard 'formalistic notions of interest and independence in favor of a realistic approach' expressly would be to overrule the Delaware Supreme Court." *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 360 (Del. Ch. 1998) (quoting Plaintiff's Brief in Opposition to Defendants' Motion to Dismiss at 29).

56 *The Problems with Executive Pay*, J. BUS. STRATEGY, Mar./Apr. 1998, at 20. Indeed, Disney may have dodged a bullet (or at least an uncomfortable shareholder proposal) in its 1999 Proxy Statement. The proposal submitted by the Communication Workers of America (CWA) Pension Fund would have required executive stock options to be much more "performance-based" than the ones Disney is currently using. Rather than options whose strike price is the stock's market price on the day of issuance (which were most, but not all of the options Eisner has received), the CWA proposal would limit "performance-based options" to "either 1) stock options with the exercise price indexed to an appropriate S&P 500 peer group index (such as the index used in the Company's annual proxy statement) or 2) premium-priced stock options, which set the exercise price of the option above the current market value of the stock." Walt Disney Co., SEC No-Action Letter, 1998 SEC No-Act LEXIS 959 (Oct. 29, 1998).

Disney sought to exclude this proposal from its 1999 Proxy Statement on the ground that it dealt with "ordinary business operations" and was excludable pursuant to Rule 14a-8(i)(7). Disney also argued that CWA had failed to provide the verification of its stock ownership in a timely fashion as required by Rules 14a-8(b) and (f). The SEC accepted this latter argument and granted a no-action letter without reaching the first question. *See id.* Nonetheless, with a little more attention and careful drafting by its proponents, this proposal appears likely to be in the Disney Proxy in 2000.

tices, and the regulation that encourages them, a serious cause for concern? Or do critics of Eisner and his ilk merely have a bad case of options envy?

The Disney story illustrates well both the progress and problems in the field of executive compensation. Current SEC disclosure rules succeed fairly well in providing clear and detailed information to shareholders concerning the compensation practices of publicly traded firms, though a few problematic areas such as termination and severance pay remain. (Remember Michael Ovitz's curious absence from the Disney proxy?)[57] There is also an increasing concern from shareholder activists about compensation that is either excessive in amount or lacking in serious performance standards, and perhaps some sharing of this concern by institutional investors. Yet these developments have not succeeded either in restraining executive pay increases or requiring higher performance standards, because most CEOs do not want them and most boards are not inclined to impose them. The result is that although there has been a substantial increase in "performance-based" compensation,[58] this has fueled an

57 Similar issues were involved in the recent controversy involving the partial government takeover and restructuring of Long Island Lighting Company (Lilco), when it was discovered that Lilco's former CEO would receive a $42 million severance package as part of the deal. This was considered particularly egregious since he was not even being terminated, but would remain CEO of the successor corporation. In response to claims by various state government officials that they had no knowledge of the severance pay, a spokesman for Lilco stated, "Executives' compensation disclosures are made in appropriate Securities and Exchange Commission filings." Bruce Lambert, *Critics Say a Lilco Takeover Would Greatly Enrich Its Chief*, N.Y. TIMES, Mar. 26, 1998, at B8.

58 Reports on executive pay universally confirm that an ever larger percentage of firms are using performance-based pay to compensate their top executives and that an increasing percentage of the pay of most top executives is performance-based. A recent study by Towers Perrin, a major compensation consultant, found that in 1996 approximately two thirds of executive pay was performance-based, as opposed to fifty-four percent in 1989. *See* Irwin M. Stelzer, *Are CEOs Overpaid?*, PUB. INTEREST, Jan. 1997, at 26; *see also* Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 20, 1998, at 2 ("The real money now comes from the exercise of options, long-term incentive plans and perks.").

In many companies, some form of stock ownership by executives is mandatory. In the last five years, over 20% of the 1000 largest U.S. companies have adopted guidelines requiring their officers to own stock equal in value to several times their annual salaries. Significantly, such rules rarely require the stock to be purchased at market price. It is frequently given to the executives or sold at a deep discount as additional executive compensation. *See* Bryant, *supra* note 31 § 3, at 1.

even greater increase in total CEO compensation, which has now reached unprecedented levels.[59]

Part of this, of course, is simply the combined effect of the trend to performance-based pay and a raging bull market. When your company's stock price is rising by ten percent or more a year, who would not seek stock options as a major chunk of their compensation? Not coincidentally, both the increase in executive pay and the rise in the stock market have been led by the "blue chips."[60] A major downturn in the market will probably dampen the rate of increase for a time, but wages are notoriously "sticky downward" (i.e. nobody likes to take a cut in pay), and CEO compensation levels are likely therefore to stay about where they are, even if stock prices drop, and they will be poised for another run up when good times return.

