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Explaining the International CEO Pay Gap: Board Capture or Market Driven?

Randall S. Thomas

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*Randall S. Thomas**

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I. INTRODUCTION

One of the most puzzling aspects of executive compensation is the pay gap that exists between American and foreign Chief Executive Officers (CEOs).¹ U.S. CEOs are paid vastly more than their foreign counterparts: they have higher base salaries, they receive larger bonuses, they get more stock options, and they are given bigger chunks of company restricted stock.² Commentators³ and the financial

1. Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 842 (2002). For business scholars' descriptions of the international pay gap for CEOs, see Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2495-97 (Orley Ashenfelter & David Card eds., 1999) (summarizing numerous studies); John M. Abowd & Michael L. Bognanno, *International Differences in Executive and Managerial Compensation*, in DIFFERENCES AND CHANGES IN WAGE STRUCTURES 67 (Richard B. Freeman & Lawrence F. Katz eds., 1995).

2. Brian R. Cheffins & Randall S. Thomas, *The Globalization (Americanization) of Executive Pay*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS, at 156-57 (Columbia University Press 2003).

3. Bebchuk et al., *supra* note 1; MARIANNE BERTRAND & SENDHIL MULLAINATHAN, DO CEOs SET THEIR OWN PAY? THE ONES WITHOUT PRINCIPLES DO 6-7 (MIT Dept. of Econ., Working Paper No. 00-26, 2000) (comparing contracting and skimming views of executive pay and concluding that pay at poorly governed firms is more accurately explained using skimming

press⁴ have been quick to claim that such differences can be explained by "Board Capture," a theory that claims powerful American executives take advantage of weak domestic boards of directors and passive, dispersed shareholders to overpay themselves exorbitantly.⁵

According to Board Capture theorists, American CEOs orchestrate the appointments of their obedient subordinates as inside directors and of friendly, passive outside directors. The net result is a board comprised of compliant directors and a Compensation Committee that lacks the aggressive hard-nosed negotiators needed to keep executive pay in check. To make matters worse, the Compensation Committee's advisors, usually paid consultants from a handful of well-known firms, have conflicts of interest that preclude them from giving truly disinterested advice. They tell directors to rely upon industry surveys of pay levels that have the (un)intended consequence of constantly ratcheting executive pay levels upward.⁶

view), http://papers.ssrn.com/paper.taf?abstract_id=223736; see also BRADFORD CORNELL, COMPENSATION AND RECRUITING: PRIVATE UNIVERSITIES VERSUS PRIVATE CORPORATIONS 12-15 (UCLA Working Paper No. 6-02, 2002) (arguing that the pay gap between American CEOs of private corporations and presidents of private universities is evidence of CEO overpayment), <http://repositories.cdlib.org/anderson/fin/6-02/>.

4. Paul Krugman, Editorial, *The Outrage Constraint*, N.Y. TIMES, Aug. 23, 2002, at A17 (praising board capture theory). But see Holman W. Jenkins, Editorial, *Outrageous CEO Pay Revisited*, WALL ST. J., Oct. 2, 2002, at A17 (criticizing the theory as "nothing more than a restatement of the greed hypothesis" and pointing out other flaws in the argument).

5. This Article uses the term Board Capture to describe a well-established stylized fact in corporate law that the board of directors of a company may be more aligned with the management than with the shareholders. JAMES D. COX ET AL., CORPORATIONS § 9.3 (2002) ("Corporate directors are often in fact chosen by management, and they do not (perhaps they cannot) effectively monitor management's conduct and the quality of its performance"). In the executive compensation area, Professor Elson has most forcefully asserted this claim. Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651 (1995) [hereinafter Elson, *The Duty of Care*]; see also Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 156-64 (1996) (describing the captured board syndrome). The board of directors becomes beholden to management for nominating them to the board. Elson, *The Duty of Care*, *supra*, at 650-51. The result is that the board becomes unable to bargain effectively on behalf of the shareholders when it comes to setting the compensation levels of the CEO and other executives. *Id.* at 655 (stating that "[t]he resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest," and that, "[i]f the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it finds itself more closely aligned with management than with shareholders, then the product of such a 'bargain' may be no bargain at all to the corporation and its owners").

This same theory recently has resurfaced under a different name, the "managerial power" theory, in an influential article. Bebchuk et al., *supra* note 1, at 754 (describing this as the managerial power view).

6. JOHN M. BIZJAK ET AL., HAS THE USE OF PEER GROUPS CONTRIBUTED TO HIGHER LEVELS OF EXECUTIVE COMPENSATION 2 (Working Paper, 2000) (finding that competitive benchmarking in setting executive pay increases executive pay levels); see also RONALD C. ANDERSON & JOHN BIZJAK, AN EMPIRICAL EXAMINATION OF THE ROLE OF THE CEO AND THE COMPENSATION

American CEO pay levels have skyrocketed, they claim, as a result of this process.

The international pay gap arises, the story goes, because foreign CEOs do not have the same power over their boards.⁷ In most foreign corporations, control shareholders act as strong checks on executive pay. Control shareholders will recoup most of the firm's rents and therefore have strong financial incentives to keep executive pay abroad at more reasonable levels. Thus, by comparison to U.S. CEOs, foreign CEOs are paid less.

In the wake of Enron, Global Crossing, and the host of other financial scandals, and the anecdotal evidence surrounding the abuse of corporate perks and compensation schemes that has surfaced in their wake, Board Capture Theory has caught the public's attention. Executive compensation has been painted as the symbol of out-of-control greed in corporate America. People here and abroad want to believe that American CEOs have been playing a one-sided game, and have been winning without really having to work hard for their pay. Board Capture Theory provides an argument supporting these claims.

This Article presents the first comprehensive theoretical analysis of the international pay gap.⁸ It is critical of the Board Capture explanation and offers several more plausible market-based theories that explain this phenomenon. The problem with relying solely on board capture as an explanation is that, while it may lead to some inflation in U.S. CEO pay levels, it does not fully explain the CEO pay gap. For example, Board Capture Theory does not tell us why executive pay in the U.S. grew so rapidly after the early 1980s.⁹ There is no evidence that CEOs' power over their boards grew during this time period; in fact, most evidence is to the contrary.¹⁰ Nor does

COMMITTEE IN STRUCTURING EXECUTIVE PAY 3 (Working Paper, 2000) (finding that adding independent directors to Compensation Committees does not reduce executive pay levels).

7. Bebchuk et al., *supra* note 1, at 844.

8. For the only other theoretical discussion of the issue in the legal literature, see Bebchuk et al., *supra* note 1, at 842-45. Those authors, however, devote only three pages of their survey of the executive compensation literature to an analysis of the international pay gap.

9. As one commentator pointed out, "If managerial power has been on the rise, why are so many CEOs fired? Why has tenure fallen and turnover increased? And why did some of the richest pay deals go to executives who hadn't been hired yet and therefore didn't have the hiring boards under their thumbs?" Jenkins, *supra* note 4.

10. Boards of directors became more independent of management and more powerful during this time period. Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 882 (2002) ("[O]utside directors are not mere lackeys of management. Several studies based on pre-1990 data document, among other things, that outside directors make it more likely that poorly performing CEOs are fired, that they enhance shareholder wealth during tender offers . . ."). The reality is that shareholders' concern about executive pay grew only when the stock market's performance fell. Institutional investors were happy to vote in favor of huge stock option plans during the bull

Board Capture Theory offer a persuasive explanation of why bigger firms pay their executives more than smaller ones, or why the supply of executives has not dramatically increased in response to the alleged huge rents that CEOs have been receiving for the last twenty years. Furthermore, Board Capture Theory does not explain why boards pay incoming CEOs so well even though the CEOs have no prior relationship with the directors. Finally, even if we accept Board Capture Theory, we still will need a mechanism to set executive pay. Market-driven forces seem necessary to accomplish this result.

This Article offers five alternative theories that justify higher pay for American CEOs than for foreign top executives. It argues that each one of these theories—Marginal Revenue Product Theory, Tournament Theory, Opportunity Cost Theory, Bargaining Theory, and Risk Adjustment Theory—present better explanations for the international CEO pay gap than Board Capture Theory.

The Article starts with the Marginal Revenue Product Theory, which rests on the economic concept that each factor of production, including managerial labor, should be paid the amount of its contribution to the value of the firm; that is, its marginal revenue product. This theory claims that American CEOs should be paid more, on average, than foreign CEOs because American CEOs contribute more to their firms' value. It claims that American firms have greater growth opportunities, have greater resources to be deployed because they are bigger, and that American CEOs play a much larger role in the decision-making process at their firms than CEOs at most foreign firms.

The second theory, the Tournament Theory, explains the international pay gap as a product of the workings of corporations' internal labor markets. In these markets, top executives' pay is the prize that is awarded to the winner of the internal labor market tournament. The tournament to win these prized positions is analogized to a single elimination tournament in sports like tennis, where the winner is given by far the largest sum of prize money. The bigger the tournament is, the bigger the prize. The tournament to become the CEO is, under this theory, a much bigger one at American firms because U.S. CEOs have so much more power than their foreign counterparts.¹¹ For instance, in the United States the CEO is

market stock price run-ups in the 1990s. See Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 47 (2000) (finding that shareholders overwhelmingly approved stock option plans during the 1990s).

11. The management structure of U.S. firms has flattened significantly in recent years so that more managers report directly to the CEO. RAGHURAM G. RAJAN & JULIE M. WULF, *THE FLATTENING FIRM: EVIDENCE FROM PANEL DATA ON THE CHANGING NATURE OF CORPORATE*

normally also the Chairman of the Board, whereas in foreign countries this is rarely the case. American CEOs' power is further enhanced compared to those of their biggest foreign rivals, Japan and Germany, because boards of directors are smaller in the United States than in Japan and have only one tier, instead of the two tier structure in Germany. Finally, the "winner-take-all" culture in the United States may condone larger top prizes in these tournaments than is socially acceptable abroad.

The third theory is based on the economic concept of opportunity costs. Opportunity costs in this context can be thought of as the amount that would be paid to a CEO in her best alternative job. The Opportunity Cost Theory recognizes that CEOs and other top executives are able to jump ship from their own firms and move to other companies, hoping to get better jobs and higher pay. In order to keep managerial talent in place, firms must pay their best executives an amount at least equal to their opportunity costs, or they will leave and go elsewhere.

The international pay gap arises because U.S. CEOs have better job options than foreign CEOs. The opening up of financial markets since the early 1980s has given U.S. CEOs better access to capital markets for financing their own businesses, raising the value of their alternative opportunities. This occurred first through the use of the leveraged buyout (LBOs and MBOs) as a method of financing a new firm, then with the tremendous growth in venture capital financing for start-ups, and later on (at least for a period of years) when the technology boom made available massive amounts of capital to finance "dot com" companies. Today, LBOs have returned to popularity, and are once again fueling the demand for top executives.¹² Established American businesses that wish to compete for managerial talent are forced to offer their executives larger pay packages to keep them from being lured away by the newcomers.

By comparison, foreign CEOs have not had nearly the same access to financial markets to launch their own businesses. Foreign financial markets are more fragmented, more regulated, offer less venture capital financing, and have fewer LBOs and MBOs. Only recently has there been an expansion of executive job opportunities with the deregulation of some capital markets, coupled with the expansion of internal labor markets, and increased managerial

HIERARCHIES 1 (Nat'l Bureau of Econ. Research, Working Paper No. 9633, 2003). The result is a steeper pay differential at the top of the organization as the prize for winning the internal job tournament increases.

12. Emily Thorton et al., *Those Bulging Buyouts*, BUS. WK., Feb. 9, 2004, at 74.

migration. These changes have increased pressure on foreign companies to pay their executives more like Americans.

The fourth explanation of the large pay gap between American and foreign CEOs, which this Article calls the Bargaining Power Theory, derives from two important forces: first, the shift in the 1980s in the relative bargaining strength of American CEOs in vetoing takeovers of their corporations; and second, the concurrent acceptance of the idea of pay-for-performance by U.S. institutional investors.¹³ Beginning in 1985, when the Delaware Supreme Court upheld the validity of the Rights Plan, or poison pill, and shortly thereafter, when the U.S. Supreme Court refused to invalidate second generation state anti-takeover statutes, there has been a shift in the legal entitlement to approve hostile takeovers from a target company's shareholders to a target firm's board of directors and management. This shift gave the American CEO tremendous power to stop a hostile takeover if the CEO did not perceive the sale of the firm to be in that executive's personal best interests.

While others have argued over whether this shift in the legal rule was efficient or inefficient, takeovers of firms have continued on a friendly basis.¹⁴ In other words, the parties have bargained around the shift of the legal rule to reach an efficient result, just as the Coase theorem would predict. The Coase theorem, however, also tells us that the shift in a legal entitlement can have distributional implications. Here, one of the distributional effects of giving managers more power to turn down takeovers is that they can demand to be compensated more by their firm as the price for agreeing to give up their jobs. Even if the CEOs only get a tiny fraction of their firm's value as the price for their agreement to be a willing target, this can still amount to a vast sum of money.

Around the same time as the legal rule was shifting, institutional shareholders were gaining greater strength as they became increasingly active in corporate governance. As the more activist funds observed the success of the LBO movement with its strong emphasis on stock-based compensation for the executives of the newly privatized firms, they lobbied, with help from academics and others, to move executive pay schemes away from fixed salary plus bonus structures toward pay-for-performance systems. This led to a surge in the use of stock options and restricted stock until today they are routine (and large) components of American CEO pay packages.

13. See Kahan & Rock, *supra* note 10, at 871 (presenting a similar argument explaining the increase during the 1990s in the levels of American executive pay).

14. *Id.* at 879-81 (explaining that "by the late 1990s, both friendly and hostile bids were regularly made by Fortune 500 companies").

The increased acceptability and greater use of stock options made them a convenient mechanism for helping to convince CEOs of target companies to accept high priced takeover bids because the sale led to a big increase in the value of the CEO's personal stock and option holdings.¹⁵

Top managers of foreign firms have not enjoyed the same increase in bargaining power because, while hostile takeovers in most foreign countries continue to be almost impossible to pull off, these firms generally have control shareholder ownership structures.¹⁶ Thus in foreign firms, control shareholders make the decision whether or not to sell the company. There is no reason for the dominant shareholder to offer the firm's CEO more money for agreeing to a sale, unless the CEO happens to be the control shareholder himself. Furthermore, there is little impetus for institutional shareholders to lobby to increase this component of foreign CEO pay because there is no need to bribe foreign CEOs.

The fifth theory, Risk Adjustment Theory, points out that American CEOs receive more of their pay in the form of stock options, and probably hold more of their wealth in company stock, than do foreign CEOs. Holding large amounts of options to buy their firm's stock and being forced to hold unbalanced personal investment portfolios create large risks for American CEOs. Their lack of diversification can be very costly to them, and they justifiably seek to be compensated for these risks. In other words, companies are forced to pay them more in order to get them to place all of their eggs in the firm's basket.

Foreign CEOs do not face these constraints. If they are professional managers at firms with control shareholders, they face less pressure to hold company stock. Alternatively, they may be the control shareholder themselves. In this situation, although they hold undiversified portfolios, they can take money from the firm in other ways without raising their compensation, such as big dividends or conflict of interest transactions.

Nor is there much reason to give foreign CEOs large grants of stock options. Options generally serve three functions in the typical dispersed ownership American firm: they give executives incentives to work harder; they help align the incentives of executives with those of shareholders as a substitute for close shareholder monitoring; and they provide compensation and help with retention of talented

15. See JOHN C. COATES IV & REINIER KRAAKMAN, *VALUING STOCK-BASED COMPENSATION: EXECUTIVE PAY AND MERGER ACTIVITY IN THE 1990S* (Working Paper, 2002).

16. See *infra* notes 401-411 and accompanying text.

executives. Historically, options have not provided these benefits at foreign firms. For example, while some form of incentive pay may stimulate these executives to work harder, foreign firms traditionally use bonus payments tied to firm performance measures. Options have not been needed for alignment purposes either, because the control shareholder can monitor the CEO's efforts relatively easily. Options are unnecessary for retention purposes when no other firms in the same labor market are offering them to their executives. Options are also a relatively expensive way of compensating managers, unless they provide other benefits, because of the need to discount their value for the additional risk borne by their often undiversified holders. These costs are an additional reason why options have been unattractive to many foreign firms. In short, foreign CEOs will bear less firm-specific risk and therefore will not need to be compensated as much for it.

From a policy perspective, what does each theory tell us about the need for government intervention in the executive pay arena? Under the theories offered in this paper, market forces dictate pay levels, and policymakers should play a secondary, supporting role in regulating executive pay levels. The Marginal Revenue Product Theory predicts that the international pay gaps will disappear if the underlying economic factors converge toward common levels. For instance, if foreign firms grow, control more resources, and have better opportunities to expand, then this theory predicts that foreign CEO compensation levels will rise if the CEO contributes disproportionately to these changes.¹⁷ International convergence to U.S. pay levels can occur but only in order to reflect an increase in the value of foreign executives.

International pay gaps will shrink, according to the Tournament Theory, if foreign CEOs' power grows. Pay levels will converge if the position of CEO in a foreign company becomes as powerful as in the American firm, so that the prize to the victor is equally large.¹⁸ As with the first theory, higher American CEO pay today seems economically justifiable, and government intervention remains unnecessary.

Opportunity Cost Theory leads to the conclusion that foreign firms will pay their executives at American pay levels only if these

17. Alternatively, institutional investors and corporate boards could exercise greater control over American firms, thereby reducing the amount of freedom that U.S. CEOs have to make decisions, and lowering their marginal revenue product. Thus, lower American CEO pay could result, and the pay gap be eliminated in that manner.

18. As with the Marginal Revenue Product Theory, tighter controls over American CEOs by corporate boards or institutional investors could reduce their power and narrow the pay gap.

executives can earn that much in alternative executive positions. This will occur where new productive opportunities are opening up in their economies. Again, convergence to higher pay levels seems justifiable if the economics are right, and government intervention has little role in closing the pay gap.

Turning to the Bargaining Theory, convergence of international pay will occur in most foreign countries only if foreign share ownership becomes more dispersed and legal barriers to takeovers are reduced. These shifts would make hostile takeovers possible and increase foreign CEOs' power to decide whether to sell the company. In the United Kingdom, and other countries with relatively weak protections for target firm managers, convergence to American levels is possible if British CEOs gain more power in takeover battles, which could happen if the English react to the new European Union takeovers directive by diluting their current law.¹⁹ If the foreign market for corporate control becomes more efficient, then the ensuing benefits to shareholders may offset any increase in executive pay so that the resulting outcome is at least wealth-neutral for shareholders in foreign companies.

Risk Adjustment Theory predicts that international pay convergence will only occur if stock and equity-based instruments move toward comparable absolute and percentage amounts of foreign and American CEOs' individual wealth. This is a difficult claim to test empirically, as little data are available on CEO wealth levels and stockholdings. At present, however, there seems little reason to think that stock option usage, the most easily observed component of this equation, will move to similar levels in the United States and abroad. American CEOs are likely to have much higher levels of option compensation and stock holdings for the foreseeable future.

Unlike the other theories, the Board Capture Theory claims that higher American executive pay is economically inefficient and policymakers should try to reduce it. Theorists of this persuasion look

19. The European Union recently adopted a weak takeovers directive. *Report on the Proposal for a European Parliament and Council Directive on Takeover Bids*, EUR. PARL. DOC. (COM 534) (2002). The directive is intended to increase standardization and transparency, but it has been diluted substantially by a provision that makes many of its requirements optional. The directive's most controversial provisions include a "board passivity" rule and a "breakthrough" rule. The board passivity rule requires a target company's board to seek shareholder approval for any defenses seeking to frustrate a bid. *Id.* Similarly, the breakthrough rule invalidates many restrictions a target may place on the transfer of its securities while a takeover bid is pending. *Id.* EC member states are not required to adopt these provisions provided companies within the state are permitted to opt in to them on an individual basis. *Id.* Furthermore, states may exempt companies from these rules if the company is the target of a takeover by a bidder that is not subject to the rules. *Id.*

to reduce American executive pay levels by increasing disclosure levels.²⁰ This Article argues that, based on past experience with the adoption of increased disclosure policies, this prescription is misguided.

Based on currently available research, the five market-based theories offer better explanations of the international CEO pay gap that shed more light on executive pay than the Board Capture Theory. Although all of the theories may be right to some extent, so that executive pay is determined both for economic reasons and by American executives' power to obtain a disproportionate share of their firm's rents, more research needs to be done to understand the dynamics of this market before governments rush in and intervene. Current economic conditions have slowed, and may stop, further increases in executive pay levels.

The remainder of this article proceeds as follows. Part II presents a survey of executive pay arrangements around the world, and an overview of the basic facts that affect executive pay on which each theory is based (at least partially). Part III lays out the board capture explanation for the international CEO pay gap. Parts IV through VIII explain five alternative hypotheses for this gap: the Marginal Revenue Product Theory, Tournament Theory, Opportunity Cost Theory, Bargaining Power Theory, and Risk Adjustment Theory. Part IX discusses what policymakers should do about the pay gap, and then present some brief conclusions.

II. THE CEO PAY GAP: THE BASIC FACTS

A. Executive Pay Arrangements Around the World

When it comes to compensation, American executives stand out as exceptional on an international basis and U.S. chief executive officers have particularly distinctive arrangements.²¹ The best publicly available data on worldwide remuneration, compiled by Towers Perrin, a global management consulting firm, illustrates this point.²² The Towers Perrin 2001 annual remuneration survey compares pay packages for different level executives at industrial companies with

20. LUCIAN A. BEBCHUK ET AL., EXECUTIVE COMPENSATION IN AMERICA: OPTIMAL CONTRACTING OR EXTRACTION OF RENTS? (Working Paper, 2001) (on file with author). These authors also advocate stronger action by institutional investors at the firm level to help bring down executive pay levels at individual firms.

21. Cheffins & Thomas, *supra* note 2, at 13, 24-25.

22. TOWERS PERRIN, WORLDWIDE TOTAL REMUNERATION 2001-2002, at 20-23 (2002).

approximately \$500 million in annual sales. Using this benchmark, it shows that total annual remuneration for a U.S. CEO averaged \$1,933,000 in 2001.²³ This total compensation was more than twice the average pay for CEOs in all of the other 25 countries surveyed, and was more than three times the average CEO pay in all but seven countries (Argentina, Brazil, Canada, China/Hong Kong, Mexico, Singapore and the United Kingdom).

By contrast, looking at lower level managers this pay gap shrinks. In 2001, Towers Perrin reports that America's human resource directors ranked first with total annual compensation of \$449,000 annually.²⁴ While this was significantly more than in other countries, the gap was not as large as with CEOs, and there are ten countries where human resource directors were paid at least half as much as their American counterparts.

A second important distinction between executive compensation in the United States and abroad is the use of incentive pay. American chief executives have more variable, or performance-based, compensation, where they benefit only if their company meets or exceeds prescribed targets. The 2001 Towers Perrin survey on worldwide remuneration shows that U.S. CEOs' annual bonuses are 56 percent of their salaries.²⁵ In addition, long term incentive-based compensation (e.g. stock options and bonus plans with multi-year targets) averaged about 161 percent of American CEOs' average salary levels.²⁶

Outside of the U.S., incentive-oriented pay is considerably less important to CEOs. For instance, there are only two jurisdictions (Australia and Venezuela) where the ratio of annual bonus to salary was higher than the 56 percent figure in the U.S.²⁷ More importantly, in long-term incentive pay comparisons American CEOs stand alone: Canada's 90 percent ratio of this form of compensation to salary was

23. *Id.* at 20. Towers Perrin defines total annual remuneration as the sum of basic compensation ("annual base salary... plus non-performance-related bonus and cash profit sharing"), variable bonus ("payment[s] related to individual performance"), long term incentives ("[a]nnual expected value of long-term incentive awards (e.g., stock options, stock grants, and other awards)"), perquisites ("[a]nnual cash value of company cars, club memberships," and other typical perquisites), and company contributions (both compulsory and noncompulsory contributions for benefits, etc.). *Id.* at 3.

24. *Id.* at 21.

25. *Id.* at 26.

26. *Id.*

27. *Id.*

the closest to the U.S. figure of 161 percent.²⁸ The United Kingdom, the highest European country, was far behind at 44 percent.²⁹

Long-term incentive schemes explain a great deal of why American CEOs are better paid than their counterparts elsewhere. Towers Perrin 2001 survey shows that an average U.S. chief executive officer was awarded approximately \$900,000 annually in long-term incentive compensation.³⁰ By comparison, in only two of the other twenty-five countries surveyed did *aggregate* annual CEO compensation come close to matching to this figure (Argentina at \$879,000 and Mexico at \$867,000).³¹

For lower level executives, Americans receive more incentive-oriented pay than their foreign counterparts, but the pay gap is not as substantial as it is for chief executives. Towers Perrin's 2001 survey found that U.S. human resource directors get long term incentive pay amounting to 66 percent of their base salary.³² As with CEOs, this percentage was higher than in any other country; however, there were two jurisdictions (Malaysia and Singapore) with relatively close figures.³³ The Towers Perrin data also show that as recently as 2000, the long-term incentive/base salary ratio was actually higher in these two countries than it was in America.³⁴

Finally, it may be important, as we shall see later, to compare pay levels in countries that have similar levels of minority shareholder protection. For our purposes, the United Kingdom provides the most comparable set of data to the United States. Turning to these data, we see a similar pattern: U.S. CEOs make far more. These differences were documented in a comparative study of executive compensation between the United States and the United Kingdom by Conyon and Murphy.³⁵ They surveyed pay arrangements in over 1600 publicly quoted U.S. corporations and found that, as of 1997, U.S. CEOs were paid on average £3,565,000 in total compensation, whereas English CEOs received only £589,000 in total pay.³⁶ American CEOs received a much smaller percentage of their pay in fixed compensation with an average of 29 percent (£1,033,850) of their pay in the form of base

28. *Id.*

29. *Id.*

30. *Id.* at 20.

31. *Id.*

32. *Id.* at 27.

33. *Id.*

34. TOWERS PERRIN, *WORLDWIDE TOTAL REMUNERATION 2000*, at 25 (2000).

35. Martin J. Conyon & Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and the United Kingdom*, 110 *ECON. J.* F640, F643 (2000) (documenting "differences in CEO pay and incentives in the United States and the United Kingdom for 1997").

36. *Id.* at F646.

salaries.³⁷ By contrast, U.K. CEOs earned 59 percent (£347,510) of their total compensation in the form of salaries, although this amounted to significantly less than the average dollar amount earned by the Americans.³⁸ This same study shows that, while annual bonuses constituted about the same percentage of total compensation in the two countries, and the percentage of CEOs receiving bonuses was roughly the same in the two countries,³⁹ the bonus payments in the United States were, on average, triple the size of those granted in Britain.⁴⁰

Stock options play a huge role in the overall compensation package for American CEOs and executives. For example, in 1997, the average American CEO received 42 percent (£1,497,300) of her total pay in the form of option grants, as against the 29 percent (£1,033,850) in the form of salaries.⁴¹ By comparison, compensating executives with stock options has been a uniquely American practice.⁴² The United Kingdom was a frontrunner for Europe, yet stock option plans were largely unknown there until the mid-1980s, when the introduction of favorable tax treatment prompted large numbers of companies to introduce executive plans.⁴³ In more recent years in the United Kingdom, income from stock-based plans has been increasing dramatically.⁴⁴ The Conyon and Murphy study shows, however, that

37. *Id.* at F646-47. The authors converted all dollar figures to English pounds using the average exchange rate during the fiscal year. *Id.* at F646 tbl. 1.

38. *Id.* at F646.

39. *Id.* at F646 tbl. 1, F647 (showing 81 percent in Britain and 83 percent in the United States). The survey, in addition to covering nearly 1700 U.S. corporations, encompassed the United Kingdom's largest 510 companies ("ranked by market capitalization"). *Id.* at F643.

40. *Id.* at F647-48. American CEOs' average annual bonuses totalled £606,050, whereas average bonuses totalled £106,020 for English CEOs. *Id.* at F646.

41. *Id.* at F646-47.

42. Shirley Fung, *How Should We Pay Them?*, ACROSS THE BOARD, June 1999, at 37-38 ("Up to now, compensating executives via stock options has been primarily an American phenomenon and one widely used here."); Luisa Kroll, *Catching Up*, FORBES, May 19, 1997, at 162. Stock option plans have been popular in the United States since at least the 1950s. Clifford W. Smith, Jr. & Ross L. Watts, *Incentive and Tax Effects of Executive Compensation Plans*, 7 AUSTL. J. MGMT. 139 (1982), reprinted in THE ECONOMICS OF ACCOUNTING POLICY CHOICE 347, 359 (Rau Ball & Clifford W. Smith, Jr. eds., 1992) ("By 1968 the qualified option was the sole long-term performance plan for 86 of the 100 largest companies in the U.S.").

43. *Executive Pay; Perky*, ECONOMIST (U.K. edition), Oct. 8, 1988, at 48 (referring to share options as "the newest executive game"); Helen Kay, *Have We Killed the Share Option?*, DIRECTOR, Oct. 1995, at 66 (including a timeline, "The Life and Times of the Share Option"); Laura Mazur, *Europay*, ACROSS THE BOARD, Jan. 1995, at 40 (noting that "[t]he tax regimes in each country are the key to the varying levels [of pay]. . . British participation [in stock options] has increased remarkably during the 1980s, boosted by tax-friendly legislation in 1984").

44. Patrick Jenkins, *Bosses Share Their Options*, FIN. TIMES, Aug. 16, 2000, at 15 (quoting a consultant expert as saying, "share schemes. . . are really the growth trend"). For a discussion of the trend in the 1990s and early 1980s, see Andy Cosh & Alan Hughes, *The Changing*

in 1997 U.K. executives received only 10 percent (£58,900) of their total compensation in the form of stock options.⁴⁵

In sum, these data show that a large pay gap exists between American CEOs and those in equivalent positions at foreign firms.

B. Background Facts Concerning Executive Pay

With the different compensation patterns in mind, this section turns next to the important factual differences between American corporations and foreign corporations that could affect comparative pay differentials. While later sections of this Article elaborate on how these facts support each of the different theories, a concise discussion of them at this point in the paper will aid the reader in deciding how well each of these theories explains reality.

First, American corporations have more dispersed share ownership structures than most foreign companies.⁴⁶ Corporate governance in continental Europe and in the market-oriented economies of East Asia is organized around control shareholder structures. For instance, in Sweden, Spain, Belgium, Italy, and the Netherlands, more than 75 percent of public companies have a control shareholder.⁴⁷ Publicly traded companies do not play nearly as important a role in these economies,⁴⁸ for only a relatively small number of European companies are public and, of these, "only a small proportion" are listed companies.⁴⁹ Even at publicly traded firms, control shareholders are prevalent and generally exercise considerable

Anatomy of Corporate Control and the Market for Executives in the United Kingdom, 24 J.L. & SOC'Y 104, 118 (1997). The number of companies using stock option schemes declined, however, during the mid-1990s as the popularity of other types of long-term incentive plans grew. Cf. CONFERENCE BD., TOP EXECUTIVE COMPENSATION. CANADA, FRANCE, THE UNITED KINGDOM, AND THE UNITED STATES 22 (1999); Conyon & Murphy, *supra* note 35, at F649-50, F666 (noting that "there has been some movement away from the traditional stock option by larger companies" in the United Kingdom).

45. Conyon & Murphy, *supra* note 35, at F646.

46. See *infra* text accompanying notes 180-207 for further discussion.

47. VAN DER ELST, THE EQUITY MARKETS, OWNERSHIP STRUCTURES AND CONTROL: TOWARDS AN INTERNATIONAL HARMONISATION? 13 (Fin. Law Inst., Universiteit Gent, Working Paper No. 2000-04, 2000) (summarizing results of earlier studies).

48. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1137-38 (1997) (finding that the average ratio of outsider held stock market to GNP of countries with French civil law is 21 percent as compared to 60 percent for common law countries).

49. VAN DER ELST, *supra* note 47, at 4. From 1990 to 1999, the number of listed companies in France, Germany, and Spain grew significantly, indicating that financing by public issuance of equity is becoming more important in these countries. *Id.* at 5-6 tbl. 3.

influence over management. The prevailing approach to corporate governance therefore is "insider/control-oriented."⁵⁰

This point has several implications for executive pay both in the United States and abroad. For American firms, the dispersed ownership structure means that the interests of managers and shareholders may diverge in important ways. Shareholders want to find alignment mechanisms that keep these interests directed toward the same goals. Stock option compensation can serve this function and is therefore likely to be much greater at American firms than at foreign firms, where alignment of interests is less of a problem.⁵¹ The absence of a controlling shareholder in American firms also gives U.S. CEOs more power to decide many things, including whether or not they wish to sell their firm.

For foreign CEO pay, one important fact is that these companies are much more likely to have controlling shareholders that either manage the firm themselves, or at least have substantial control over the professionals that run the company.⁵² These controlling shareholders will not generally want to give up control of their firms involuntarily and will therefore resist giving large amounts of equity to professional managers,⁵³ and will try to defeat hostile takeovers of their firms.⁵⁴

Many foreign corporations are controlled by majority shareholders that appoint themselves, or their relatives, to top management positions.⁵⁵ Weak minority shareholder protections in almost all foreign countries permit these CEOs to take large amounts of money out of their firms in conflict-of-interest transactions.⁵⁶ In some countries, the absence of corporate disclosure rules may permit

50. Erik Berglöf, *A Note on the Typology of Financial Systems*, in *COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS* 151, 159-64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997) (" 'Insider control' is commonly used to denote a situation with strong control by management . . . "); Hans J. Blommestein, *The New Financial Landscape and Its Impact on Corporate Governance*, in *CORPORATE GOVERNANCE, FINANCIAL MARKETS AND GLOBAL CONVERGENCE* 41, 56-59 (Morten Balling et al. eds., 1998) (explaining that the " 'insider model' . . . relies heavily on the accountability of board members to the stakeholders they represent").

51. See *infra* notes 185-191.

52. See *infra* notes 107-110.

53. See *infra* text accompanying note 105.

54. See *infra* notes 393-404.

55. See MARA FACCIO & LARRY H.P. LANG, *THE SEPARATION OF OWNERSHIP AND CONTROL: AN ANALYSIS OF ULTIMATE OWNERSHIP IN WESTERN EUROPEAN CORPORATIONS* 2 (Working Paper, 2001); STIJN CLAESSENS ET AL., *ULTIMATE CONTROLLING OWNERS OF EAST ASIAN CORPORATIONS AND EXPROPRIATION OF MINORITY SHAREHOLDERS* 17 (World Bank Brookings Institution, Working Paper, 1998) (providing data that supports this proposition).

56. CLAESSENS ET AL., *supra* note 55, at 3. See generally Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 758-61 (1997).

control shareholders to hide these dealings from the public's view.⁵⁷ Thus, for firms where the controlling shareholders are also the managers, available compensation data may grossly understate actual payments to their CEOs, and render comparisons of reported compensation values misleading.⁵⁸ To properly compare international CEOs' total "take home" pay, it would be helpful to adjust for these other forms of compensation, so as to measure all cash flows from the firm to its top executive.⁵⁹ Lacking data to correct for these cash flows, we should recognize that these foreign firms' CEOs' total remuneration could be substantially greater than the figures reported at other foreign corporations.⁶⁰

On an aggregate level, national averages will be distorted in countries where firms with control shareholders acting as chief executive officers are dominant.⁶¹ Within any national labor market, the prevailing compensation rates for foreign CEOs will reflect the effects of (legal) self-dealing transactions by dominant shareholders. Thus, if CEOs at Italian firms with dominant shareholders expect to receive both direct compensation and other side payments from conflict-of-interest transactions, and these firms set compensation

57. For a general discussion of the differences in executive pay disclosure regimes, see Cheffins & Thomas, *supra* note 2, at 166-168.18. Where disclosure rules for executive compensation are stronger than those for self-dealing transactions, this may cause the control shareholder to prefer to take money out of the company through those transactions rather than in direct compensation payments.

58. At these firms, the observed compensation gap disappears for other executives because lower level foreign managers may not have the same opportunities to engage in self-enrichment as the CEOs at their firms.

59. The private benefits of control are documented in ALEXANDER DYCK & LUIGI ZINGALES, PRIVATE BENEFITS OF CONTROL: AN INTERNATIONAL COMPARISON 5-7 (Working Paper, 2002) and Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis*, 68 J. FIN. ECON. 325 (2003). Dyck and Zingales examined 393 control transactions in 39 countries between 1990 and 2000. DYCK & ZINGALES, *supra*, at 3. They found that the average premium for corporate control was 14 percent (ranging from -4 percent to 65 percent) and that, "the premium paid for control is higher when the buyer comes from a country that protects investors less (and thus is more willing or able to extract private benefits)." *Id.* at 2.

60. Bebchuk et al., *supra* note 1, at 844-45. One question this point raises is why would dominant shareholders not pay themselves huge salaries as well as take the private benefits of control? Although Board Capture theorists have not offered an answer to this question, one possible response is that control shareholders do pay themselves more, but since they don't need compensation consultants to justify their pay, they don't report any information about compensation, including to private sources, and therefore these figures are not factored into any comparisons.

61. If there are weak minority investor protections, shareholder returns will suffer at firms with dominant shareholders even if they employ professional managers, although for a somewhat different reason. At these firms, the monitoring efforts by the dominant shareholder may constrain the firm's CEO from engaging in conflict-of-interest transactions; the dominant shareholder, however, will not be so deterred. Thus, minority shareholders may trade lower executive compensation for higher returns to the dominant shareholder. In both cases, they lose.

levels within the Italian economy, then executives at all firms may find their total pay reduced to a market level that reflects these effects. In other words, even firms that forgo such side payments will offer their executives lower compensation because that is the market rate for compensating these executives.

Second, there are other important differences between American firms and foreign firms. For example, American firms are much bigger than foreign companies.⁶² American CEOs therefore control more resources, and may have more opportunities to create wealth for their shareholders.⁶³ Furthermore, U.S. CEOs may be more powerful than their foreign counterparts with greater authority to initiate crucial decisions, such as selling the company,⁶⁴ because there is no controlling shareholder.