But is the ever increasing wealth of successful CEOs a matter for serious public concern? America has always been a land of opportunity. Why should we care if a group with managerial talent is getting a

---

59 While there is universal agreement that the compensation of CEOs has risen enormously in the 1990s, getting hard data as to exactly how much it has risen turns out to be surprisingly difficult. Surprising because the raw data for such statistics, the compensation paid to the top executives of publicly traded companies is now easily available from their proxy statements. Compiling that data, however, is another matter. *Business Week* and *Forbes* both publish annual surveys of executive pay, but their methodologies (and their numbers) differ considerably. *Business Week* looks at the compensation of the two highest paid executives at approximately 365 companies, and it generally provides the average increase in (1) salary and bonus only and (2) total compensation (which includes the exercise of stock options). *Forbes* looks at the same data, but for CEOs only, and uses a broader survey of approximately 800 companies. *Forbes* computes the rise in median pay for this group rather than average pay, which tends to lessen the impact of Eisner and other super-rich CEOs on the numbers. Finally, both *Forbes* and *Business Week* compute total pay by looking at payments received each year through the exercise of options, not at the grants of unexercised options during the year. Since executives tend to wait to exercise their options until the market is high, this gives the total pay numbers for both *Forbes* and *Business Week* a certain roller coaster quality.

Nonetheless, there seems to be little dispute that there have been some big raises lately in the executive suites. In its survey for 1998, *Business Week* found a 36% increase in total pay (80% of it in options and other long term compensation). *See* Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 19, 1999, at 72. In 1997, *Business Week* found that in total average pay had risen 35% over the previous year, (although average salary and bonus alone had dropped slightly). *See* Reingold, *supra* note 58, at 2. *Business Week* reported that the annual increase in total CEO compensation for 1996 was 54%; for salary and bonus alone, 39%. *See* Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 21, 1997, at 58.

60 The Dow Jones Industrials Index is comprised of the stock prices of some of America's largest companies. Its rise to 10,000 in 1999 represents a 263% increase for the decade. *See* Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 19, 1999, at 72.

lot richer a lot faster than it used to? If we have indeed achieved a fairly transparent system of executive remuneration which creates incentives for managers to maximize shareholder value and provides those managers with enormous benefits while doing so, maybe we should just pat ourselves on the back and invest in some more index funds. This is not a stupid position; I suspect that it is the one held by most people in the business community as well as a majority of corporate law academics.

But this benign perspective on current compensation practices rests ultimately on the view that nobody is really getting hurt by excessive compensation. Sure, there may be a few CEOs who are getting more than they would get in a perfect (or perfectly competitive) world, but as long as the shareholders are happy (and when the Dow is at 10,000, they certainly seem happy), who else has a right to complain? This view itself, however, is a significant part of the problem. The idea that any level of compensation is justifiable so long as it is performance-based is the very view expressed by the Disney Compensation Committee. It is a view which encourages boards to abdicate their critical role in setting reasonable limits on managerial compensation, increasing the perennial danger of wealth transfers from shareholder to managers, and exacerbating other undesirable societal trends.

Who is hurt by excessive executive pay? Certainly those shareholders are hurt whose earnings are diminished or whose shares are diluted by options grants to CEOs. Investors as a group are hurt if more deals are being structured to meet performance goals or compensation concerns of incumbent management rather than to maximize shareholder returns, or if fewer talented managers are interested in starting or investing in new businesses because equally great and far less risky returns are available to them from managing established ones. And society as a whole is likely to be hurt if an increasing number of its brightest and most talented people feel obligated to pursue managerial careers but become frustrated by their failure to make it to the lucrative top of an increasingly unequal "winner take all society."

A. *Shareholder Concerns*

As the recent Disney vote indicates, even shareholders of fairly successful companies are beginning to realize that giving CEOs whatever they want so long as it is "performance-based" is not in the best interests of shareholders. In the first place, what CEOs mostly want is lots of compensation for very little risk. Shareholders, even if

willing to pay lots of compensation, want it to be at risk to provide the appropriate incentives. Second, all of that compensation has to come from somewhere, and that somewhere is the shareholder's earnings per share, either through diminished profits or dilution of outstanding shares. Finally, managerial overreaching and directorial acquiescence may be tolerable in good financial times, but may create habits that are difficult to break when economic times turn bad. The possibility of wealth transfers from shareholders to managers has existed for a long time. Performance-based pay, however, provides new and audacious ways to accomplish such transfers.