Third, pay inequalities are a bigger social issue abroad than in the U.S. This difference surfaces both in popular discussion of income inequalities and in the internal corporate cultures of corporations.⁶⁵ This increased societal focus may create strong pressures on executive pay practices, although their strength can shift over time. Each of the theories explored in the remainder of the paper relies upon some of these background facts, often providing different explanations of their significance.⁶⁶ Part III begins with a discussion of the Board Capture Theory.

III. THE BOARD CAPTURE THEORY

A. The American Story

Board capture critics of American executive compensation practices have claimed that the board of directors of most American public corporations has been “captured” by the company’s CEO.⁶⁷ This theory starts with the hypothesis that directors of public companies

62. See *infra* notes 155-158.

63. See *infra* notes 139-152.

64. See *infra* notes 159-170.

65. See *infra* notes 212-250.

66. Thus, repetition of some of this information is inevitable. I have tried to minimize repetition in the paper.

67. See *supra* note 5. Even critics of the Board Capture Theory agree that in the area of executive compensation, directors tend to err in favor of awarding managers higher pay and that “judgment calls tend systematically to favor the CEO.” Murphy, *supra* note 1, at 2518 (rejecting the “cynical scenario of entrenched compensation committees rubber-stamping increasingly lucrative pay programs with a wink and a nod”).

are frequently nominated to the board by the company's executives⁶⁸ and receive large fees and benefits (in amounts determined largely by those same executives) for their services.⁶⁹ Board capture leads to high executive pay since these directors, many of whom are current or retired executives themselves,⁷⁰ are predisposed to award the company's executives attractive pay packages because of the manner in which they are selected (or, once selected, kept on the board),⁷¹ the amount they are paid, and their background. Both board dynamics and social dynamics discourage directors from contesting executive pay levels.⁷² Directors that do raise objections can expect little gain and potential sanctions for their efforts.⁷³ This raises the spectre that executive pay levels are not the product of effective arms'-length bargaining by directors on behalf of the shareholders.

To assess the strength of board capture as an explanation of allegedly excessive American CEO pay, we must first understand how boards set executive pay at publicly traded American companies. Typically, the board of directors delegates the job of investigating and determining the appropriate levels of executive pay to its Compensation Committee.⁷⁴ This committee negotiates with the CEO to decide what to pay her.⁷⁵ Ideally, this negotiation should look something like the following:

68. James D. Cox, *The ALL, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1243 (1993) ("[T]he prevalent ethos of nominating committees [is] to submit names believed acceptable to the CEO . . ."); Bebchuk et al., *supra* note 1, at 766-67 ("Traditionally, the CEO has dominated the director nomination process.").

69. Because the CEO sets directors' pay and outside directors set the CEO's pay, an "almost incestuous" relationship exists between them, and their pay levels are positively correlated. Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1873 (1992) (reviewing GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1991)).

70. Cox, *supra* note 68, at 1235 n.8 (citing studies).

71. Bebchuk et al., *supra* note 1, at 767 ("The CEO can use his power and influence to encourage the appointment and reappointment of independent directors who are not likely to challenge his compensation.").

72. *Id.* at 767-69 (discussing the "support or fire" ethos of many boards, the need for groups to placate members at the expense of interests not directly represented, and the presence of other CEOs on the Compensation Committee as contributing to higher levels of executive pay).

73. *Id.* at 769-71 (explaining that directors receive little monetary benefit from reducing executive pay and risk being thrown off the board or having their reputations as directors tarnished).

74. GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 214 (1991); Murphy, *supra* note 1, at 2517; Bebchuk et al., *supra* note 1, at 765.

75. Professor Murphy has a somewhat different view of the role of the Compensation Committee. He claims that the Compensation Committee should not try to set pay levels and programs, but rather "define and enforce the company's compensation strategy, and to monitor the process while being mindful that executives (like other individuals) prefer more to less." Murphy, *supra* note 1, at 2518.

From an economic standpoint, a CEO is the seller of his own services, the compensation committee is the buyer of his services, and whatever the executive receives in the way of pay is the price of his services. Under classic economic theory, a reasonable price is obtained through arm's-length negotiations between an informed seller and an informed buyer.⁷⁶

Unfortunately, critics claim, hard-nosed negotiations hardly ever occur. On the one side of the table, there is the CEO as seller. CEOs have been involved with fixing their own and other employees' compensation packages for years, they have professional compensation staff that work for them, and they hire professional compensation consultants.⁷⁷ In short, top management is a well-informed seller with ample incentive to negotiate aggressively to protect its interests.

The Compensation Committee, sitting across the room, is claimed to be in a much weaker position. This committee would normally be comprised exclusively of non-employee directors handpicked by the CEO,⁷⁸ many of whom would be current or retired executives from other public companies, and none of whom would spend much time on this work.⁷⁹ Compensation Committee members have limited time, lack information, and operate in the reactive mode in which boards function.⁸⁰

To assist it in performing its tasks, the Compensation Committee will usually retain the services of an expert compensation consultant.⁸¹ The CEO may recommend that the committee choose a

76. CRYSTAL, *supra* note 74, at 215; Bebchuk et al., *supra* note 1, at 764 (attributing this view to financial economists and the "optimal contracting" theorists).

77. CRYSTAL, *supra* note 74, at 43, 215.

78. JAMES D. COX & THOMAS L. HAZEN, *CORPORATIONS* § 11.05 (2d ed. 2003) ("[C]ompensation decisions are routinely submitted to the outside directors for their separate approval.").

79. CRYSTAL, *supra* note 74, at 214. "A board's compensation committee typically consists of about five outside directors—directors who are not employees of the company and who, at least theoretically, have no economic ties to the company. The committee meets several times a year, sometimes every time there is a board meeting." *Id.*

80. Murphy, *supra* note 1, at 2518 ("Compensation committees, which typically meet only six to eight times a year, lack both the time and expertise to be involved in the minutia of pay design."); Bebchuk et al., *supra* note 1, at 772-73 ("[D]irectors will rely heavily, if not almost exclusively, on the information and proposal provided by the compensation consultant."); Cox, *supra* note 68, at 1237 & nn.18-20 (citing studies and arguing that "[o]utside directors spend most of their time reacting to management's strategic planning and reviewing other corporate policies and practices, to an extent that allows only infrequent explicit and formal review of management's performance" (citations omitted)).

81. Crystal states that companies routinely hire compensation consultants to advise the company about top executives' pay. CRYSTAL, *supra* note 74, at 42-50. Murphy claims that Compensation Committees "rarely" retain their own compensation consultant, but rather rely on the company's human resource department for initial recommendations for pay levels and new incentive plans. Murphy, *supra* note 1, at 2517.

particular expert.⁸² Most of these experts come from a handful of well-known consulting firms specializing in executive compensation matters, many of which provide a wide variety of other consulting services to the company.⁸³ The Compensation Committee's consultant, however, is supposed to scrutinize the company's executives' pay. Critics of this process argue that, in fact, these consultants know that they have actually been hired by the CEO to ensure that she receives a substantial pay increase.⁸⁴

The Compensation Committee asks the compensation expert to compile information about the pay scales of executives at other comparable companies.⁸⁵ Using this information, the consultant prepares a report to the committee comparing the compensation of executives at comparable companies with that of the company's executives.⁸⁶ The compensation consultant uses this information to advise the committee where the company's executives fall within the remuneration spectrum.⁸⁷

The Compensation Committee, as the buyer of executive services, is rarely well informed. These part-time directors spend only a few days a year focusing on company business and are invariably less knowledgeable than the executives with whom they are negotiating. They rely on the compensation consultant to inform them

82. CRYSTAL, *supra* note 74, at 218 ("Ostensibly, compensation consultants were hired by the CEO to perform an objective analysis of the company's executive pay package and to make whatever recommendations the consultant felt were appropriate. In reality, if those recommendations did not cause the CEO to earn more money than he was earning before the compensation consultant appeared on the scene, the latter was rapidly shown the door.").

83. *Id.* at 218-20.

Most executive compensation consultants are employed by firms that do more than executive compensation consulting. . . . Indeed, in many cases, the revenues derived from a given client for such work as actuarial consulting dwarf by several orders of magnitude the revenues for executive compensation consulting. So, bucking a CEO and telling him that he ought to cut his bloated pay package can potentially cost a consulting firm not only the loss of executive compensation revenues but the loss of much larger revenues being generated from other services.

Id. at 219.

84. Bebchuk et al., *supra* note 1, at 790 ("[T]he process through which pay consultants are retained—and some evidence regarding their use—suggest that managers use compensation consultants primarily to justify executive pay, rather than to optimize it.").

85. CRYSTAL, *supra* note 74, at 220 ("Companies are solicited to complete often voluminous questionnaires on the types of compensation plans they use, how the plans work, and how much executives earn from them. These data are then analyzed statistically, and reports are sent back to participating companies."); Murphy, *supra* note 1, at 9 (surveys are universally used in setting executive compensation).

86. CRYSTAL, *supra* note 74, at 45.

87. By definition, some of the executives in the comparable group of companies will receive above average compensation, and others will receive below average compensation. For example, if 100 corporations are included in the comparable group, then the executives of at least 50 of them must be receiving below average compensation. *Id.* at 220-21.

about the possible ramifications of executive pay plans.⁸⁸ Oftentimes the consultant provides only a limited number of rosy scenarios that leave the directors uninformed about the potential problems with pay packages.⁸⁹

Even when they have adequate information, corporate boards are unwilling to pay top executives below the average level of executive compensation. As the leading critic of executive compensation practices in this country has said:

Companies have a sort of institutional pride, and consciously paying a CEO below the average constitutes a blow to that institutional pride. Talk to a member of the board about this issue, and he'll likely tell you that "our company is as good as anyone else's, and therefore we're not going to be cheap and pay below the average."⁹⁰

Compensation consultants supply the justifications needed to rationalize this attitude.⁹¹ If the company is performing well, an increase can be justified to reflect the executives' contribution to this strong performance.⁹² This increase may be coupled with the adoption of a policy requiring premium pay for executives.⁹³ If the company is performing poorly, compensation increases are said to be needed to stop the loss of top officers or to create incentives for improved performance.⁹⁴

This leads to a "ratchet" effect: as executives that are being paid less than the average level demand and receive the additional

88. *Id.* at 224.

89. *Id.* at 50 ("The committee [does not know] that other performance scenarios—scenarios that are at once more likely to occur and more gloomy than the one the consultant presented—will produce horrifyingly large payouts."). Honest consultants discuss both the advantages and the disadvantages of the pay package, including how it will affect the company's costs and the various scenarios that could affect executive pay. *Id.* at 49. Less forthcoming consultants will only present the case where things work out best for the company. *Id.* at 50. Crystal is particularly critical of some consultants' failure to inform the Compensation Committee about the lack of performance risk in executive pay arrangements. *See id.* at 225 ("This failure to present the compensation committee with the results of scenarios is particularly onerous given that so many CEOs are engaged in trying to squeeze every bit of risk out of their pay packages.").

90. *Id.* at 221.

91. Yablon, *supra* note 69, at 1878-79.

92. CRYSTAL, *supra* note 74, at 221. Crystal claims that only those performance measures which support an increase in pay will be presented to the directors. *See id.* ("[T]he comparisons that 'come out right'—i.e., show that the company is indeed an above-average performer—will be trotted in front of the compensation committee to justify the above-average pay."). This may require restructuring the data base so that some companies are taken out and others added in. *Id.* at 222.

93. *Id.* at 223. Crystal claims that his surveys have shown that more than one-third of the companies he examined had policies of paying their executives in the top 25 percent of all comparable companies, and the other two-thirds of the sample had policies of paying their executives at the average level. *Id.* None of the companies studied by Crystal aimed to pay their executives less than the average level. *Id.*

94. Yablon, *supra* note 69, at 1878.

compensation necessary to bring their pay levels up to the desired amount and executives who are performing well receive increases, then the average itself rises.⁹⁵ The greater the increases granted, the faster the average will increase for all executives at comparable companies, and the greater will be their demands at the next year's negotiation.⁹⁶ Empirical research on this effect has been mixed, with some studies finding a statistically significant positive effect on executive pay.⁹⁷

Nor are Compensation Committees aggressive bargainers.⁹⁸ Even if they are independent directors, without any direct employment relationship with the CEO, the directors are unlikely to want to ruffle the top executive's feathers. All of the directors on the board will have been selected to be on the board by the company's

95. Murphy, *supra* note 1, at 2498; Bebchuk et al., *supra* note 1, at 790 ("It is widely understood that the methodology of compensation consultants and boards in devising compensation plans results in a "ratcheting up" of salaries."). A rising stock market may also contribute to the upward ratcheting of the size of stock option grants in recent years. As Professor Murphy explains:

The mechanical explanation for the explosion in stock options is rooted in institutional details on granting practices and exacerbated by the recent bull market. According to a 1997 Towers Perrin survey, 40 percent of large companies grant options on a "fixed value" basis, 40 percent on a "fixed share" basis, and the remaining 20 percent use a variety of other methods. Under fixed-value grants, the number of options granted is determined by dividing a dollar-value target award (typically determined using compensation surveys that express grant targets as a multiple of base salary) by the Black-Scholes option value. Under fixed-share grants, the number of shares is determined at one date (using the same surveys), and fixed for several years. Thus, in periods of escalating stock prices, the Black-Scholes value of shares granted under fixed-share programs will also escalate. Moreover, since the companies with fixed-share programs participate in compensation surveys, the survey multiples will increase, which in turn will increase grants in companies with fixed-value programs. The net result is a ratcheting of option grants that corresponds to an escalating stock market.

Murphy, *supra* note 1, at 2515-16.

96. Numerous justifications can be provided for executive pay increases. For a hard-working executive who is committed to doing her best for the company, she has good reason to believe that she should receive better than average compensation. Furthermore, as one leading critic of executive compensation has noted, "most CEOs consider the fact that their compensation is below average to be a grave threat to the future well-being and competitiveness of the company." Yablon, *supra* note 69, at 1878 (discussing Professor Crystal's views on compensation). If every CEO believes that she ought to be paid in the top quarter of the scale of comparable companies, strong pressure will be placed on the Compensation Committee to accommodate those demands. *Id.*

97. One study has found that executives who are paid less than the median level for their peer group receive abnormally large pay increases, even when their firms experience worse accounting and stock price performance than their peers. BIZJAK ET AL., *supra* note 6, at 3. This result would strongly suggest that political and institutional aspects of the executive pay process contribute to higher pay levels. Other studies have found conflicting results. See, e.g., Murphy, *supra* note 1 (summarizing other studies).

98. CRYSTAL, *supra* note 74, at 226-27. The one exception is when the board has already decided to remove the CEO from office. *Id.* at 227.

CEO.⁹⁹ Many of them are executives from other companies, who are frequently better paid than the management of the company on whose board they sit.¹⁰⁰ The CEO will also determine the directors' compensation for their work for the company, and director pay levels have risen in step with executive pay in recent years.¹⁰¹ As Professor Crystal noted:

[T]he board of directors determines the pay of the CEO, and for all practical purposes, the CEO determines the pay of the board of directors. Is it any accident, then, that there is a statistical relationship between how highly the CEO is paid and how highly his outside directors are paid?¹⁰²

After completing its work, the Compensation Committee will prepare a report and recommendation to the board for routine approval.¹⁰³

Shareholders have no direct input in this process.¹⁰⁴ They can voice their feeling to the board of directors in a variety of ways after the package is approved by the board, but this only indirectly affects how the process is conducted. Furthermore, while shareholders must approve certain types of stock options that are often part of executive pay packages, they do not otherwise vote on compensation matters.¹⁰⁵ Shareholders' ability to collectively monitor executive compensation levels in the United States is doubtful.¹⁰⁶

Board Capture theorists conclude that U.S. CEOs are grossly overpaid. But this is only part of the puzzle. We must still ask why foreign CEOs are paid so much less than their American counterparts.

99. Board members are obligated to the CEO even where the board has a nominating committee of independent directors because a nomination will not proceed without the CEO's approval. *Id.* at 226.

100. *Id.* at 227.

101. *Id.* at 228-29.

102. *Id.* at 230.

103. Murphy, *supra* note 1, at 2518.

104. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1071 (1999).

105. *Id.* at 1038.

106. *See id.* at 1071-72 ("Even assuming shareholders could reach consensus on what reforms might be appropriate, investors would have difficulty launching a broad enough campaign to implement them everywhere."). *But see* Bebchuk et al., *supra* note 1, at 786-91 (arguing that the main constraint on executive pay levels is shareholder and societal "outrage" over excessive pay and that some compensation devices are designed to "camouflage" high pay from shareholders and the public to avoid this outrage).

B. The International Explanation

Board Capture theorists claim that the CEO pay gap is the result of international differences in CEO power.¹⁰⁷ In the United States, shareholder ownership patterns are dispersed and no large shareholders act as balances to the considerable powers of the CEO. American CEOs have limited ability to extract rents from their firms through self-dealing arrangements, and thus they concentrate their efforts at self-enrichment on increasing their compensation levels.¹⁰⁸

Internationally, CEOs face a different type of negotiator across the table from them: controlling shareholders.¹⁰⁹ In most foreign countries, stock ownership is much more concentrated than in the United States, and many firms are controlled by majority shareholders. These large blockholders have incentives to set firm limits on managerial pay. Consider, for instance, companies with a concentrated ownership structure where the CEO is not part of the controlling group or family. In these circumstances, those with a controlling interest should be motivated to prevent excessive compensation because any surplus in the firm reverts to the shareholders, including those in the dominant position.¹¹⁰ "Professional CEOs hired by companies with more concentrated ownership and companies controlled by a large shareholder will therefore extract less rents than the CEOs of U.S. firms, whose shareholders are more likely to be dispersed and therefore less able to closely monitor the CEOs."¹¹¹

This story, however, holds little water at firms where the top executives are also the control shareholders. These managers have strong incentives to divert funds into their own pockets when there are weak protections of minority shareholders. Minority shareholder protections and disclosure rules are much weaker in almost all foreign

107. See Bebchuk et al., *supra* note 1, at 842-43 (providing explanations for the U.S./international CEO pay gap).

108. *Id.* at 844.

109. Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 9 (2000) ("The corporate directors in these countries . . . tend to have a stake in closer monitoring—they represent significant shareholders . . .").

110. See Bebchuk et al., *supra* note 1, at 844 ("When share ownership is more concentrated, the CEO will have less power (unless, in firms with a controlling shareholder, the CEO is related to the controlling shareholder)."); see also Kannan Ramaswamy et al., *A Study of the Determinants of CEO Compensation in India*, 40 MGMT INT'L REV. 167, 182 (2000) (finding that family owned firms in India pay lower executive compensation than firms with dispersed ownership). For an example of this process in action, see S. Karene Witcher, *Executive Pay Growth in Asia Is Stalling*, ASIAN WALL ST. J., June 2, 1998, at 6.