All of these concerns come together in two of the most troubling aspects of current compensation practices—megagrants of stock options and options repricing. Excessive performance-based pay can result from either excessive amounts of compensation or insufficient performance requirements. These days, the most spectacular forms of excess are "mega-grants" of stock options, like the eight million options paid to Eisner. Such payments, which do not reduce corporate income (at least in the year they are made) have become, if not exactly the norm, a not uncommon feature of the compensation landscape. As such megagrants become an accepted feature of compensation practice, it becomes easier for compensation consultants and the committees they advise to justify their use for other CEOs in other companies.[61] Indeed, the trend toward showering CEOs with options has become so pronounced that even many of the shareholder advocates who were prime movers of the pay for performance bandwagon are expressing some second thoughts.

Their concern, not surprisingly, is with diminution in risk and loss of incentives. If the CEO is handed an options package with a present value of one hundred million dollars, an average or even below average rise in market price of the underlying stock will be enough to make him quite rich.[62] About the only thing he really has

61 Another way to pile on the options is through "reloads." These are options which, when exercised, automatically confer on their owner the right to receive additional options (although a smaller number than the amount being exercised). The ostensible purpose is to encourage CEOs to exercise their options early, but the effect is also to increase the total number of options granted and to remove board discretion from the grant of the reloads. *See* Jennifer Reingold & Leah Nathans Spiro, *Nice Option If You Can Get It*, BUS. WK., May 4, 1998, at 111.

62 Lawrence Cunningham, describing Warren Buffett's views on these matters, notes that

> simply by retaining and reinvesting earnings, managers can report annual earnings increases without so much as lifting a finger to improve real returns on capital. Stock options thus often rob shareholders of wealth and allocate the booty to executives. . . .

to worry about is a major sell off or crash, and even that can be solved by a little option repricing. In short, while large grants of stock options are generally considered performance-based pay, they often involve large payments with very little risk attached.[63]

Granting large blocks of options not only reduces the CEOs risk, but potentially dilutes the wealth of existing shareholders. Institutional investors talk about the "overhang" effect created when options relating to ten percent or more of a company's shares are held by executives and waiting to be exercised. The point is not that such megagrants are always a bad idea and should be prohibited, but that they impose heavy and often hidden costs on existing shareholders and should therefore not be granted by boards lightly or as a matter of course.

A similar point can be made about another recent focus of shareholder concern—options repricing. Critical to the idea of performance-based pay is that managers must have a credible fear that poor corporate performance will decrease their compensation. Because most American companies have been doing very well in recent years, the impact of performance-based pay on unsuccessful companies is spotty and unclear. Some managers have indeed accepted the downs as wells as the ups of incentives, taking sharply reduced, even zero pay when stock prices have dipped,[64] but there are also a disturbing number of cases in which failed performance-based plans have simply been replaced with new, richer plans with easier targets. This has outraged some shareholder advocates who rightly point out that other

---

> Stock options can encourage owner-like thinking among managers, Buffett agrees, but the alignment will not be perfect. Shareholders are exposed to the downside risks of sub-optimal capital deployment in a way that an option holder is not.

Lawrence A. Cunningham, *Warren Buffett on the Role of the Board*, 19 CORP. BOARD 6, 9 (1998). Cunningham tells us that Buffett concludes that "stock options should simply not be part of an executive's compensation." *Id.*

63 Die-hard supporters of such grants will rightly point out that just because such options provide enormous wealth with little risk does not mean that they fail to create incentives. The options will still make the CEOs substantially richer as the company's stock continues to rise, and perhaps nobody ever feels they are rich enough. Accordingly, the potential decrease in incentives attributed to megagrants, while plausible, ultimately rests on unknowable psychological factors.

64 Last year, when Disney's stock price and earnings were flat, Eisner's bonus was reduced to five million dollars from $9.9 million the previous year. Given the extraordinary levels that CEO pay has reached, it is hard to know what to make of this. On the one hand, it was a substantial pay cut of 49%. On the other hand, it was still a five million dollar bonus for flat earnings.

investors do not get such second chances, and have even suggested a ban on option repricing.

An exclusive focus on repricing, however, reflects a misunderstanding of the basic problem, which is not about the use of certain forms of pay, but the acquiescence of boards in pay packages that provide CEOs with little incentive or downside risk. The critical issue is not the repricing itself, but whether the CEO knows, or has a reasonable expectation, that a poor stock performance will result in a repricing. Obviously, such expectations will destroy any incentive effect the options plan might have had. But viewed as a *compensation* decision, repricing a CEO's options may be a reasonable compensation strategy if offered by a board to create new incentives for a CEO, where the prior downturn is not seen as a CEO's fault and where the repricing creates no expectation of further repricings.[65] The comparison with the losses of other shareholders is essentially a red herring because, although in the form of an investment opportunity, the board's decision is really about compensation and creating appropriate incentives for future performance. As we will see, however, the creation of such confusion between investors and managers is itself one of the problems of performance-based pay.

A final and serious danger for shareholders is the increased incentive performance-based pay gives CEOs to manipulate the timing of reports about corporate performance and perhaps to manipulate the substance of those reports as well. This is not traditional insider trading, but the harder to detect and police problem of CEOs delaying or accelerating disclosure of information because of the effect it may have on a personal compensation issue.[66] Announcements of bad corporate news will tend to come after, rather than before, the

65 One possible example would be AirTrans Holdings, Inc., formerly Valujet, which took on a new CEO in late 1996, after the May 1996 crash of a Valujet plane. When the stock continued to fall in the three months after the new CEO took office, making the options he had been given at the time he was hired virtually worthless, he was given new options based on the board's judgment that the continued stock decline was not due to the CEO's performance. *See* Barry Flynn, *Paid for Performance—Good or Bad: CFB's Annual Survey of Executive Pay Has Again Found That Corporations' Top Officials Reap Huge Rewards Whether or Not They Manage Well*, ORLANDO SENTINEL, May 25, 1998, at 20.

66 For example, the Chicago Herald reported, "Investors are reportedly angered that earnings estimates were lowered and 6400 additional job cuts were announced just weeks after [former Sunbeam Corp. Chief Executive] Dunlap signed a three-year, $70 million deal to remain in the top spot of the consumer products company." Mike Comerford, *Executive Severance Packages Create a Stir*, CHICAGO DAILY HERALD, June 17, 1998, Business, at 1.

date a CEO has exercised his options.[67] CEOs have all the traditional informational advantages of intimate knowledge of the company, as well as power over the timing of such public announcements.

Even more troubling may be the effect on corporate performance. Most compensation is tied to earnings either directly, (through performance goals),[68] or indirectly, through stock price. There is a growing concern, both at the SEC and among investors, about the increasing use of accounting gimmicks to inflate corporate earnings.[69] Some have even suggested that the increased use of stock options and other performance-based CEO compensation may be a factor in the increased use of such tricks.[70]

B. *Concerns About Economic Incentives*

The issues raised thus far about performance-based pay are really just new variations of traditional shareholder concerns. The most troubling issues raised by the growth of performance-based compensation, however, are based on an entirely different and more morally complicated set of issues. These larger societal issues are posed most

---

67 Conversely, bad news might be announced preliminarily if a CEO is about to receive an options grant at market, thereby giving the CEO a lower price against which to appreciate. While the former example might constitute an insider trading violation (although one with significant problems of proof), the latter example probably does not.

68 For example, Eisner's bonuses in fiscal 1999 and thereafter are tied to increases in earnings per share. *See* 1997 DISNEY PROXY STATEMENT, *supra* note 17, at 23.

69 *See* Jack O'Dwyer, *Levitt Hits Accounting "Gimmicks,"* 31 JACK O'DWYER'S NEWSLETTER 7 (1998); Richard A. Oppel, Jr., *Buffett Deplores Trend of Manipulated Earnings*, N.Y. TIMES, Mar. 15, 1999, at C2. Disney was accused of such practices in an article by accounting professor Abraham Briloff in *Barrons* in May 1998. *See* Abraham J. Briloff, *Disney's Real Magic: Is the Entertainment Giant's Accounting Pure Mickey Mouse*, BARRONS, Mar. 23, 1998, at 17. Briloff alleged that the company, by taking an undisclosed reserve of $2.5 billion in connection with its acquisition of Cap Cities, was able to charge expenses in subsequent years against that reserve, rather than against current income. It was alleged that this enabled Disney to report a 25% increase in earnings for fiscal 1997, whereas without it the increase would have been only 15%. *See* O'Dwyer, *supra*; Oppel, *supra*. The article was apparently a factor in the subsequent decline of Disney stock.