111. Bebchuk et al., *supra* note 1, at 844.

countries than in the United States, creating opportunities for managerial abuses.¹¹²

Weak legal protections for minority shareholders have important implications for international executive pay comparisons because CEOs of foreign firms can take money out of their firms and pay themselves large amounts without shareholders being able to object effectively.¹¹³ Weak corporate disclosure rules reinforce this effect because they permit these transactions to be hidden from shareholders' view.¹¹⁴ Surveys of compensation levels will therefore understate the amounts that executives are paid in this situation.¹¹⁵

For that reason we can only make meaningful comparisons of compensation data in countries with similar levels of minority shareholder protection, such as the United Kingdom. Yet as we saw in Part II.A, even when we compare the United States to the United Kingdom, we find a substantial pay gap for CEOs.

The Board Capture Theory again claims that American CEOs' power provides the only explanation for these pay differentials.¹¹⁶ Share ownership is more concentrated in the United Kingdom than in the United States, allowing shareholders to coordinate their actions more easily, and act as better monitors of management. The more concentrated share ownership patterns in the United Kingdom leads

112. See *id.* (discussing the types of abuses by a controlling group or family, such as self-dealing and the taking of business opportunities); Cheffins & Thomas, *supra* note 2, at 164, 167 (lax disclosure rules outside of the U.S.).

113. DYCK & ZINGALES, *supra* note 59, at 41 (examining average premium in international change of control transactions and finding that it is higher when the buyer comes from a country with weak protections for minority investors).

114. A secondary impact of weak disclosure rules is that foreign firms' shareholders may be provided minimal information about executive compensation, making it difficult to determine compensation levels at foreign firms.

115. This understatement could result even if compensation consultants report information about otherwise private average compensation levels, such as the information contained in the Towers Perrin study discussed above. These controlling shareholders could choose to get cash out of their firms in other ways, such as engaging in self-dealing transactions, and not call such payments compensation. I would expect that executive pay levels will adjust to a level that reflects the effects of various corporate law, securities law, stock exchange listing requirements, and tax rates of the foreign firms' countries of origin. Controlling shareholders may choose to keep compensation levels low for tax reasons, or disclosure regimes may require them to advise shareholders of these payments and take their monies out of the firm in readily available alternative forms. Bebchuk et al., *supra* note 1, at 845 ("By paying himself a reasonable compensation, the controlling shareholder might be able to create the impression that he is being loyal to minority shareholders.").

116. See *id.* at 844 (discussing U.S. and international CEOs' power to extract rents through their executive compensation).

to CEOs having less power.¹¹⁷ Less CEO power (and more shareholder power) leads to lower compensation.¹¹⁸

Finally, Board Capture Theory also purports to explain the smaller international pay comparisons for lower-level managers.¹¹⁹ Here, the argument is that the power difference at American firms is concentrated with CEOs or the top two or three executives. Excess compensation will therefore be paid only to these top managers, and the compensation gap will be only at, or near, the top level of management.¹²⁰ International comparisons of human resource directors, such as those given in the Towers Perrin data, will therefore show little difference in pay levels because these lower level executives have little power to extract rents.

C. Board Capture Theory's Weaknesses

While there are several attractive features to Board Capture Theory, there are also fundamental problems with the claim that it is the best explanation of American executive pay levels and the international pay gap. First, Board Capture Theory does not offer an explanation for why there has been such a big increase in American executive pay and the growth in the use of stock options in the 1980s and onward.¹²¹ All available evidence seems to show independent directors getting stronger and more numerous, CEO tenure declining, and CEO turnover increasing during the same time period.¹²² These results are the opposite of what the theory would predict.

Second, Board Capture Theory does not correct for the larger size of American firms. Bigger firms are more complex, have more resources, and pay more. This needs to be taken into account when comparing compensation levels. Nor does Board Capture Theory offer an explanation for why allegedly excessive executive pay has not led to an increase in the supply of executives. In other words, if there are

117. *Id.*

118. Executive pay in the U.K., however, has been rising steadily even as institutional investor activism has been on the upswing. See BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE, AND OPERATION* 64 (1997) (discussing institutional investor activism).

119. See Bebchuk et al., *supra* note 1, at 845 ("[I]t is not surprising that . . . lower-level executives who do not have a significant share of corporate power do not enjoy higher compensation than their non-U.S. peers.").

120. *Id.*

121. Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1886 (2001).

122. See Bebchuk et al., *supra* note 1, at 773-74 (summarizing studies showing decline in CEO tenure and increase in terminations, but arguing that such changes have no effect on CEO pay packages).

huge rents available to American CEOs over the past twenty years, why don't we see a supply side reaction? Most importantly from our international perspective, why don't we see large movements of skilled foreign executives into the U.S. market, instead of the relatively small migrations that are occurring? By contrast, there seem to be fairly extensive migrations of skilled technical workers to substantial wage disparities (and outmigrations too).¹²³

Furthermore, why aren't there more home grown executives becoming available with the requisite skills? What are the barriers to entry to domestic competitors in the labor market for CEOs? While other domestic labor markets seem to respond to perceived rents by increasing the supply of workers, why don't executive labor markets? Barriers to entry may exist, but Board Capture Theory offers no explanation for them.

The presence of long term contracts does not seem to be a satisfactory explanation. First, about one-third of CEOs lack employment contracts.¹²⁴ Second, the term of a CEO employment contract is usually three or five years. So, even CEOs with contracts do not have life tenure.¹²⁵ Finally, almost all of these contracts permit termination with or without cause.¹²⁶ If there are no barriers to entry, but just a small supply of very talented, qualified people, then the high returns to CEOs are justifiable as payments to scarce factors of production.

Third, if Board Capture Theory is the explanation for high CEO pay, why do we see boards paying huge sums to attract outside candidates as CEOs? There must be market forces at work here when the existing board has no prior relationship with the incoming CEO. So we cannot fully ignore markets as an explanation of CEO pay.

Finally, if we are to claim that executives are overpaid, we need to have a way of determining what the appropriate level of their pay should be. In other words, if the market for executives in the U.S. is distorted by collusion among executives and their boards of directors, how can we determine what the right pay level is? Presumably we would need to fall back on economic theories to make

123. See *infra* notes 311-331 and accompanying text.

124. STEWART J. SCHWAB & RANDALL S. THOMAS, WHAT DO CEOs BARGAIN FOR?: AN EMPIRICAL STUDY OF KEY LEGAL COMPONENTS OF CEO CONTRACTS 14 (Working Paper, 2004).

125. Murphy's survey article summarizes evidence from several studies on turnover rates for American CEOs. These surveys show that there is significant variation in the annual departure rates, but that the range over the period 1970 to 1995 is from a low of 7.7 percent to a high of 22.5 percent. Murphy, *supra* note 1, at 2544-45.

126. SCHWAB & THOMAS, *supra* note 124, at 11.

such a determination, perhaps by calculating the executives' marginal revenue product or opportunity costs of employment.

Who will make decisions about the appropriate level of pay if not the board? If we are relying on institutional investors as our monitors, then they as outsiders to the firm will need to be able to make these calculations on the basis of public information, which seems like a daunting task. It is hard to see why these corporate outsiders are better positioned to set executive pay and monitor it in the future than boards of directors. As a practical matter, institutions are not interested in doing micro-level management, but only in setting broad parameters.

While Board Capture Theory provides one possible solution to the puzzle of why the international CEO pay gap exists, the next five sections provide alternative theories that focus more on the underlying international economic forces at work. In particular, economic theory and the experience outside of the U.S. are more closely examined to provide a more sophisticated understanding of executive pay arrangements.

IV. MARGINAL REVENUE PRODUCT THEORY

In neo-classical economic analysis, well-functioning labor markets have informed active buyers and sellers. In this world, arms'-length negotiations between an informed buyer, the board of directors or its Compensation Committee, and an informed seller, the CEO, lead to a competitive price prevailing in the market.¹²⁷ The firm hires additional labor up to the point that the cost of an additional worker, the wage rate, equals the additional revenue that the worker brings into the firm, that worker's marginal revenue product.¹²⁸ Thus, this model predicts that the firm's CEO should be paid her marginal revenue product in a competitive labor market. If an executive contributes more to the firm, then the executive should be more highly compensated.

127. In a perfectly competitive market, there are a large number of sellers of a uniform product, a large number of consumers of the product, low barriers to entry and perfect information about market conditions. HAL R. VARIAN, MICROECONOMIC ANALYSIS 55 (1978). When these conditions prevail, a profit-maximizing firm will set the price of its goods equal to its marginal revenue, which also equals its marginal cost. *Id.*

128. DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 14-15 (1993); PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 327 (1992).

A. CEOs that Have a Bigger Impact on Firm Value Should Be Paid More

CEOs, or more generally good management, can create a lot of value for shareholders. One recent survey of empirical research claims that 10-20 percent of firm performance can be attributed to the economic climate, while an additional 30-45 percent of performance depends on the state of the firm's industry.¹²⁹ The residual amount, or 35-60 percent of firm value, could be attributed to management.¹³⁰ Individual managers' approaches make a big difference in determining dividend policy, acquisition and diversification strategy, cost-cutting policies, and a host of other corporate activities, which in turn affect firm performance.¹³¹

In short, good management can have quite an impact on firm value. Existing empirical evidence shows that firms pay good managers exceptionally well.¹³² We would expect then that if top management's contribution to firm value is lower in foreign countries than in the U.S., then foreign top executives will be paid less than American CEOs.

If executives are to be compensated based on their contribution to firm value, then we can generate several predictions about executive compensation. First, we would expect that firms with more growth opportunities will compensate their managers more highly, as their executives can, *ex ante*, contribute more to firm value by choosing the best growth opportunities.¹³³ In other words, CEOs of companies with more of their firm's value tied up in future growth opportunities should be paid more.

A second prediction is that executives at larger firms that have greater resources to be deployed by their managers will be able to add more value.¹³⁴ As Professor Rosen noted, "[a]ctivities of top

129. Rakesh Khurana, *The Curse of the Superstar CEO*, HARV. BUS. REV., Sept. 2002, at 60, 63.

130. *The Curse of Charisma*, ECONOMIST, Sept. 7, 2002, at 58.

131. MARIANNE BETRAND & ANTOINETTE SCHOAR, *MANAGING WITH STYLE: THE EFFECT OF MANAGERS ON FIRM POLICIES* (Working Paper, 2002).

132. *Id.* at 24 ("Firms . . . pay a premium for managers that are associated with higher rates of return on assets.").

133. Clifford W. Smith, Jr. & Ross L. Watts, *The Investment Opportunity Set and Corporate Financing, Dividend, and Compensation Policies*, 32 J. FIN. ECON. 263, 264, 274 (1992). We would also expect them to receive more of their compensation in the form of stock options. *Id.* at 275; see also Jennifer J. Gaver & Kenneth M. Gaver, *Additional Evidence on the Association Between the Investment Opportunity Set and Corporate Financing, Dividend, and Compensation Policies*, 16 J. ACCT. & ECON. 125, 157 (1993).

134. Smith & Watts, *supra* note 133, at 274 ("In general, the larger the firm, the larger the stock of real resources that can be affected by a given managerial decision. Managers of larger

management are magnified geometrically because they affect recursively the productivity of those who work below them in the organization."¹³⁵ Large firm's executives will have a greater "scale of operations" impact on value that will lead these firms to offer their executives higher compensation. Larger firms may also employ better-qualified, more talented, and therefore better-paid, executives.¹³⁶ Furthermore, mergers that create larger firms will increase executive compensation. If firms engage in mergers that increase the pool of assets controlled by their managers, higher executive pay will result. Finally, the bigger firms' CEOs will handle more complex organizations and therefore deserve higher pay. The positive correlation between executive pay and firm size is widely observed at American firms.¹³⁷

Third, different economic systems may give CEOs different organizational powers. Economies where the CEO makes all of the most crucial decisions should pay their executives more, on average, because of CEOs' greater impact on firm value. By contrast, in economies in which the CEOs' powers are comparatively small, we would expect that executive pay would be systematically lower.

Each of these factors will mean that, within the U.S. managerial labor market, we would expect to see high growth firms, larger firms, and, most generally, firms where CEOs exercise substantial decision-making powers, to receive higher compensation. Assuming that the supply of talented managers is relatively fixed in the short run, the demand for good executives will drive industry-wide (and possibly national) compensation levels for all good managers upward to this level.¹³⁸

B. Do U.S. CEOs Create More Firm Value and Therefore Deserve Higher Pay?

What are the implications of this model for international pay systems? First, if firms in some countries have, on average, greater growth opportunities than firms in other countries, we would expect

firms thus have a higher value added, so we expect higher compensation for executives of larger firms.").

135. Sherwin Rosen, *Contracts and the Market for Executives*, in 1 THE ECONOMICS OF EXECUTIVE COMPENSATION 300, 302 (Kevin F. Hallock & Kevin J. Murphy eds., 1999).

136. Murphy, *supra* note 1, at 2493.

137. Smith & Watts, *supra* note 133, at 280 ("We expect firms with more growth options to have higher compensation. . ."); cf. Murphy, *supra* note 1, at 2493-95 ("Recent data suggest that the relation between CEO pay and company size has weakened over time.").

138. This process may be facilitated by the use of pay surveys within industries and across firms.

them to pay greater levels of executive pay. Second, if firms in one country are generally larger than firms in another country, we would expect the firms in the first country to pay their executives more, on average, than those in the second country. Third, if some economic systems give executives more decision-making functions within the firm, we would expect their CEOs to get paid more. The remainder of this section develops the argument that, on the whole, American firms are larger, have better growth opportunities, and have more powerful CEOs, and thus we expect that executive compensation in the U.S. would be higher than it is elsewhere.

1. Do American Firms Have Greater Growth Opportunities?

If U.S. firms, on average, have higher growth opportunities that offer their managers more opportunities to contribute to firm value,¹³⁹ then American CEOs would have higher marginal revenue products than their foreign counterparts and should be paid more. One possible basis for such a claim is that the U.S. economy is the leader in the area of intangible (intellectual) property, and that such property is the main engine of future economic growth.

Intangibles are the engine of future economic growth.¹⁴⁰ As one well-known commentator has stated:

Wealth and growth in today's economy are driven primarily by intangible (intellectual) assets. Physical and financial assets are rapidly becoming commodities, yielding at best an average return on investment. Abnormal profits, dominant competitive positions, and sometimes even temporary monopolies are achieved by the sound deployment of intangibles, along with other types of assets.¹⁴¹

Intangible assets have been defined as "a claim to future benefits that does not have a physical or financial (a stock or a bond) embodiment."¹⁴² Intangible assets fall into three categories:¹⁴³ 1)

139. See Smith & Watts, *supra* note 133, at 264, 274 (discussing firms' opportunity sets and hypothesizing that "the larger the proportion of firm value represented by growth options, the greater the manager's compensation").

140. "The ability to create, distribute and exploit knowledge is increasingly central to competitive advantage, wealth creation and better standards of living." ORGANISATION FOR ECON. CO-OPERATION & DEV. (OECD), OECD SCIENCE, TECHNOLOGY AND INDUSTRY SCOREBOARD: TOWARDS A KNOWLEDGE-BASED ECONOMY 7 (2001) [hereinafter OECD SCOREBOARD].

141. BARUCH LEV, INTANGIBLES: MANAGEMENT, MEASUREMENT, AND REPORTING 1 (2001).

142. *Id.* at 5. Lev treats the terms intangibles (primarily used by accountants), knowledge assets (economists), and intellectual capital (management and legal scholars) interchangeably. *Id.* "When the claim is legally secured, . . . the asset is generally referred to as *intellectual property*." *Id.* (emphasis added).

143. "[A]lthough it is convenient to classify intangibles by their major generator—discovery, organizational design, or human resource practices—the assets are often created by a combination of these sources." *Id.* at 7.

discovery, 2) organizational structure, and 3) human resources. Discovery consists of innovation; research and development (R&D)¹⁴⁴ is the primary example of discovery.¹⁴⁵ Organizational design is the set of unique practices and structures within a company that give it a competitive edge and can be measured using data on information and communication technology.¹⁴⁶ Human resource intangibles are the most difficult to measure, but the most "pronounced in successful corporations."¹⁴⁷

In each of the three categories, the United States is at, or near, the top in virtually all measures. On a prorated basis, U.S. R&D falls behind some smaller European nations and perhaps Japan.¹⁴⁸ The United States seems to be the most productive nation in terms of

144. R&D can be measured directly as the investment in or expenditure on R&D, although the relationship between these investments and the end-benefits (often sales) can be too attenuated to provide certainty about the effects of R&D on performance. *Id.* at 57. Lev specifies the difficulties as the long "time lag between the investment in R&D and the realization of benefits [and] . . . biases and distortions in reported profits—arising from firms' attempt to 'manage' investors' perceptions. . . [which] might cloud the intrinsic relationship between R&D and its subsequent benefits." *Id.* Alternative "output indicators" for R&D include the capital market values of corporations and patents. *Id.*

145. Lev offers Merck & Co.'s "massive and highly successful innovation effort partially reflected by R&D expenditures" as an example. *Id.* at 6.

146. See *id.* (discussing Dell's and Cisco's unique organizational designs, based on information and communication technology). If computers (and, more broadly, Information and Communication Technology, or ICT) are a "proxy" for organizational capital, as Lev suggests, then the U.S.'s intensive investment in ICT is evidence of a strong base of organizational capital (and knowledge capital in general). "The development and diffusion of ICT, has simplified and reduced the cost of codifying and diffusing knowledge. ICT has facilitated greater co-operation among researchers and research organisations, increasing the effectiveness of research work. ICT has also reduced barriers to entry in some R&D activities." ORGANISATION FOR ECON. CO-OPERATION & DEV., SCIENCE, TECHNOLOGY AND INDUSTRY OUTLOOK: DRIVERS OF GROWTH: INFORMATION TECHNOLOGY, INNOVATION AND ENTREPRENEURSHIP 58 (2001).

147. See LEV, *supra* note 141, at 14. While Lev classifies the knowledge embedded in a firm's human resources as an intangible asset, Stephen Gates comments that, "[t]he . . . (GAAP) of the United States require that to record anything as an asset a company must demonstrate that it has effective control of it. This condition makes it exceedingly difficult to consider a company's employees as its assets." *Id.* at 181. The difference might be important for Lev's goal of greater accounting disclosure of intangibles, but is really semantic at heart, as Gates continues, "[n]evertheless, many a company's value chain depends critically on teams of key employees." *Id.* at 182.

148. The US ranks fourth in Gross Domestic Expenditure on R&D (GERD) at 2.64 percent of GDP. OECD SCOREBOARD, *supra* note 140, at 147. Unless otherwise indicated, these OECD statistics are for 1999. Sweden (3.80 percent) is first while Japan (3.04 percent) and Germany (2.44 percent) are in the same neighborhood as the United States. *Id.* In absolute terms, however, the United States dwarfs other nations in GERD, with \$226,428.2 million, 43.6 percent of the OECD total; the EU (28.4 percent, of which Germany's 8.7 percent is the largest) and Japan (17.3 percent) combined barely exceed the U.S. total. *Id.* at 148 (using 1995 purchasing power parities dollars).

patents,¹⁴⁹ and possesses the most advanced venture capital infrastructure, which provides for turning invention into business success.¹⁵⁰ The U.S.'s advantages in organizational capital are even clearer, as it dominates the OECD's Information and Communication Technology (ICT) measures.¹⁵¹ Finally, the United States boasts the most educated and best-trained work force in the world, an indication that its level of human capital is second to none.¹⁵²

If intangibles are the biggest engine of future economic growth, and the United States is the world leader in creating and using intangibles, then it would seem to follow that the greatest opportunities for economic growth are at American firms. If firms with greater growth opportunities should pay their managers more because they can create more wealth, then American CEOs would be entitled to higher pay than their foreign counterparts.

Of course this focus on intangibles, innovation, and human resources may have just been a passing fad in the 1990s and one that should not command much attention in the future. After all, Enron was supposedly strong in each of these areas, and that was of little comfort to shareholders when its credit lines dried up and it plunged into bankruptcy. Hence, even if investors believed in the "new economy" in the 1990s, and were thus willing to reward executives

149. The OECD provides information about patents, the "intermediate" stage of discovery, from the European Patent Office (EPO). The United States received far more patents from the EPO than any other single nation (28.54 percent to runner-up Germany's 20.37 percent and Japan's 16.53 percent), but is far outdone by the EU collectively (46.98 percent). *Id.* at 175. Data from the US Patent and Trademark Office (USPTO) may broaden the picture. 47.2 percent of United States-issued patents were to U.S. nongovernment organizations ("mostly corporations"), compared to 31.2 percent for their counterparts from other nations. B.H. HALL ET AL., THE NBER PATENT CITATIONS DATA FILE: LESSONS, INSIGHTS AND METHODOLOGICAL TOOLS 12 (Working Paper No. 8498, 2001). Of those patents that were assigned, 60.9 percent went to a U.S. grantee organization (including the government) or individual; the United States thus has a greater share of its own patent office's grants than does the EU (roughly 61 percent to 47 percent). OECD SCORECARD, *supra* note 140, at 11.

150. Venture capital is an indicator of research intensity and innovation because it "is a major source of funding for new technology-based firms and plays a crucial role in promoting the radical innovations often carried out by these firms." OECD SCOREBOARD, *supra* note 140, at 44.

151. The United States invests 8.0 percent of its GDP in ICT to Japan's 7.5 percent; Europe is less than 6 percent ("with some exceptions, such as Sweden, which invests over 8 per cent"). DANIELE ARCHIBUGI & ALBERTO COCO, THE TECHNOLOGICAL PERFORMANCE OF EUROPE IN A GLOBAL SETTING 1 (Working Paper, 2001), <http://www.econ.uniurb.it/zanfei/convegno/papers/archibugi-coco.pdf>. Moreover, the United States boasts the highest rate of ICT investment as a percentage of non-residential gross fixed capital formation among major economies, between 30-40 percent. OECD SCOREBOARD, *supra* note 140, at 65.

152. The United States performs well in the methods used by the OECD to measure the role of human resources in the knowledge-based economy. Among those aged 25-64, 27 percent of Americans had a university-level degree. OECD SCOREBOARD, *supra* note 140, at 171. Only Norway and the Netherlands also exceed 20 percent with Japan at 18 percent and Germany at 13 percent. *Id.*

richly who could deliver in that environment, it may be irrelevant in the new millennium. As documented below, however, even if we totally disregard these factors, there remain strong arguments that American CEOs have greater marginal revenue products than foreign CEOs.

2. Are American Firms Larger?

One of the most strongly established empirical results in the executive compensation area is that bigger firms pay their managers more.¹⁵³ As noted above,¹⁵⁴ the theory is that larger firms have more resources affected by managerial decisions, and therefore managers can create greater value added. Hence we expect to see big firms paying their executives more and they do.

American firms are the biggest firms in the world. If we look at the Wall Street Journal's 2001 list of the 100 largest companies in the world, the top six firms (General Electric, Microsoft, Wal-Mart Stores, Exxon Mobil, Pfizer, and Johnson & Johnson) are all American.¹⁵⁵ If we look more deeply into the list, we find that 14 out of the top 20 and 33 out of the top 50 are American. By comparison, the next largest competitor is the United Kingdom, which has 8 companies in the top 50, including two that list their headquarters as both in the Netherlands and the U.K. (Royal Dutch/Shell and Unilever).¹⁵⁶

Why are American firms larger? One important factor is that the U.S. domestic market for goods and services is the largest in the world. American firms have been able to expand internally to a larger size than is possible in most other countries without having to overcome external trade barriers and higher transportation costs. Although these barriers have been reduced in recent years in some sectors, many U.S. firms still have the first mover advantage of having been established in the domestic market earlier. Furthermore, in many sectors the size of the domestic market continues to be important as trade and other barriers to international corporate growth have only been lowered, not eliminated.

These differences in firm size, however, are not a complete explanation for the international pay gap. For example, the Towers Perrin data cited in Part II.A is for firms of similar size. Furthermore, Conyon and Murphy¹⁵⁷ and another study by Core¹⁵⁸ find that U.S.

153. See, e.g., Smith & Watts, *supra* note 133, at 274.

154. See *supra* text accompanying notes 134-136.

155. *The Global Giants*, WALL ST. J., Oct. 14, 2002, at R10.

156. *Id.*

157. Conyon & Murphy, *supra* note 35, at F668.

CEOs get paid more even after controlling for firm size. Thus, we must continue to search for a fuller explanation of the international pay gap.

3. American CEOs Have a Bigger Role Within the Firm

Different economic systems allocate power within the corporation differently. For my purposes, this leads to the question: are there systematic differences in the CEOs' contribution to the success of a company across companies? In the U.S., where the shareholder base of most major corporations is widely dispersed, the chief executive plays a pivotal leadership role and has tremendous discretion in decision making. While her actions are subject to the approval of the company's board of directors, this approval is broadly delegated for all but the most extraordinary transactions.

The CEO is usually the true leader in U.S. companies. For example, at most American firms the top manager holds both the position of chairman of the board and that of CEO. American CEOs thus have an enormous power to make decisions that affect firm value, and therefore a high *ex ante* marginal revenue product.¹⁵⁹ In these circumstances, the fact that U.S. companies pay their chief executives more recognizes their high impact on the firm's future performance.

In many foreign economies, where the norm is concentrated shareholder ownership, the role of the CEO is fundamentally smaller. In these countries most large corporations have a control shareholder or controlling shareholder group. The foreign CEO, while still the most important manager in the firm, does not have as much discretion as the American CEO to take unbridled actions. The controlling shareholder(s) will make critical decisions about the future of the firm.¹⁶⁰

In fact, the CEO may be more accurately thought of as merely a first among equals who carries out a bureaucratic set of tasks that could be performed capably enough by various others. In other countries, the "first among equals" view is held by many. Certainly in

158. John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449 (2000).

159. C.K. Prahalad & Yves Doz, *The CEO: A Visible Hand in Wealth Creation?*, J. APPLIED CORP. FIN., Fall 2000, at 20, 20-21, 34 (arguing that CEOs have become more critical in wealth creation in recent years).

160. See *supra* Part I.B.

Japan the CEO does not have the same sort of "leader" status that he has in the United States.¹⁶¹

Moreover, even in the United Kingdom, where shareholder dispersion is more widespread than elsewhere in Europe (although not as dispersed as in the United States), CEOs' powers are more circumscribed than in America.¹⁶² Institutional ownership in the United Kingdom increased significantly during the 1990s.¹⁶³ During that time period, under pressure from institutional investors, U.K. companies split the roles of chairman of the board and CEO, thereby weakening the CEO's position within the company.¹⁶⁴ This suggests that the marginal revenue product of American CEOs may be greater than that of foreign CEOs, which would provide a justification for paying U.S. top executives more.

Continental European CEOs may have less discretion in running their companies than American CEOs for a second reason: they cannot adjust their labor inputs of production and corresponding capital-labor input ratios as readily as American CEOs.¹⁶⁵ For example, if the labor force levels are set at inefficiently high levels at a European corporation, current legal restrictions and corporate governance arrangements in these countries limit worker layoffs.¹⁶⁶ Workers have more rights to resist job cuts. Thus, while foreign CEOs can adjust their firms' capital structure to more efficient levels,¹⁶⁷ they

161. See, e.g., Pearl Meyer, *Corporations Must Police Executive Salaries*, N.Y. TIMES, Apr. 30, 1992, at A22 (stating that Japanese CEOs are lower paid than American CEOs because, among other things, they are the "first among equals").

162. Institutional shareholders, however, are more powerful in the U.K. than in the U.S. Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002 (1994). They can therefore provide a stronger check on the CEOs' powers than U.S. institutions do on American CEOs.

163. CHEFFINS, *supra* note 118, at 64.

164. Note, however, that CEO pay has grown dramatically in Britain since the early 1990s, when the CEO/Chairman split first became standard practice. Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say over Executive Pay?: Learning From The US Experience*, 1 J. CORP. L. STUDIES 277, 280-81 (2001). However, the level of increases in the United Kingdom have not been close to those in the United States.

165. For a thorough discussion of the European countries' tradeoffs between employment levels and social welfare policies, see CTR. FOR ECON. POLICY RESEARCH, UNEMPLOYMENT POLICY: GOVERNMENT OPTIONS FOR THE LABOUR MARKET (Dennis J. Snower & Guillermo de la Dehesa eds., 1997).

166. Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 551-52 (2000) [hereinafter Roe, *Political Preconditions*]; see also MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 36-37 (2003).

167. Roe argues that managers may be reluctant to restructure the firm quickly even when in shareholders' best interests, but rather will prefer to move slowly to avoid "social opprobrium." Roe, *Political Preconditions*, *supra* note 166, at 553.

are limited in their ability to shift capital-labor ratios to more efficient levels.

By comparison, the U.S. manager can move labor around more easily.¹⁶⁸ Worker layoffs, while unpopular, are relatively common at American firms, particularly in economic downturns. As U.S. CEOs have the same access (or better) to capital markets as their European counterparts, they can adjust their firms' capital-labor ratios more quickly to new, more efficient levels when needed. For our purposes, this means that American CEOs can have more impact on firm value than European chief executives, and provides another justification for their higher pay. More generally, if regulation levels in the United States are lower than abroad, this allows U.S. CEOs more flexibility to adjust firm output and to increase the potential value that they can create.

The stakeholder orientation of some corporate governance systems may reinforce this notion. Stakeholder systems constrain executives' discretion by subjecting executives to many competing demands from different constituencies. Corporate executives in continental Europe and the market-oriented economies in Asia often act to pursue a range of "social" objectives, rather than simply seeking to maximize profits for shareholders.¹⁶⁹ This orientation could impact manager's marginal revenue product compensation by reducing their ability to create shareholder value.¹⁷⁰ Furthermore, to the extent that diverting corporate resources to achieve social goals results in lower value creation for the firm, we could anticipate that manager's marginal revenue product would be lower in stakeholder-oriented firms than in shareholder-oriented firms.

V. TOURNAMENT THEORY

A second and related theory that offers a potential explanation of international executive pay differentials is that U.S. CEOs are paid

168. ROE, *supra* note 166, at 46

169. See, e.g., Ronald Dore, *The Asian Form of Capitalism*, in *THE CORPORATE TRIANGLE: THE STRUCTURE AND PERFORMANCE OF CORPORATE SYSTEMS IN A GLOBAL ECONOMY* 35, 42-43, 47 (1997); Amanda Bennett, *Managers' Incomes Aren't Worlds Apart*, *WALL ST. J.*, Oct. 12, 1992, at B1; Herbert A. Henzler, *The New Era of Eurocapitalism*, *HARV. BUS. REV.*, 57, 60-61, July-Aug. 1992.

170. This orientation also could impact the composition of pay packages by discouraging the use of pay for performance incentive pay, most heavily used in American compensation packages. Other stakeholders likely are wary of pay schemes that focus solely on furthering the interests of the shareholder class. Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 *AM. J. COMP. L.* 497, 513-16 (2002) (discussing hostility to new executive pay initiatives).

more because they are the victors in the "biggest" tournaments. This tournament theory of executive pay claims that internal firm labor markets are like single elimination tournaments: as the winners advance, the prize of moving on to the next round of the competition gets disproportionately larger. The winner of the whole tournament becomes the CEO, getting the most power within the firm and the largest pay packet.

The greater the power that the CEO exercises, the more fierce the competition to win. If American firms give their CEOs more power than foreign firms do, then we would expect that obtaining the chief executive position at one of these corporations would offer the biggest prizes. In short, U.S. executive pay should be greater than in foreign firms if internal tournaments are bigger events at American firms.

A. The Bigger the Prize, the Bigger the Payoff

Academics at both business schools and law schools often analogize promotions within an internal labor market to tournaments: the best performers in the workplace are promoted to the next level of jobs.¹⁷¹ At each level of the organizational job ladder, workers are competing with other workers for a fixed number of spots in elimination tournaments.¹⁷² The winner of the tournament receives

171. The analogy is to single elimination sports tournaments, such as tennis tournaments. EDWARD LAZEAR, PERSONNEL ECONOMICS FOR MANAGERS 225 (1997). The best player wins the match and receives the prize associated with being the winner. In this context, relative performance is the key.

Firm internal labor markets are claimed to be like these sports tournaments in several ways. *Id.* First, the participants in most internal labor markets are restricted to persons already working for the firm in the position just below the one with an opening. *Id.* at 227. Second, workers are promoted because they are relatively better than the other workers in their current position. *Id.* Third, workers allegedly try harder to obtain the promotion based on the spread between their current compensation and the compensation for workers at the next level; that is, the spread in pay. *Id.* However, if there are other factors that affect workers' chances of promotion, such as luck or variables outside of their control, it will reduce workers' incentives to work harder and require larger wage gaps between positions to induce the same level of increased worker effort. *Id.* at 235. For an extensive discussion of tournament theory as an explanation for corporate pay scales, see *id.* at 223-52.

Tournament theory has been applied in models of law firm promotion of associate lawyers. See, e.g., MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM (1991). For a recent critique of this application, see generally David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Firms*, 84 VA. L. REV. 1581 (1998).

172. Tournaments have several advantages as a method of allocating promotions: first, they require only ordinal information about the relative capabilities of the contestants for the jobs, which is generally reasonably available at a relatively low cost; second, looking at relative performance eliminates the common elements of uncertainty that may affect the performance of all of the applicants; and third, they reduce the incentives that employers may have to act

the immediate prize of a better job with higher pay and benefits, plus the valuable chance to compete for a job at the next level.¹⁷³ The value of this "option" to compete later for higher positions gives additional incentives to the players in the lower rounds.¹⁷⁴

As the winners progress up the job ladder, there are fewer higher levels to attain. For each winner, this reduces the value of their option to compete for future jobs. In order to maintain the incentives to compete, an employer must therefore increase the direct financial gains from obtaining a promotion as individuals rise in the hierarchy.¹⁷⁵ In other words, the amount of the increase in pay associated with a promotion must increase as an individual reaches the higher managerial levels. This is especially true for the pay gap between the CEO and the level of executives directly below that position, because there are no further competitions for the CEO to win.¹⁷⁶ In fact, empirical studies have demonstrated that pay differentials increase between ranks as workers climb corporate job ladders, with the promotion to CEO resulting in an extraordinary jump in pay.¹⁷⁷

Tournament theory offers an explanation for large disparities between the payments corporations make to middle managers and workers on the one hand and CEOs on the other.¹⁷⁸ Competitors are incentivized by the high spread in their potential payoffs to seek the higher positions. This incentive is claimed to lead to greater productivity and a more efficient organization.¹⁷⁹ It also explains why bigger firms pay their CEOs more than smaller ones: bigger firms have more resources, their CEOs have more power, and thus the prize for winning the tournament is larger.

opportunistically in reneging on performance payments. LAZEAR, *supra* note 171, at 243-45; MILGROM & ROBERTS, *supra* note 128, at 367-69.

Some other fundamental characteristics of economic tournament theory include difficulty monitoring the quality of the work performed by the workers and that firms nevertheless succeed in providing incentives that stimulate employees to work hard. Wilkins & Gulati, *supra* note 171, at 1584; see also CHARLES A. O'REILLY ET AL., OVERPAID CEOs AND UNDERPAID MANAGERS: EQUITY AND EXECUTIVE COMPENSATION 6 (Working Paper, 1996).

173. LAZEAR, *supra* note 171, at 240; MILGROM & ROBERTS, *supra* note 128, at 376; O'REILLY ET AL., *supra* note 172, at 6.

174. LAZEAR, *supra* note 171, at 240. Some players may choose not to compete. To the extent that numerous workers elect this option, the validity of this assumption of tournament theory must be called into question. Wilkins & Gulati, *supra* note 171, at 1606-08.

175. LAZEAR, *supra* note 171, at 240; MILGROM & ROBERTS, *supra* note 128, at 376.

176. LAZEAR, *supra* note 171, at 240.

177. MILGROM & ROBERTS, *supra* note 128, at 376. But see HAROLD DEMSETZ, *Management Compensation and Tournament Theory*, in *THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES* 110, 133-34 (1995).

178. O'REILLY ET AL., *supra* note 172, at 3.

179. *Id.* at 6.

Tournament theory may also explain why the gap between lower and upper level employees has increased so rapidly in recent years. The restructuring of American business that began in the late 1980s resulted in the downsizing of many levels of middle managers and a flattening of the management structure of American corporations.¹⁸⁰ Tournament theory predicts that reducing the number of levels of potential promotions will lower the incentives that workers have to strive for advancement unless there are offsetting increases in the pay associated with higher level jobs.¹⁸¹ Raising CEO pay increases the ultimate prize that a manager can win through promotions and thus offsets the disincentives of having fewer intermediate advancement steps.¹⁸² Although tournament theory is not without its critics, it does offer a coherent explanation of internal corporate pay differentials.¹⁸³

Internationally, CEOs have less power in the control-shareholder-dominated companies that are most prevalent abroad. Less power equates with smaller prizes for winning the tournament. Foreign CEO pay should therefore be lower than CEO pay in the United States. Equally importantly, foreign firms' control

180. RAJAN & WULF, *supra* note 11, at 1, 35.

181. MILGROM & ROBERTS, *supra* note 128, at 428.

182. Tournament theory also suggests an explanation for why incentive pay is the largest component of CEO compensation. Once workers reach the top of the pyramid, there is nowhere else to advance. Any financial incentives, therefore, must come from payment for performance. Thus, as is observed, explicit performance pay should become most important to those at the top of the organization. *Id.*

183. Tournament theorists have been criticized for ignoring the negative effects on those that do not advance and obtain the prizes. O'REILLY ET AL., *supra* note 172, at 7. In settings where cooperation is more valuable than competition, such as may frequently be the case within teams, tournaments can create ill will and mistrust that will hurt productivity. "In this sense, tournament theory is based on the assumption that competition encourages increased effort but ignores the effects of competition when performance results from cooperation among interdependent participants." *Id.*; Wilkins & Gulati, *supra* note 171, at 1614 ("A firm structured entirely as a tournament would not be an environment that fostered cooperation simply because one's success in the standard tournament is a direct function of others not performing as well."). In other words, firms holding tournaments wind up full of "losers" in the management ranks below the CEO.