70 *See* David W. Tice, *You Still Can't Trust Corporate Earnings Numbers: Outlandish Accounting Methods Still Build Up to Awful Letdowns*, ON WALL STREET, Dec. 1, 1998 ("I believe that the proliferation of stock options has given issuers extra incentive to keep Wall Street happy. Stock options represent at least 45% of executive compensation (according to a 1996 study), and there's nothing like meeting Wall Street expectations to drive a stock (and its options) higher and higher."). It should be noted that during the same period that Disney was, according to Professor Briloff, overstating earnings, Eisner chose to exercise his options and reduce his stake in Disney. *See supra* note 50.

strongly by successful CEOs, those like Eisner who have overseen major increases in corporate profitability and intoxicating rises in stock prices.[71] With performance-based pay, some of these executives have become not merely rich, not merely very rich, but stupendously, incomprehensibly, bone-chillingly rich. Are there social, economic, or moral reasons to seek to prevent CEOs of publicly traded firms from using their positions to amass sizeable personal fortunes?

The increasing amounts of money being paid to a small number of corporate managers poses troubling questions about economic incentives and social equity. Although a capitalist critique of CEO pay may sound like an oxymoron, there is something vaguely anti-capitalist in performance-based compensation that gives managers all the benefits of successful stock investments while removing most of the downside risk. Traditionally, there have been significant differences in the risk/reward structures of owners and managers. Entrepreneurs and venture capitalists investing in start up or small companies took large risks in the hope of obtaining even larger rewards. Corporate raiders and LBO (leveraged buyout) specialists were also willing to put their (admittedly often borrowed) money where their mouths were. Managers of established corporations, who took much smaller risks, could not expect to receive the same levels of income as a successful entrepreneur, investor, or corporate raider.

The levels of compensation that are now becoming available to successful CEOs threaten to erode this distinction between managers and owners. One effect may be on the kind of deals CEOs pursue. We are already seeing various kinds of "going public" transactions in which one of the benefits cited is the increased ability of the company to pay its executives in stock options. In the hostile takeovers and LBOs of the 1980s, entrepreneurs spent large amounts to acquire control. In the 1990s, the deals are friendlier and seem less about control and more about size. Some entrepreneurs, most famously Ted Turner, have been willing to give up control in exchange for a managerial

---

71 Eisner should not be viewed as a particularly egregious example of CEO greed, but as simply the leader of a trend. Another celebrated recent example of excessive pay for successful performance has been Charles Wang, CEO and co-founder of Computer Associates, Inc. (CA). Wang was the recipient of a performance-based bonus plan under whose terms he was to receive the lion's share of a stock grant of over 20 million shares if the company's stock rose above $53.33 and stayed there for 60 days. The bonus plan was set when CA's stock was around $22, so the achievement of the performance goal, which provided Wang with stock valued at $675 million when it was reached in May 1998, was obviously a successful result. As of September 1998, CA stock was back to selling for around $30. *See* Richard J. Dalton, Jr. & Pradnya Joshi, *Company Jackpot/3 Computer Associates Split $1.1 Billion of Stock*, NEWSDAY, May 22, 1998, at A3.

position in a larger publicly held company. Many of the mega-deals of the 1990s not only provide enormous payouts to the option-holding managers of the merged companies, but more ominously, hold out the prospect of even larger pay packages to the managers of the larger, newly created entity. Perhaps these new corporate giants really need to pay such amounts to attract the top level managerial talent to exploit the synergistic potential of these new mega-firms, but the trend seems disturbingly reminiscent of the conglomerate mergers of the 1960s.

Equally troubling are the incentive effects of a corporate world in which CEOs of existing companies make as much as top entrepreneurs and investors. The problem is not that Bill Gates deserves to make more than Michael Eisner in any deep moral sense, or even that he has a harder job. But people who try to emulate Bill Gates and create moderately successful new businesses are an important source of jobs and economic growth. It is not at all clear that the same is true for people who try to emulate Michael Eisner and wind up stuck in middle management.

C. *Equality Concerns*

This brings us finally to the relationship between CEO pay and income inequality. From a traditional liberal perspective, the increased concentration of wealth in the hands of a very few people poses substantial dangers: reduced incentives for promising students to pursue socially beneficial but low paying careers in education, engineering, etc., when the lure of business school beckons, and the growth of a politics of resentment among the less well off that can be exploited by left or right wing demagogues.[72]

In their book, *The Winner-Take-All Society*,[73] Professors Robert Frank and Philip Cook describe both the changes they see as leading to the increase in income inequality in America and the policy arguments for seeking to limit and reverse that trend. The danger is not so much class warfare (although in a country that has seen urban riots, rural militia movements, and repeated Pat Buchanan Presidential bids, such dangers cannot be completely ignored) but the threat to fairness, community, and decency created by vast disparities in wealth. Almost nobody, rich or poor, wants to live in a society dominated by a

---

72 Peter Drucker, the dean of management gurus, opposes current trends in executive compensation largely on this basis, and according to Drucker, J.P. Morgan would have opposed them as well. *See* Bill Tieleman, *Executive Pay Backlash: Corporate Gurus Predict Action as Inequality Grows*, NAT'L POST, Jan. 4, 1999, at C4.