A related concern is that managers may be able to increase their chances of advancing to higher positions through political manoeuvres and acts of sabotage rather than because of their merits. This conduct undermines the efficiency arguments in favor of a tournament style pay structure and supports a more compressed wage structure in the upper levels of organizations. O'REILLY ET AL., *supra* note 172, at 7; see also Wilkins & Gulati, *supra* note 171, at 1614-16 (noting potential for sabotage in competitive setting; also pointing out that those determining who advances in the firm may not judge candidates solely on their merits but also on whether they perceive them to be threats).

A third problem is that at least one prominent economist has found that tournament theory is not empirically supported as an explanation of variations in CEO compensation. Demsetz, *supra* note 177, at 121.

shareholders are likely to want to retain their power within their family. Children and relatives of the controlling shareholder therefore have an excellent chance of being promoted to the top job. As outsiders are destined never to arise above the middle level management ranks, the internal tournaments for jobs at these firms will offer much lower prizes to outsiders.

B. Do Dispersed Ownership and the Winner-Take-All Culture Increase Executive Pay Levels?

If the American CEO has powers significantly greater than those of CEOs in other countries, then tournament theory would predict that the prize for winning the competition at the American firm would be far greater than that at foreign firms. Why might this be the case? I have already suggested some reasons that might explain these differences in the preceding section: American CEOs may have greater decision-making powers, they may run larger firms, and they may have more impact on firm value. In this section, I develop two more complementary hypotheses: first, that the dispersed ownership structures at U.S. firms give their CEOs more power than foreign CEOs and increase the need for stock option compensation; and, second, that the American winner-take-all culture condones super payoffs to the victors which are culturally unacceptable abroad.

1. Dispersed Shareholder Ownership Increases the Tournament Prize and the Use of Stock Options

The stereotypical large American publicly traded company has a widely dispersed shareholder base. This has two important effects on executive pay: it gives CEOs more power because shareholders are ineffective checks on their actions; and it increases the need for stock options, which can lead to enormous pay increases in bull stock markets. While the first of these points has been previously discussed,¹⁸⁴ the second requires some additional elaboration.

Agency costs in American corporations are an important problem because there is no one shareholder, or group of shareholders, with sufficient equity ownership to monitor managers as closely as in many foreign systems where similar sized firms will have a controlling shareholder. Instead, shareholders of U.S. firms rely more upon alternative corporate governance techniques to insure that managers act in the shareholders' best interests, including alignment devices

184. See *supra* notes 51-111 and accompanying text.

such as incentive pay systems.¹⁸⁵ If managers' pay is based on the return that shareholders receive, executives will have a financial incentive to act in a manner that serves the interests of those who own equity.¹⁸⁶

For executives, though, substituting stock options for other forms of compensation increases the riskiness of their pay package. As several scholars have shown, executives discount the value of stock option awards to reflect this risk.¹⁸⁷ As a result, in order to maintain the value of the tournament prize, companies must offer the winner more options and greater upside potential to compensate for the higher risks of no returns if the options fail to pay off. In other words, the potential prize for CEOs is increased so as to compensate them for the additional risk element added to their compensation packages for alignment purposes.

This analysis of the role of stock options makes sense in dispersed ownership systems, such as the United States and Britain. Not surprisingly, investors in the U.S. and the U.K. have, at least until very recently, strongly advocated the use of pay for performance in executive compensation.¹⁸⁸ Moreover, shareholders in both countries have generally been content to see executive pay rise substantially so long as the increase has been incentive oriented.¹⁸⁹ Pay packages that carried large components of stock options yielded enormous returns in the booming stock markets of the 1990s.

185. For a more detailed outline of the points made here, see Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 14-15, 17 (1999).

186. On this philosophy, see, for example, ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 221-22 (2d ed. 2001); Albie Brooks et al., *Issues Associated with Chief Executive Officer Remuneration: Shareholders' Perspectives*, 17 COMPANY & SEC. L.J. 360, 363 (1999); John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, ECON. POL'Y REV., Apr. 2003, at 27, 29-30; Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 279-80 (1999).

187. See, e.g., BRIAN HALL & KEVIN J. MURPHY, STOCK OPTIONS FOR UNDIVERSIFIED EXECUTIVES 2-3 (USC Marshall Sch. of Bus., Working Paper No. 01-16, 2001); Lisa K. Muelbroek, *The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options*, FIN. MGMT., Summer 2001, at 5.

188. Cheffins & Thomas, *supra* note 164, at 308. On the United States, see also Daisy Maxey & Richard C. ten Wolde, *Fund Managers Watch CEO Pay When Shopping*, ASIAN WALL ST. J., May 27, 1998, at 19; Stuart L. Gillian, *Has Pay for Performance Gone Awry? Views from a Corporate Governance Forum*, RES. DIALOGUE, July 2001, at 1, 3. On the U.K., see also Mary Fagan, *How Not to Skin a Fat Cat*, SUNDAY TELEGRAPH, July 18, 1999, at 21.

189. Cheffins & Thomas, *supra* note 164, at 294, 312 (noting, though, that British shareholders might be more prepared to take a stand against lucrative pay arrangements than American investors). On the U.K., see also David Robertson, *Fat Cats To Be Collared*, SCOT. ON SUNDAY, Apr. 4, 1999, at B5.

In a country with concentrated shareholder ownership, corporate governance systems operate differently. Control shareholder(s) have strong financial incentives to monitor, to discipline, and, if necessary, to remove disloyal or ineffective managers.¹⁹⁰ As control shareholders can effectively constrain self-serving managerial conduct, the agency cost rationale for incentive-oriented pay falls away to a large extent.¹⁹¹ Monitoring, in other words, will function as a substitute for performance-related compensation.

Performance-oriented pay is less useful for other reasons as well. First, control shareholders may be concerned about granting large option awards to top managers for fear of diluting their control of the firm.¹⁹² Second, foreign executives may attach less value to restricted stock, or stock options, if their companies are privately held.¹⁹³ Even for publicly traded firms, they may have a small free float of their stock because of their concentrated ownership structure, thereby reducing the value of their stock price as a gauge of managerial performance.¹⁹⁴ In short, concentrated ownership systems have to some degree suppressed adoption of the performance-oriented compensation model associated with American executive pay.

190. Brian R. Cheffins, *Minority Shareholders and Corporate Governance*, 21 COMPANY L. 41, 42 (2000).

191. Todd T. Milbourn, *Financial Systems and Corporate Governance*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 170, 172 (1998); Ramaswamy, *supra* note 110, at 71; Giorgio Brunello et al., *Executive Compensation and Firm Performance in Italy*, 19 INT'L J. INDUST. ORG. 133, 139-40 (2001); YUN W. PARK ET AL., CONTROLLING SHAREHOLDER AND EXECUTIVE INCENTIVE STRUCTURE: CANADIAN EVIDENCE 1-2 (Working Paper, 2000). Note, though, that tournament theory predicts that incentive-based compensation may be used more extensively for lower-ranking executives in companies with concentrated ownership structures. THOMAS BATES ET AL., PROMOTION INCENTIVES AND EXECUTIVE COMPENSATION IN FAMILY FIRMS 16 (Working Paper, 2000).

192. BATES ET AL., *supra* note 191, at 17.

193. John M. Abowd & David S. Kaplan, *Executive Compensation: Six Questions that Need Answering*, J. ECON. PERSP., Fall 1999, at 145, 156 (1999); Andrea Melis, *Corporate Governance in Italy*, in 8 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 347, 353 (2000); Mazur, *supra* note 43; Tara Parker-Pope, *So Far Away*, WALL ST. J., Apr. 11, 1996, at R12; *see also* Yun M. Park, *Executive Pay Practices in Family Controlled Firms in Canada: A Preliminary Study*, in INNOVATION AND ENTREPRENEURSHIP IN WESTERN CANADA: FROM FAMILY BUSINESSES TO MULTINATIONALS 321 (James J. Chrisman et al. ed., 2002) (saying that fear of self-dealing by controlling shareholders will deter executives from seeking stock-based incentives).

194. A smaller size float results in more noise in stock price movements, that is, changes that are unrelated to prospective future earnings. *See, e.g., Throw Out the Rule-Book*, ECONOMIST, May 26, 2001, at 112; Maurizio Dallocchio, *Why Do Italian Stocks Read Like Opinion Polls?*, WALL ST. J. EUR., June 11, 2001, at 7.

Empirical evidence from Canada, India, and Italy confirms this hypothesis.¹⁹⁵

In recent years, some scholars have argued that empirical evidence reveals that Continental European countries are moving toward more dispersed ownership structures at larger companies. Markets for equity securities have become more developed throughout the world.¹⁹⁶ Outside of the United States, data compiled by the Conference Board show a measurable decline in the stakes held in the 25 largest corporations by banks and non-financial companies in Germany, France, and Japan.¹⁹⁷ These holders were the traditional allies of the founding families and managements that ran the largest European and Japanese corporations.

At the same time, more activist shareholders are accumulating larger positions in these firms. For example, U.S. and U.K. institutional shareholders' stakes in the forty largest companies on the Paris bourse have now increased to roughly 35 percent.¹⁹⁸ More generally, U.S. institutional shareholders have dramatically increased their investments in foreign equities. Thus, the largest twenty-five U.S. pension funds held \$110.8 billion in foreign equities in 1996, but by September 1999, this figure had grown to \$265.5 billion.¹⁹⁹

Assuming for the moment that a movement toward more dispersed ownership is occurring, or will occur, this could have significant implications for international executive pay trends. For example, if the movement toward increased portfolio investment by pension funds, mutual funds, and other financial institutions from the U.S. and the U.K. continues,²⁰⁰ then when companies from continental

195. Brunello et al., *supra* note 191, at 141, 155; Park, *supra* note 193, at 321; Ramaswamy et al., *supra* note 110; PARK ET AL., *supra* note 189, at 8, 10.

196. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 452 n.21 (2001) (discussing development of equity markets in Latin America).

197. JOHN COFFEE, JR., THE RISE OF DISPERSED OWNERSHIP: THE ROLE OF LAW IN THE SEPARATION OF OWNERSHIP AND CONTROL 14-15 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 182, 2001); see Brancato, *Corporations Outside U.S. Become More Subject to Investor Demands*, CORPOR. GOVERNANCE ADVISOR, July/Aug. 2000, at 1. The data cited are for a one year period between September 30, 1998 and September 30, 1999. For France, they show a drop from 33.5 percent to 30.2 percent, in Germany, 24.2 percent to 17.8 percent, and in Japan, 21.2 percent to 14 percent. COFFEE, *supra*, at 14-15. For such a short time period, this represents a very substantial unwinding of these traditional shareholders positions, although this study did not document where the shares sold came to rest.

198. COFFEE, *supra* note 197, at 15 n.22; see John Tagliabue, *Resisting Those Ugly Americans*, N.Y. TIMES, Jan. 9, 2000, § 3, at 1, 10.

199. COFFEE, *supra* note 197, at 15.

200. William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 234 (1999); Robert Graham, *A Punctured Reputation*, FIN. TIMES, Sept. 29, 1999, at 24; *Lean*,

Europe, Asia, and Latin America raise funds on international capital markets, they may be more responsive to the preferences of these institutions.²⁰¹ American and British institutional shareholders have historically been more favorably disposed towards incentive-oriented managerial remuneration.²⁰² Thus, a shift toward less concentrated stock ownership could cause executive pay at these firms to shift toward awarding more options and incentive-based pay.²⁰³ If stock markets regain their upward momentum, this would lead to pay increases abroad.

More comprehensive data compiled by Van der Elst, although showing some shifts toward more dispersed ownership, still illustrate the continued importance of control shareholder ownership structures. Van der Elst finds, consistent with the evidence cited above, the strength of the nonfinancial sector is decreasing in most European countries, while foreign and institutional investors' holdings are increasing.²⁰⁴ In Germany, for example, from 1990 to 1999, data on 500 nonfinancial companies show that the percentage of widely held companies increased from less than 15 percent to more than 25 percent.²⁰⁵ A similar shift can be seen in Belgium, although not in France and Italy.²⁰⁶

However, it does not appear that control shareholders are disappearing in the Continental European companies. One indication of this continued presence is that the size of the average voting block of the largest shareholder in all Continental European country firms

Mean European, *ECONOMIST*, Apr. 29, 2000, at 5; Mary O'Sullivan, *Corporate Governance and Globalization*, 570 *ANNALS AMER. ACAD. POL. & SOC. SCI.* 153, 167 (2000).

201. Thomas Kamm, *Continental Drift: Europe Marks a Year of Serious Flirtation with the Free Market*, *WALL ST. J.*, Dec. 30, 1999, at A1; *The Pull of the Markets*, *LATIN FIN.*, Mar. 1, 2001, at 14; Sara Calian, *Foreigners Make European Firms More Shareholder Friendly*, *WALL ST. J.* (Interactive Edition), July 26, 2001; see also Patrick J. Lyons, *A Global Vote for U.S. Style of Corporate Openness*, *N.Y. TIMES*, May 9, 1999 (saying that the priorities of German and Japanese institutional investors were similar to those of their Anglo-American counterparts), 1999 WL 9884074.

Some commentators are skeptical that these investors will have much influence over managerial decisions. *The Chaebol Spurn Change*, *ECONOMIST*, July 22, 2000, at 59-60; Craig Karmin, *Corporate-Governance Issues Hamper Emerging Markets*, *WALL ST. J.*, Nov. 8, 2000, at C1; Peter Martin, *Anglo-Saxon Angst*, *FIN. TIMES*, Sept. 2/3, 2000, at 18; Phillip Webster, *Italy's Grand Families Back in the Frame*, *SUNDAY BUS.*, Aug. 5, 2001, at 14. Thus, it cannot be taken for granted that the preferences which U.S. and U.K. investors have concerning executive pay arrangements will have more than a marginal influence for the foreseeable future.

202. See *supra* notes 35-40 and accompanying text.

203. See *France's Boardroom Revolution*, *WALL ST. J.*, Oct. 17, 1995, at A20; Tom Leander, *The Global Shakeup in Executive Compensation*, *GLOBAL FIN.*, Aug. 1998, at 12-14; David Woodruff, *Europe, A Latecomer, Embraces Options*, *WALL ST. J.*, May 15, 2001, at A18.

204. VAN DER ELST, *supra* note 47, at 22, 27.

205. *Id.* at 28-29.

206. *Id.* at 30-33.

remains more than twice as large as that of U.S. and U.K. firms.²⁰⁷ Similarly, control shareholder ownership stakes remain very high at newly listed companies in continental Europe²⁰⁸ and at other listed companies.²⁰⁹ If this pattern continues, controlling shareholders presumably will still play a dominant role even if the current move to the public stock market remains on track.²¹⁰ Finally, the number of companies with control shareholders is much greater in continental European countries than in the United States and United Kingdom, and shows little sign of changing.²¹¹

This Article concludes that if the Continental European countries are moving toward more dispersed ownership structures, which remains a debatable point, the move appears to be very gradual. If shareholder dispersion is in fact not emerging in Continental Europe, this will slow any shifts towards the use of stock options. On the other hand, if such dispersion is increasing, then the move toward bigger tournaments for foreign CEOs may be underway, with higher executive pay checks not far behind.

2. Does the Winner-Take-All Culture Affect Executive Pay?

Even if Tournament Theory would lead us to conclude that foreign CEOs should be getting paychecks more along American lines, there may be cultural reasons why big differences in pay may be less acceptable abroad. In other words, cultural factors may prevent companies outside of the United States from conducting tournaments

207. *Id.* at 35. The median value for the average voting block of the largest shareholder of American and British firms is around 15 percent, whereas in continental Europe, the values range from a low of 36.6 percent in Spain to 41.7 percent in Belgium, 46.1 percent in Germany, 48.1 percent in Italy, and 52 percent in France. *Id.* Furthermore, in some countries, only nonvoting stock is traded on the stock market. *Id.*

208. *Id.* at 37 (showing that the average voting block of the largest shareholder at newly public firms is more than 50 percent in Italy and France, almost 50 percent in Belgium, and more than 40 percent in Spain and Germany); see MARC GOERGEN, CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: A STUDY OF GERMAN AND U.K. INITIAL PUBLIC OFFERINGS 51-56, 78-83 (1998) (examining the U.K. and Germany); Wayne H. Mikkelson et al., *Ownership and Operating Performance of Companies that Go Public*, 44 J. FIN. ECON. 281, 286-89 (1997) (examining the U.S.); Marco Pagano et al., *Why Do Companies Go Public? An Empirical Analysis*, 53 J. FIN. 27, 56-60 (1998) (examining Italy); MARTIN HOLMÉN & PETER HÖGFELDT, A LAW AND FINANCE ANALYSIS OF INITIAL PUBLIC OFFERINGS 20-21, 24 (Working Paper, 2003) (examining Sweden).

209. VAN DER ELST, *supra* note 47, at 37-38 (stating that the concentration of voting rights is even greater at other stock exchange listed companies than with newly listed companies).

210. Cheffins, *supra* note 185, at 36 (discussing the situation in Italy).

211. VAN DER ELST, *supra* note 47, at 39-41 (providing data showing that in the United States and the United Kingdom slightly more than 10 percent of firms surveyed were majority controlled, with much higher numbers in Continental European countries like Italy (62 percent), France (57.5 percent), and Germany (48.5 percent)).

that offer such highly lucrative prizes.²¹² If this is true, it could help explain the lower levels of executive pay abroad.

Legal academics are just beginning to appreciate the importance of culture as an explanatory variable for differences in corporate governance systems.²¹³ One problem has been the difficulty of defining culture precisely,²¹⁴ as many things ascribed to it boil down to particular legal and financial arrangements.²¹⁵ Still, culture may be pivotally important in the area of comparative corporate governance and is frequently cited as an explanation for why executive pay arrangements differ considerably on a country-by-country basis.²¹⁶ This section will therefore examine culture as a factor in determining executive pay and define it as a society's shared values, understandings, and assumptions.²¹⁷

When culture is invoked to analyze executive pay, a common refrain is that the milieu is different in the United States than it is elsewhere. The United States is said to be highly "tolerant of income inequality, especially if the inequality is driven by differences in effort, talent or entrepreneurial risk taking."²¹⁸ Certainly, if we look at the Gini coefficients for income distribution, the U.S. income distribution is more unequal than in Japan or the continental European countries.²¹⁹ The "winner-take-all" orientation of Americans²²⁰

212. Legal arrangements could constrain the size of the prize awarded in the tournament. For example, Australia and Germany have legal rules that require executive pay at public companies to be reasonable. CHEFFINS & THOMAS, *supra* note 2. In practice, however, the impact of these regulations is minimal. *Id.* The United States also imposes a reasonableness requirement for executive compensation but only for closely held companies. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 600-01 (2001). Courts apply this standard to discourage close corporations from paying their executives disguised dividends to reduce their tax burden. *Id.*

213. Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance System*, 26 DEL. J. CORP. L. 147, 152-57 (2001) [hereinafter Licht, *The Mother of All Path Dependencies*]; AMIR N. LICHT ET AL., CULTURE, LAW, AND FINANCE: CULTURAL DIMENSIONS OF CORPORATE GOVERNANCE LAWS 3-4 (Working Paper, 2001).

214. Licht, *The Mother of All Path Dependencies*, *supra* note 213, at 166.

215. *Back on Top?*, ECONOMIST, Sept. 16, 1995, at 15.

216. Conyon & Murphy, *supra* note 35, at F667-68; Steven E. Gross & Per L. Wingerup, *Global Pay? Maybe Not Yet!*, COMPENSATION & BENEFITS REV., July-Aug. 1999, at 25; Sydney R. Robertson, *Establishing Global Compensation Strategies*, in THE COMPENSATION HANDBOOK: A STATE-OF-THE-ART GUIDE TO COMPENSATION STRATEGY AND DESIGN 606-07 (Lance A. Berger & Dorothy R. Berger ed., 4th ed. 2000); Jill Elswick, *Relative Values*, EMPLOYEE BENEFIT NEWS, June 15, 2001, 2001 WL 7984504.

217. See HELEN DERESKY, INTERNATIONAL MANAGEMENT: MANAGING ACROSS BORDERS AND CULTURES 105 (3d ed. 2000).

218. Conyon & Murphy, *supra* note 35, at F667.

219. DWIGHT H. PERKINS ET AL., ECONOMICS OF DEVELOPMENT 121 (5th ed. 2001).

220. ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY (1995) (coining this term).

provides a hospitable platform for lucrative performance-oriented executive pay.²²¹ This influential theory claims that American society is built around the principle that the winner of any competition, including that to become a corporate CEO, is entitled to capture enormous benefits.²²²

In contrast, in Japan and Europe, many commentators have claimed that there are strong egalitarian impulses against large pay differentials²²³ or conspicuous displays of wealth.²²⁴ Such feelings were quite evident in the recent national uproar in Sweden over the severance pay package awarded by Swiss industrial giant ABB to Percy Barnevik. The uproar ultimately led that company's board of directors to demand the return of much of these monies, and badly tarnished Barnevik's image as a corporate governance reformer.²²⁵ Culture therefore frequently is offered as a reason why executive pay is much lower outside the United States.²²⁶

Culture may constrain executive pay levels even in the English Commonwealth countries, including the United Kingdom, Canada and Australia, which have many similarities in corporate governance structures to the American system.²²⁷ For instance, "[t]he British [are claimed to] have always been suspicious of wealth, particularly of the rich who made their money in the marketplace."²²⁸ This bias may partly explain why U.K. executive pay arrangements have historically not been as lucrative or performance-oriented as those in the United

221. James Cox, *U.S. Success Draws Envy, Protests*, USA TODAY, Aug. 3, 2000, at B1; Michael Crawford, *Peanuts for Elephants*, CANADIAN BUS., July 1994, at 16-17; Richard Morais et al., *The Global Boss' Pay: Where (and How) The Money Is*, FORBES, June 7, 1993, at 90; Maria Slade, *NZ Executives Paid Third World Salaries*, INDEP. BUS. WKLY., Sept. 26, 1997, at 23. For anecdotal evidence consistent with this view, see David Leonhardt, *Executive Pay Drops Off the Political Radar*, N.Y. TIMES, Apr. 16, 2000, 2000 WL 21240320.

222. This theory also may explain why U.S. non-CEO executives are not paid much better than their counterparts elsewhere: the focus in America is on winning the tournament. The losers will receive much smaller rewards.

223. Shirley Fung, *How Should We Pay Them?*, ACROSS THE BOARD, June 1999, at 39; see also Gross & Wingerup, *supra* note 216; Tara Parker-Pope, *supra* note 193, at R12.

224. See, e.g., Shawn Tully, *American Bosses Are Overpaid... Or Their Counterparts in Europe Are Underpaid*, FORTUNE, Nov. 7, 1988, at 124. Hence, the adage in Japan: "When in public, wear cotton. If you must wear silk, wear it at home." Michael Berger, *A Look at Salaries in Japan*, S.F. CHRON., May 9, 1988, at B8.

225. Charles Goldsmith, *Barnevik Saga Could Hold Sweden Back*, WALL ST. J., Feb. 21, 2002, at A14.

226. Deborah Orr, *Damn Yankees*, FORBES, May 17, 1999, at 206-07; see also Herbert A. Henzler, *The New Era of Eurocapitalism*, HARV. BUS. REV., Jul.-Aug. 1992, at 60; David Cay Johnston, *American-Style Pay Moves Abroad: Importance of Stock Options Expands in Global Economy*, N.Y. TIMES, Sept. 3, 1998, at C1.

227. On business culture typologies, see DERESKY, *supra* note 217, at 117-18.

228. William Rees-Mogg, *The Fat Cat is the Pensioner's Friend*, TIMES, June 3, 1996, at 20; see also Parker-Pope, *supra* note 193, at R12.

States.²²⁹ Similarly, executive pay differentials between the United States and Canada may come from fundamental cultural differences,²³⁰ such as Canada's "stubborn egalitarian streak."²³¹ In Australia, managerial compensation experts make the same claims to account for lower executive pay there.²³²

For our purposes, the cultural explanation for executive pay differentials has two important aspects. The first arises out of internal corporate checks: executives are said to find the large American pay packages distasteful.²³³ To the extent that internal corporate cultures firmly embody such self-restraint, it will act as something of a brake on a move towards U.S.-style executive compensation.

Culture could have a second effect on executive pay through a broader societal resistance to higher executive pay.²³⁴ When executive pay packages become sufficiently lucrative, they may violate equity norms within society and cause a backlash.²³⁵ Societal outrage over high corporate pay could stimulate corporate self-discipline,²³⁶ producing various social and reputation costs for the directors who set executive compensation and for the managers who are paid under generous service contracts.²³⁷ Directors will be reluctant to approve, and executives will be hesitant to seek, compensation arrangements that might be viewed by observers as outrageous.²³⁸

Even if corporate self-discipline turns out to be weak, societal outrage may act as a catalyst for government reform. For example, in

229. Conyon & Murphy, *supra* note 35, at F667-68; Martin Van der Weyer, *Too Much Cream*, INDEP., Aug. 16, 1998, at 16.

230. Crawford, *supra* note 221, at 17.

231. Deirdre McMurdy, *Taking Stock of Options*, MACLEAN'S, Apr. 28, 1997, at 49; *see also* Paul Waldie, *Canadian CEOs in Middle of Pay Pack*, GLOBE & MAIL, Apr. 26, 1999, at B6.

232. Slade, *supra* note 221, at 23; *see also* Florence Chong, *Salary Secrets: What Companies Have to Fear*, BUS. REV. WKLY, June 5, 1987, at 50; Margaret Lyons, *Australia's Top Executives: Are They Paid Too Much?*, BUS. REV. WKLY., Nov. 16, 1990, at 52; Julie McBeth, *Who Pays the Top Salaries*, BUS. REV. WKLY, Nov. 25, 1988, at 60.

233. John Burgess, *Big Bucks For Executives Finds Some Favor Abroad*, WASH. POST, Oct. 20, 1991, at H1; Gross & Wingerup, *supra* note 216, at 27; Johnston, *supra* note 226, at C1; Joann S. Lublin, *The American Advantage*, WALL ST. J., Apr. 17, 1991, at R4; Orr, *supra* note 226, at 207; Tully, *supra* note 224, at 124.

234. BEBCHUK ET AL., *supra* note 20, at 33.

235. Duncan Brown, *The Third Way: The Future of Pay and Rewards Strategies in Europe*, ACA J., 2d Q., 2000 at 15; Romesh Ratnesar, *The Get Rich Quick Option*, TIME EUR., Mar. 13, 2000, <http://www.time.com/time/europe/magazine/2000/313/stock.html>; *Those Egalitarian Swedes*, ECONOMIST, June 3, 2000, at 51.

236. CHEFFINS, *supra* note 163.

237. BEBCHUK ET AL., *supra* note 20, at 33; *see also* Alex Brummer, *Failing Brakes on Boardroom Pay*, GUARDIAN, Jun. 1, 1996, at 38.

238. BEBCHUK ET AL., *supra* note 20, at 24. For an example of this process, *see* Parker-Pope, *supra* note 193, at R12.

1993, President Clinton fulfilled a campaign pledge to halt "excessive executive pay" by spurring changes to tax law that meant a corporation which paid an executive more than \$1 million annually could only treat the expenditure as deductible for tax purposes if the additional pay was "performance-based."²³⁹ While ultimately this provision of the tax code did little to rein in pay increases,²⁴⁰ it illustrates how popular opinion can pressure governments to take direct action to reduce executive pay levels.

A second example of how public opinion can lead to reform of executive practices is the United Kingdom's Confederation of Business Industry decision to set up the Greenbury Committee. At the time, disquiet over executive pay levels had motivated the British government to contemplate introducing tougher statutory regulation.²⁴¹ Instead, the Greenbury Committee was created, and the government let it consider the matter. The Committee Report contained recommendations that prompted remuneration-oriented changes to the London Stock Exchange's listing rules.²⁴² While the work done by the Greenbury Committee did not fully satisfy the critics of executive pay,²⁴³ it does indicate that public upset can lead to reform intended to address controversial remuneration practices.

Even if culture is a barrier to higher executive pay in foreign countries, however, the U.K. experience reveals that the values in question can change. During the 1970s, British executives were paid less than their counterparts in all other major industrial countries.²⁴⁴ The British managerial culture was said to be similar to West Germany's, and U.K. companies were claimed to have highly egalitarian reward structures.²⁴⁵

Things changed dramatically in the next decade. During the 1980s, the British government was controlled by a Conservative

239. Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 714, 738 (1995).

240. BRIAN HALL & JEFFREY LIEBMAN, *THE TAXATION OF EXECUTIVE COMPENSATION* 6-7 (Nat'l Bureau of Econ. Research, Working Paper No. 7596, 2000) (finding that this rule had only a minor effect on the composition of pay packages and none on the level of total compensation).

241. CHEFFINS, *supra* note 118, at 655-57.

242. *Id.* at 375-76.

243. See, e.g., Graef Crystal, *Need a Good Laugh? Look at Caps on Executive Pay*, L.A. TIMES, May 21, 1995, at D2; *How Greenbury Has Boosted Executive Excess*, INDEP. (London), June 29, 1996, at 17.

244. *International Executive Compensation*, WHARTON MAG., Winter 1978, at 58; Hugh Parker, *The Effective Executive: What Is He Worth?*, MCKINSEY Q., Winter 1976, at 27-28.

245. See generally CHRISTEL LANE, *MANAGEMENT AND LABOUR IN EUROPE: THE INDUSTRIAL ENTERPRISE IN GERMANY, BRITAIN AND FRANCE* 131-32 (1989); Andreas Budde et al., *Corporate Goals, Managerial Objectives, and Organizational Structures in British and West German Companies*, 3 ORG. STUDIES 1 (1982).

administration imbued with a free-market ideology. Executive pay practices changed profoundly. In 1988, *Fortune* magazine declared that: "A pay revolution is shaking Britain. Prime Minister Margaret Thatcher's bracing brand of capitalism brought not just tax cuts and high profits but also a profound change in public attitudes. Big pay packages are no longer frowned upon."²⁴⁶ Managerial compensation took off between the time when the Conservatives took office in 1979 and 1994 so that the gross pay of chief executives in larger U.K. public companies rose nearly 600 percent.²⁴⁷ By virtue of this surge, by the mid-1990s British CEOs were among the better paid in the industrialized world.²⁴⁸

Over the past year, public concerns about big pay gaps seem to have grown. In many European countries, there have been cries of outrage over American-style pay packages awarded to local executives.²⁴⁹ Even in the United States, the popular press has decried big pay packages and the gap between the top managers and lower level employees.²⁵⁰ It is too soon to tell if this shift in attitudes will have a lasting impact on the international CEO pay gap.

VI. OPPORTUNITY COST THEORY

The Opportunity Cost Theory claims that the returns to skilled labor, such as top corporate management, have increased in the U.S. in recent years.²⁵¹ This has occurred as increased access to financial markets has driven down the barriers to entry in many industries, which, accompanied by increased international competition, has forced large vertically integrated firms to break up and allowed the development of many smaller niche firms. The human capital required by these smaller firms is much less firm specific than before, allowing

246. Tully, *supra* note 224, at 132; see Van der Weyer, *supra* 229 (discussing how matters progressed in the following decade).

247. David Goodhart, *In Search of Wages that Work*, FIN. TIMES, June 27, 1994, at 16.

248. Abowd & Kaplan, *supra* note 193, at 146. It is possible that the 1970s were exceptional and the pay surge in the 1980s and 1990s brought matters back into line with longer-term trends. Derek Matthews, *Fat Is a Relative Issue*, MGMT. TODAY, June 1996, at 53.

249. Jennifer Hill & Charles M. Yablon, *Corporate Governance and Executive Remuneration: Rediscovering Managerial Position Conflict*, 25 U. NEW S. WALES L.J. 1, 11 (2002).

250. See, e.g., Simon London, *A Risky Option*, FIN. TIMES, July 1, 2002, at 19. See generally CONFERENCE BD., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE (Working Paper, 2002) (citing excessive use of stock options, lax boards of directors, and other factors as causes of excessive executive compensation).

251. RAGHURAM RAJAN & LUIGI ZINGALES, FINANCE AND ECONOMIC FREEDOM 39 (Working Paper, 2001) (on file with author). In general, the rate of return to skilled labor is higher in the U.S. than in Europe. See generally Paul Krugman, *Past and Prospective Causes of High Unemployment*, 79 ECON. REV. 21 (1994).

skilled managers to change jobs more easily, or to create their own firms. Both of these options have led to a shift in the balance of power within firms, shifting it toward skilled labor and away from capital, thereby increasing the returns to skilled labor.²⁵² The implications of this shift in power for executive compensation are obvious: established firms will need to offer their most skilled employees, the ones that have the most alternative options for employment, a larger piece of the firm's surplus in order to retain them.

The financial revolution that has enabled American managers to gain more power as compared to capital has not, until very recently, spread to other countries. As is discussed below, Continental Europe and the market-oriented economies of Asia have not witnessed the expansion of financial markets with nearly the speed, nor to the degree, that the United States has. Furthermore, many foreign countries have smaller internal labor markets for managers, more capital intensive industries, and more restrictive legal regulations on executive pay arrangements, all of which will tend to depress executive compensation. The Opportunity Cost Theory therefore predicts that executive pay in those nations will not reach the levels seen in the United States as indeed it has not.

A. American CEOs' Opportunity Costs Are Higher than those of Foreign CEOs and Therefore American CEOs Are Paid More

By the 1930s, larger, vertically integrated firms controlled most of the U.S. economy.²⁵³ These firms employed professional salaried managers²⁵⁴ and "dominated most sectors of the U.S. economy."²⁵⁵ They were heavily capital intensive, with oligopolistic positions in their industry and protected by high barriers to entry.²⁵⁶

252. This has been accompanied by increasing income inequality in the United States. See Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437 (2002).

253. BRIAN R. CHEFFINS, INVESTOR SENTIMENT AND ANTITRUST LAW AS DETERMINANTS OF CORPORATE OWNERSHIP STRUCTURE: THE GREAT MERGER WAVE OF 1897 TO 1903, at 10 (Berkeley Olin Program in Law & Econ., Working Paper, 2002).

254. The modern multiunit business enterprise replaced the small traditional enterprise when administrative coordination permitted greater productivity, lower costs, and higher profits than coordination by market mechanisms. ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 6 (1977).

255. Raghuram Rajan & Luigi Zingales, *The Governance of the New Enterprise*, in *CORPORATE GOVERNANCE* 207 (X. Vives ed., 2000); CHEFFINS, *supra* note 253, at 5, 10 (noting that by 1932 matters had progressed to the point where "Adolf Berle and Gardiner Means could proclaim in *The Modern Corporation & Private Property* that 'a separation of ownership and control' had emerged in America's larger public companies.").

256. Large-scale production in a single firm became possible, but the new importance of physical capital made it extremely difficult to set up a competing firm. Raghuram Rajan & Luigi

Managers of these firms were unable to break away and start their own businesses because large amounts of capital were needed to start a competing firm and existing financial markets were underdeveloped.²⁵⁷ Furthermore, managers' skills were highly firm specific, with limited transferability to other industries.²⁵⁸ Steep managerial hierarchies were created with increasing power and pay to reward those that stayed with the company.²⁵⁹ Unskilled labor was minimally paid, but was able to move relatively freely to other firms to get employment. Skilled, nonmanagerial workers, however, who developed specialized human capital, were poorly paid, and unable to leave the firm without sacrificing most of their human capital.²⁶⁰ Some scholars have claimed that the result was "tremendous compression of the wages of educated, white collar workers relative to blue-collar workers."²⁶¹

Zingales, *The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms*, 116 Q.J. ECON. 805 (2001).

257. Most importantly, "given the limited alternative opportunities for specialized human capital and the difficulty of reproducing the mass of inanimate assets these corporations had created, the critical resource was inanimate assets to which the human capital was tied." Rajan & Zingales, *supra* note 255, at 208.

258. Employees could be authoritatively controlled because their skills were often specialized to the firm and were not readily marketable to other employers. *Id.* at 208. In other words, "employees were tied to the firm largely because they were technically specialized . . . there was a very limited market for their skills." *Id.* at 215. Furthermore, within the same industry, "gentleman's agreements" between competitors stopped them from poaching each other's managers. RAJAN & ZINGALES, *supra* note 251, at 16.

259. "Through its control of the firm's assets, the headquarters effectively controlled the main source of employment open to their specialized employees." Rajan & Zingales, *supra* note 255, at 208. Thus, power was concentrated at the top of the firm. "Once the command-and-control system of the MBE was in place, the main problem became one of how to guarantee enough power to employees who specialized, so as to motivate their specific investments." *Id.* at 208. The solution was steep organizational hierarchies with intermediate levels of management. "The steep hierarchy was a way for top management to cede some power to intermediate management by giving them control over some resources (the lower level employees). Higher positions in the hierarchy were associated with higher rents and were a reward for employees." *Id.*

260. RAJAN & ZINGALES, *supra* note 251, at 16-17.

261. *Id.* at 18. Wage structure narrowed considerably from 1903 to 1956, according to one study. CLAUDIA GOLDIN & LAWRENCE F. KATZ, THE RETURNS TO SKILL ACROSS THE TWENTIETH CENTURY UNITED STATES 5 (Nat'l Bureau of Econ. Research, Working Paper No. 7126, 1999) (citing Paul G. Keat, *Long-Run Changes in Occupational Wage Structure, 1900-1956*, 68 J. POL. ECON. 584 (1960)), <http://www.economics.harvard.edu/~goldin/papers/inequality.pdf>. This narrowing was attributed to "decreased costs of training and education, in part due to the increase in publicly funded formal education." *Id.* (citing Harry Ober, *Occupational Wage Differentials, 1907-47*, MONTHLY LAB. REV. 274 (1948)). Another study found the wage structure narrowing from 1907 to 1947, principally during the late 1910s and the late 1930s to 1947; this study attributed the narrowing to "inflation, changes in 'fairness' norms in setting wages at the lower end, and automation in rendering many unskilled jobs superfluous." *Id.* at 6 (citing Ober, *supra*).