73 *See* ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY (1995).

small group of extremely wealthy people, a somewhat larger group of the fairly well off, and a large majority of individuals who are barely making ends meet. That said, however, it must be conceded that CEO pay has little to do with the income gap between rich and poor, which is much more a function of disparities in education, decline in the labor movement, and changes in the job market.

CEO pay is much more directly involved in the growing disparity of incomes within the top twenty percent. This is the concern to which Frank and Cook's book is primarily addressed, and they make a persuasive argument that in a society in which the vast majority of benefits go to the lucky few, there will be a great deal of inefficient utilization of resources as people fail to accurately assess their chances of hitting the big time. Such people will waste time, energy, and resources struggling to become, say, unhappy and not very successful executives, corporate lawyers, or basketball players, when, if pay scales for other jobs had been a little closer to those of top CEOs, lawyers or ball players, they might have found more satisfying careers as teachers, carpenters, or engineers. Thus, Frank and Cook argue, the growth of income inequality violates norms, not only of fairness, but of efficiency as well.

But what about the argument that these folks are worth it—that they create enormous value for the people who pay them? Unlike the older critics of executives and others who earn similar amounts, Frank and Cook do not deny that they may well be "worth it" in the narrow sense that existing markets make it rational for owners or investors in certain enterprises to pay enormous amounts for the services of certain individuals. But markets themselves are artificial things, constantly changing due to developments in technology, regulation, and taste. Clearly, if motion pictures and television had not been invented, Mel Gibson and Michael Jordan, even with precisely the same skills, would not command the compensation they get in today's markets. The public corporation itself, as we noted previously, is the product of the legal development of capital markets in early twentieth century. In short, the fact that highly paid executives may be "worth it" given the market in which they sell their services does not make them any more normatively entitled to such compensation than a lottery winner.

But even if excessive executive compensation poses all these problems, and even if a little more board oversight and restraint in approving CEO pay packages would be a good thing generally, this does not mean that additional regulation is advisable. The increased regulation may create more problems than it solves, or the problem

may be self-correcting. We consider these issues and a modest proposal for change in the next Section.

V. The Three Million Dollar Solution—Deductibility Caps and Performance-Based Pay

Ideally, under the American system of corporate governance, the primary source of restraint and deliberation with respect to executive compensation decisions should be the board of directors, particularly its compensation committee. In practice, directors rarely have reasons to negotiate hard on CEO salaries, but they often do have powerful incentives to give the CEO what he wants. In addition to the intangible ties of friendship and admiration that frequently unite directors with the CEO who may have been responsible for their appointment, there is the sound managerial judgment that a happy CEO is likely to be a maximally productive CEO. Accordingly, if that CEO thinks he needs eight million options to perform his best, who wants to try to bargain him down to four million, thereby running the risk he may feel resentful or unloved and spend more time either at the golf course or looking for another job. Moreover, there is undoubtedly a compensation consultant standing by, assuring the board that the compensation package requested by the CEO is easily justifiable in light of general rises in compensation levels, the fact that most of it is performance-based, etc. In short, once the board has decided that their current CEO is the right person for the job (and that tends to be the attitude of most incumbent boards), they have little incentive to exercise restraint in negotiating his compensation package.

Is there anyone else who might encourage limits on executive compensation? Institutional investors are obvious candidates, but they operate under many of the same constraints as directors. It may well be worthwhile for relational investors with sizable stakes in a company to seek to remove CEOs who are underperforming or opposed to value-enhancing corporate restructurings. But if a relational investor basically approves of current management and is looking to the CEO to increase corporate earnings and share value, such an investor has little incentive to pick a fight over a few million dollars of CEO compensation.

At one time I had hoped that corporate gadflies and investor activists, by publicizing and bringing lawsuits against the worst abuses, might impose a general restraining influence on compensation decisions. But this has not come to pass.

In the absence of any other likely sources of limits on the ever upward trend of compensation decisions, I submit it is time to rethink

the idea of a deductibility cap. I know the idea of governmental limits on the amounts someone can earn seem anathema to many on ideological grounds. But a deductibility cap is far from a prohibition or any sort of wage or price control. It simply says that for every dollar above the cap which the board decides to pay to its CEO as compensation, it must also pay thirty-five cents[74] to the federal government. Indeed, it is precisely the extreme reluctance of American business people to pay extra amounts of corporate tax, in contrast to their general willingness to pay extra amounts of executive compensation, which makes the deductibility cap a potentially effective restraint on excessive compensation. It provides a marker, a signpost, at which boards and compensation committees are likely to stop and consider the compensation decision more closely, with their reluctance to incur the double corporate tax bite acting as a counterweight to their general inclination to give the CEO whatever he wants.

It should be remembered, of course, that there already is a deductibility cap in the current tax law, but by applying only to nonperformance-based pay, the message it sends is that there are no limits with respect to performance-based pay. As we have seen, it is this same attitude which underlies the philosophy of many compensation committees and has the pernicious effect of causing them to abdicate any efforts at restraint. A deductibility cap on total pay (performance-based as well as not) would have a salutary effect of reminding boards that all forms of compensation must meet criteria of reasonableness.

It is not difficult to design a deductibility cap that would apply to all forms of compensation while retaining strong incentives toward performance-based pay. One could keep the current one million dollar cap on nonperformance-based compensation, but give corporations a right to deduct an additional amount, I would propose an additional two million dollars, in performance-based pay. The fact that companies can pay up to three million dollars to their executives in performance-based form while only one million dollars in straight salary should still provide a powerful incentive for most companies and executives to prefer performance-based pay.

Another incentive to performance-based pay would be to compute the deductibility cap on the present value of the options or other performance-based pay at the time of its issuance. Thus, stock options, for example, could be valued in accordance with the Black-

74 The current marginal corporate tax rate is 35%. Of course, the company does not actually have to pay tax on the compensation, the CEO does that in any event. Rather, it loses the right to deduct the one dollar as an expense and therefore loses the 35 cent tax benefit, which amounts to the same thing.

Scholes option pricing model. The law would provide a cap on the deductibility of payments attributable to options with a present value above the deductibility cap.[75] Options that met the deductibility criterion, however, would still provide performance-based incentives, since they would still increase in value one dollar for every dollar rise in the company's stock.

Valuing such pay on a risk discounted basis, moreover, might channel the natural competition among CEOs into more shareholder-beneficial forms. It is likely that the push for ever higher levels of executive compensation is at least as much the result of competition *among* CEOs for recognition and reward as it is a reflection of CEO demands for a living wage. Valuing compensation on a risk discounted present-value basis would mean that a CEO could get more compensation, within the deductibility cap, if he were willing to accept more risk. For example, a CEO who was willing to accept options with a strike price ten percent above market could receive more such options than a CEO who demanded a strike price equal to market on the day of issuance and still qualify under the deductibility cap. A CEO who took options set at twenty-five percent over market could receive even more. There are indications that many CEOs would be inclined to take such riskier compensation, which represents a vote of confidence in both their own managerial skills and their company's prospects. If the *Forbes* and *Business Week* surveys focused not merely on which CEOs made the most, but on which CEOs realized the most total value from securities with an initial risk discounted present value of three million dollars, they would provide a closer alignment between CEO success and shareholder benefit.

What are the likely objections to a revised deductibility cap? The most predictable is a general ideological objection to governmental interference in the market for executive compensation. If superstar CEOs can command multi-million dollar bonuses in today's market, more power to them, and the government has no business poking its nose into the compensation-setting process. Pointing out that the government already regulates the compensation setting in various ways would have little weight as a counterargument, since the inevita-

75 Since options are generally not deductible or charged to earnings by the corporations when issued, but rather when they are exercised, the determination of appropriate tax treatment and the effect of the deductibility cap would take place in different years. For example, if stock options issued in year one had a present value in that year of $2.9 million, any payment made by the company in relation to the exercise of those options would be deductible even in later years, even if that latter amount was, say, $10 million in year five.

ble rejoinder would be that the present limits on executive compensation should also be abolished.

The more cogent objection to this line of argument is to question its premise that, absent governmental regulation, the CEO compensation-setting process would be an efficient one, characterized by arms length bargaining and a rational assessment by the board of the value the CEO creates for the firm. As we have seen, compensation decisions rarely resemble arms length bargains but involve inherent tensions and conflicts of interest, and the results often raise questions as to the board's impartiality and objectivity. But all big CEO pay packages are not inherently breaches of fiduciary duty either. Rather, an honest assessment of the compensation-setting process in American public companies would recognize, as the Delaware Supreme Court put it in another context, "the omnipresent specter that a board [and management] may be acting primarily in its own interests"[76] when determining CEO pay. Such concerns, as the Delaware Supreme Court also recognized, call not for a flat prohibition on the questionable conduct, but for higher levels of consideration and review, such as those a deductibility cap might promote.

The above considerations also respond to a more sophisticated version of the prior objection, which is "Why single out CEOs?" Lots of people are earning enormous compensation these days,[77] yet only CEO pay is subject to these special tax rules. The answer, of course, is that only CEOs are likely to have the kind of intimate relationships with the people who are setting their salaries, which inherently raise concerns. In addition to the fact that CEO compensation is more likely to involve excessive wealth transfers than corporate payments to movie stars or investment bankers, a restraint on CEO compensation may have salutary effects on other spiraling pay scales. If, as seems likely, most people judge appropriate compensation levels in comparison with their own pay, a limit on their own compensation may make CEOs a little more reluctant to approve big corporate payments to others when the benefits of such payments to the company are not clearly apparent.

---

76 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. Ch. 1985).

77 As Russell Baker recently put it,

> The big—really big!—paydays are pretty much confined to two lines of work. One is drawing a crowd. The bigger the crowd you draw, the bigger the pay. The other lucrative line of work consists of moving vast clumps of money from one pocket to the other. The legal rules in this line of work allow people who move the money to skim percentages of the money being moved.

Russell Baker, *Observer: Up There in High Dungeon*, N.Y. TIMES, June 12, 1998, at A21.

Aside from these philosophical objections, there are various technical concerns that might be raised. Present valuations of uncertain future returns is not an exact science. There are certainly dangers that companies will "massage" the computations to bring their present value calculations within the deductibility cap. Exotic forms of compensation might be concocted for which relatively standard valuation methods like the Black-Scholes model do not exist, giving companies greater leeway to avoid the rules. All these points boil down to the concern that some companies will cheat and other will hire high priced experts to help them beat the system. In short, a deductibility cap will be treated like any other restrictive tax rule. But the nice thing about the deductibility cap is that it does not have to be perfect to work well. Even if companies can find ways to pay their CEO compensation with a value of somewhat more than three million dollars, the fact that boards focus on and feel constrained by the three million dollar limit would mean that the deductibility cap was performing its function, which is simply to promote restraint on executive pay levels.

A greater concern is that the deductibility cap might actually raise compensation levels by turning the maximum level of pay into a minimum. There is some indication of such a tendency in connection with the present one million dollar salary cap. Given current trends in executive pay, however, it is hard to imagine that incentives to boost pay will be increased by a three million dollar deductibility cap. Three million dollars is already at or close to median total pay according to many of the surveys. Compensation committees that feel their companies are too small or too poor to pay that level of compensation are unlikely to change their views as a result of a deductibility limit. Even if they do, the limit would remain as a restraint on future increases.

VI. Conclusion

A story is told about a college dean, an unusually kind and dedicated scholar. One day, right in the middle of a faculty meeting, discussion of curricular issues was interrupted by celestial music and an angel descending from heaven. "Dean," said the angel, "because of your great benevolence and good works, I have been authorized to grant you a gift. You may choose any one of the following: (1) profound wisdom and knowledge of the universe; (2) wealth beyond your wildest dreams; or (3) an extremely long life in perfect health and fitness."

The Dean, who was dedicated to the life of the mind, did not take long to answer. "I would like the knowledge, please," he replied.

There was immediately a loud thunderclap, a puff of white smoke, and then the Dean sat alone again in front of the faculty, a bemused expression on his face. After a long silence, one of the faculty members spoke up, "Dean, can you give us any insights based on your new wisdom?" The Dean looked at them all for a minute and said, "I should have taken the money."

Convincing CEOs not to take the money, and compliant boards not to authorize its payment, is a difficult task. This task has been made more difficult by the pay for performance movement, which may sometimes bring the incentives of shareholders and CEOs into closer alignment. But it also gives CEOs new justifications for larger pay packages and directors fewer reasons to expect criticism for approving them. A cap on deductibility of excessive levels of executive pay will not reverse this trend, but it may help to reintroduce into compensation committee meetings and compensation decisions that most underappreciated of virtues—moderation.