These vertically integrated firms continued to grow until the 1970s.²⁶² Beginning around that time, several forces combined to force their break up. Although the relative importance of these forces in bringing about the breakup cannot be unraveled completely, three things in particular should be focused on: increased openness in trade and markets, financial innovations, and new technologies.²⁶³ Increasing international trade expanded product markets so that domestic oligopolies had to do battle with their international brethren.²⁶⁴ This pressured domestic firms to deconstruct themselves to purchase intermediate goods from more efficient providers, and created new openings for smaller, intermediate good manufacturers to supply both domestic and international competitors.²⁶⁵

A second important force leading to the breakup of the integrated firms was the development of new, more flexible technologies.²⁶⁶ These improvements led to smaller firms, as they reduced the scale required for efficient production, the costs of exchanging information with other firms, and the costs of transacting with outsiders.²⁶⁷ As intermediate good producers flourished, even the larger, vertically integrated firms needed to restructure themselves to use outside products where they made economic sense.²⁶⁸ Beginning in the mid-1970s, more and more smaller firms have emerged, and the average firm size in the U.S. economy has shrunk.²⁶⁹ These new intermediate-sized competitors are potential employers and skilled workers thus have a choice to quit the big companies if they become dissatisfied.

262. RAJAN & ZINGALES, *supra* note 251, at 21.

263. *Id.* at 22-27.

264. Cross-border trade has expanded market size tremendously, "doing away with previously oligopolistic national markets and dissipating the first mover advantage." Rajan & Zingales, *supra* note 255, at 212.

265. RAJAN & ZINGALES, *supra* note 251, at 22. Traditionally, Japanese industrial firms would outsource at the intermediate level. Rajan & Zingales, *supra* note 255, at 213. Increased international trade therefore placed subunits of vertically integrated American firms in competition with independent intermediate suppliers from Japan. *Id.* The latter were typically more efficient, because they did not have the luxury of being subsidized by a larger vertically integrated firm. Therefore, once international markets opened, these American subunits that were not competitive and had to be divested, breaking up vertical integration. *Id.*

266. Raghuram G. Rajan & Luigi Zingales, *The Influence of the Financial Revolution on the Nature of Firms*, AM. ECON. REV.: PAPERS & PROCEEDINGS OF THE AM. ECON. ASS'N, May 2001, at 206, 209.

267. RAJAN & ZINGALES, *supra* note 251, at 24.

268. Rajan & Zingales, *supra* note 255, at 213.

269. RAJAN & ZINGALES, *supra* note 251, at 29. Mega-mergers in the 1990s may have increased firm size during that time period, but this did not fully offset the decline from the mid-1970s. *Id.* at 30.

Third, there were substantial financial innovations, and ultimately a financial "revolution" that facilitated the change. Financial innovations contributing to the breakup of vertically integrated firms included the MBO. In the 1980s, a wave of manager-driven leveraged buyouts emerged as the "[m]anagers of profitable units sought complete independence . . . pay[ing] their parent firm to be set free."²⁷⁰ MBOs liberated frustrated managers that wanted to start up their own firms. Suddenly large pools of capital were available to finance new private firms either by buying divisions of existing larger companies or by purchasing an entire firm. Executive compensation at these firms was heavily skewed toward equity ownership with the new managers receiving large amounts of stock options and/or restricted stock.²⁷¹

Venture capital became "a major source of funding for new technology-based firms and play[ed] a crucial role in promoting the radical innovations often carried out by these firms."²⁷² Venture capital in the United States exploded during the 1990s, from \$2.65 billion in venture capital investments in 1991 to \$9.42 billion in 1996; in 1995 there was \$37.2 billion under venture capital management.²⁷³ Venture capital in North America is oriented toward high-technology sectors ("communications, information technology and health and biotechnology") with "more than 80 percent of total VC investment in the U.S. and around 67 percent in Canada. This is far above the figures for Japan and the EU."²⁷⁴ It became the leading source of start-up capital for many innovative sectors of the American economy during this time.

At the same time, there was a veritable revolution in American financial markets. As Rajan and Zingales state:

The ability of financial institutions to price a variety of exotic instruments, and to assess and spread risks, has increased. More data on potential borrowers is now available, and it is also more timely. Improvements in accounting disclosure have resulted in greater borrower transparency. Deregulation has resulted in greater competition and better

270. RAJAN & ZINGALES, *supra* note 251, at 23. "Leveraged buyouts provide management with the opportunity, through the use of debt, to acquire ownership of the corporation and to make large profits." James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121, 122 (1988). The profit potential for managers was even greater when they could use inside information to pay shareholders less than fair value. *Id.*

271. The volume of LBOs in the United States peaked at more than \$160 billion in 1988. See Arthur Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 328 n.464.

272. OECD SCOREBOARD, *supra* note 140, at 44.

273. Gerald Hane, *Comparing University-Industry Linkages in the United States and Japan*, in *INDUSTRIALIZING KNOWLEDGE: UNIVERSITY-INDUSTRY LINKAGES IN JAPAN AND THE UNITED STATES* 20, 42 (Lewis M. Branscomb et al. eds., 1999).

274. *Id.*

prices in financial markets. Finally, regulatory barriers protecting the turf of different kinds of financial institutions have come down, resulting in the emergence of new institutional forms.²⁷⁵

The increased availability of capital has made "alienable assets such as plant and equipment easy to come by," making the primary means by which a traditional firm controlled managers, control of expensive physical assets,²⁷⁶ no longer powerful as a means of control; "[i]f need be, [managers] can break away, raise finance directly in the market, and replicate the assets."²⁷⁷

The opportunities for American executives expanded tremendously. For example, the internet boom of the late 1990s created great opportunities for U.S. managers to start up new businesses. Sparked by the high level of potential returns, massive amounts of financial capital moved into high tech and other internet-oriented industries. Almost anyone with a good idea and a modest amount of managerial experience could start up a new firm. Although this boom lasted less than a decade, it had a dramatic effect on executive pay levels.

These changes increased the employment options for managers, at least for a period of time.²⁷⁸ More flexible production technologies, and more similar production processes, have increased skilled workers' mobility. New access to financial markets has allowed unhappy managers, or skilled workers, to leave established firms and

275. Rajan & Zingales, *supra* note 266, at 206.

276. *Id.* at 207.

277. *Id.* Under the traditional regime, when physical assets were paramount, owners permitted managers to reinvest because "this secured them property rights on growth opportunities," while it enhanced the "career and earnings potential" for managers. *Id.* After the "revolution," during the 1980s, managers "had to make a case to shareholders that the investment would be profitable, and a variety of mechanisms were put in place to compel insiders [managers] to repay cash if the case was found wanting. These changes . . . helped sever the link between assets in place and growth opportunities." *Id.* Managers could just as easily convince *outside* investors of the value of their projects as current shareholders, so taking their new ventures outside the firm was now much more feasible. *Id.* at 207-08.

In other words, the financial revolution has subjected internal decisions to greater scrutiny, while making outside decisions easier. Unless there is a strong complementarity between assets in place and growth opportunities from a technological point of view, there is no reason why new opportunities should be undertaken within the legal shell represented by the existing company.

Id. at 208.

278. RAJAN & ZINGALES, *supra* note 251, at 26.

start-up their own companies.²⁷⁹ Capital investment needs have become much less of a barrier to entry in most industries.²⁸⁰

Individual executives' greater potential to move from current jobs raises their opportunity cost of working at an established firm.²⁸¹ Increased bargaining power for skilled managers permits them to hold firms hostage, extracting rents from these firms even if there are perfectly competitive capital markets. This is particularly true for skills, such as managerial talent, that are in high demand.²⁸²

Human capital has become increasingly important in today's marketplace.²⁸³ This trend is evidenced by the sharp increase in the percentage of firms' value that is not attributable to physical assets, illustrating that human capital's value to the firm has increased.²⁸⁴ In other words: "The view of the corporation of old was one where capital hired labor. The modern corporation could equally well be thought of as labor renting capital."²⁸⁵

Talented managers' value has increased with the value of human capital.²⁸⁶ The power to control human capital, the key to the

279. Raghuram G. Rajan & Luigi Zingales, *Financial Systems, Industrial Structure, and Growth*, 17 OXFORD REVIEW OF ECONOMIC POLICY 467, 470 (2001).

280. RAJAN & ZINGALES, *supra* note 251, at 29. "Improvements in financial markets have made it easier to finance large investments, so capital intensity is no longer a source of protection against competition." Rajan & Zingales, *supra* note 255, at 212.

281. These changes may also increase income inequalities within the U.S. Studies have documented the increased inequality in wage levels between highly skilled workers and the lowest level wage earners. From 1963 to 1989, for instance, one study found that real wages for the most skilled workers rose by about 40 percent, whereas those of the least skilled labor group declined by about 5 percent. Chinhui Juhn et al., *Wage Inequality and the Rise in Returns to Skill*, 101 J. POL. ECON. 410, 411 (1993). Years of schooling and labor market experience did not account for much of this increased wage differential.

Other studies have found evidence of an increased demand for skilled labor in the American economy. See Lawrence Katz & Kevin Murphy, *Changes in Relative Wages 1963-1987: Supply and Demand Factors*, 107 Q.J. ECON. 35, 76-77 (1992).

282. Juhn et al., *supra* note 281, at 441.

283. Stephen Machin & John Van Reenan, *Technology and Changes in Skill Structure: Evidence from Seven OECD Countries*, 113 Q. J. ECON 1215, 1217 (1998). Rajan and Zingales offer the financial sector as an example. Previously, when financial capital was less available, loan officers at banks were simply dispensers of funds; they had little value without their access to the bank's funds. See Rajan & Zingales, *supra* note 255, at 210-11. "Competition from markets and other institutions" made the ability to channel funding less unique. *Id.* Now, the loan officer's value is derived from "new ideas for structured financing for firms . . . [and] innovative and customized deals." *Id.* at 211. The loan officer's value to the bank is now rooted in "human capital, both in terms of her product and industry knowledge, and her client relationships." *Id.*

284. See, e.g., BARUCH LEV, *INTANGIBLES* (2001) (arguing that "[w]ealth and growth in today's economy are driven primarily by intangible (intellectual) assets").

285. RAJAN & ZINGALES, *supra* note 251, at 33.

286. Rajan and Zingales point to the bond trading group at Salomon Brothers in the late 1980s and early 1990s as an example. The head of the group, John Meriweather, was fired after a "misguided attempt to corner the Treasury bill auction" hurt the firm badly. See Rajan &

smooth functioning of teams of skilled labor at many modern corporations, rests in the hands of those executives with the managerial skills to resolve interpersonal conflicts, and the investment skills to deploy financial capital wisely.²⁸⁷ The returns to these workers have increased commensurately.

What are the implications of these trends for executive pay? As Rajan and Zingales state:

Firms pay their managers more, not so much to provide incentives, though couching it in those terms keeps shareholders more docile, but because the labor market for top managers gives them no alternative. Furthermore, as assets are no longer sufficient for investors to exercise control over the firm, it is supremely important to have the right top management team, building links to the rest of the firm. . . . All of this is not to say that there is not the occasional "pet" board that rewards its CEO for spectacular underperformance, but rather that the trend is too important to be dismissed as simply greed or the sudden discovery that incentives matter.²⁸⁸

High executive pay is thus a reflection of skilled managers' value to firms in a world where human capital has become crucial.

The Opportunity Cost Theory also provides an explanation for the increased disparity in recent years in the pay ratios between executives and other workers. Wages were tightly compressed in the era when capital was king and laborers of all types were paid poorly. As skilled labor's share of the firm's surplus soared, and unskilled labor's grew more slowly, the pay ratio between skilled and unskilled labor escalated. While this shift raises important social questions about the need to protect unskilled workers, the underlying cause of the shift rests on a reallocation of the firm's surplus toward the more productive factor of production, skilled labor.

B. Do Limited Financial Market Access and Smaller Managerial Labor Markets Constrain Foreign Executive Pay?

If we accept the Opportunity Cost Theory as the appropriate explanation for increased executive pay in the United States, what does it tell us about the origins of the pay gap between American and foreign executives? If executive pay levels accurately reflect the returns to skilled labor, then the Opportunity Cost Theory's prediction should be that the returns to managerial inputs are lower at foreign

Zingales, *supra* note 255, at 211. Meriweather formed a new company that eventually attracted a group of Salomon's traders responsible for 87 percent of its 1990-93 profits. With financial capital widely available, the traders were free to rent that resource wherever they pleased; their ties to Meriweather, a form of human capital, were stronger than their loyalty to Salomon, whose name and funds they were only renting. *Id.* at 212.

287. RAJAN & ZINGALES, *supra* note 251, at 35.

288. *Id.* at 39.

companies than at American firms. There are two factors that may explain why, in the past, foreign CEOs have had lower opportunity costs, and therefore received lower pay, than American CEOs: first, foreign executives' more limited access to financial capital; second, the more limited job options of foreign executives. Lastly, I consider, and tentatively reject, claims that America's top managers receive higher pay because they experience greater job turnover than their foreign counterparts.

These forces, however, may be changing. International labor markets are growing, and financial capital is becoming more available to foreign executives. If these trends continue, then the Opportunity Cost Theory leads us to predict that executive pay levels will converge.

1. Foreign Executives Have Had More Limited Access to Financial Markets for Start-Up Capital

Recent research suggests that financial development facilitates the creation of new firms.²⁸⁹ As Rajan and Zingales have noted,

[n]ew firms depend more on external finance than established firms . . . financial development has almost twice the economic effect on the growth of the number of establishments in an industry as it has on the growth of their average size. This suggests that an additional indirect channel through which financial development could influence growth is by disproportionately improving the prospects of younger firms.²⁹⁰

Focusing first on European executives, the fractionalized nature of continental European capital markets and securities regulation has made it more difficult and expensive for executives to raise capital to start new firms. "EU market capitalization is only about half that of the U.S., even though the EU economy is about three-quarters the size

289. LUIGI GUIO ET AL., *THE REAL EFFECTS OF LOCAL FINANCIAL DEVELOPMENT* 4 (Working Paper, 2001). They use the "conditional probability of being rejected [for credit] as a measure of financial underdevelopment." *Id.* at 8, 12 (indicating that the source for this information is the Italian Survey of Households Income and Wealth). The results were divided by region, of which Italy has 20 (one was dropped because it had too few reports). *Id.* Because demand for financial development could "generate its own supply," the authors "instrument [their] indicator of financial development with exogenous determinants of the degree of financial development such as the level of judicial inefficiency and the level of social capital." *Id.*

For other studies finding a link between financial market development and growth, see Robert King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q. J. ECON. 717 (1993); Marco Pagano, *Financial Markets and Growth: An Overview*, 37 EUR. ECON. REV. 613 (1993). Financial market development can have two desirable effects on macroeconomic growth: first, it can lead to greater capital accumulation by reducing the fraction of savings that is lost in the intermediation process; and second, it can lead to a more efficient allocation of savings through improved risk sharing and more efficient sharing of information about investment alternatives. FREIDRICH HEINEMANN & MATHIAS JOPP, *THE BENEFITS OF A WORKING EUROPEAN RETAIL MARKET FOR FINANCIAL SERVICES* 40 (2002).

290. Rajan & Zingales, *supra* note 279, at 470.

of American economic output.”²⁹¹ The EU has struggled to transform its “chronic underperformer” financial markets into pan-European powerhouses by enacting a package of new legislation, the Financial Services Action Plan, to create common rules for all financial transactions throughout the EU by 2005.²⁹² Still, entrenched interests have fought these changes, arguing that their own national systems should be adopted as the EU standard. While some of the disputes have been settled,²⁹³ others may never be resolved, leaving the financial system fractured and the cost of capital counterproductively high.²⁹⁴

Venture capital funding, a prime source of financing for start-ups in the United States, is much less available in Europe. “According to a study conducted last year by the European Commission, European venture capitalists invest roughly one-third the amount their U.S. counterparts do.”²⁹⁵ Similar figures compiled by the OECD suggest that German and French venture capital funding are at approximately one-quarter the levels found in the U.S.²⁹⁶ This suggests that funding start-ups will be more difficult in Europe, and therefore there will be fewer potential opportunities for executives to create their own firms.²⁹⁷

291. Paul Hofheinz, *A Capital Idea*, WALL ST. J., Oct. 14, 2002, at R4.

292. *Id.*

293. The EU has adopted several measures that will facilitate a pan-European financial system including, a single accounting standard for all listed companies, rules permitting mutual funds to sell their products throughout the EU, common standards for collateral in bankruptcies, and a common ban on insider trading and market manipulation. *Id.*

294. *Id.* Some of the unresolved issues are the proposed EU Takeovers Directive, common disclosure requirements for IPO prospectuses, procedures for cross border pension fund investing, and patent regulations that will validate filings across all of the EU. *Id.*

295. *Id.* Moreover, funding levels may be only the tip of the iceberg. What may be more important is the organizational features of venture capital financing. As one author said: “The key feature of VC in New Economy Innovation Systems . . . is not so much financial investment, important as that is, but quality, informed business management of commercialization of science.” Philip Cooke, *New Economy Innovation Systems: Biotechnology in Europe and the USA*, 8 *INDUSTRY & INNOVATION* 267, 267 (2001).

296. Sebastian Moffett, *Japan's Entrepreneurs Say Hawaii Offers a Better Business Climate*, WALL ST. J., Oct. 15, 2002, at A16.

297. The importance of venture capital financing is stressed by several studies. For example, Philip Cooke argues:

[I]nnovation is the fundamental source of value, seeking it out is an investment imperative, and systemic search and selection (i.e. active “scouring” of research labs) procedures by VCs [venture capital firms] is the main means of exploiting gains from public investment in basic research. In traditional innovation systems analysis, there is an emphasis on the role of public agencies and even strategies, some promoted at regional level, particularly in the EU. Whether by accident or not, EU innovation rates are low compared to the USA, and VC is more pronounced in the USA. The logic of the last two statements suggests the vigorous investment strategies of private investors and innovators, revealed most clearly in new economy sectors like

Management buyouts are much more common in the United States than in Europe.²⁹⁸ With the exception of the United Kingdom, which has a fairly active market, there are very few buy-out transactions.²⁹⁹ Furthermore, "the principal role of buy-outs in much of continental Europe has been confined to the financing of ownership transfers in the large private and family-run sector,"³⁰⁰ which are rarely designed to facilitate professional executives' new firms. MBO transactions "are unknown to Europe outside of the U.K."³⁰¹

Similar problems exist in Asia. Venture capital financing is very limited there.³⁰² For example, OECD statistics show that venture capital investments in the United States amount to 0.29 percent of GDP.³⁰³ By comparison, in Japan, venture capital funding amounts to a mere 0.02 percent of GDP, and financing is unavailable in any form for many entrepreneurs.³⁰⁴ Japanese venture funds also concentrate their investments in mature industries in intermediate stage (mezzanine) financings, not in start-up companies.³⁰⁵

biotechnology and IT, help explain the difference in innovation performance to a considerable extent.

Cooke, *supra* note 295, at 268 (citations omitted).

This is echoed by Brian F. Lavoie and Ian M. Sheldon, who argue that

since biotechnology R&D is lengthy, the rate at which a firm can invest will have important implications for average time to build, or equivalently, the rate of innovation This disparity between the US and Europe may be attributable to the fact that European firms face more difficulties in obtaining investment capital. [Europe] seemingly has no shortage of venture capital . . . [b]ut most of it has been going into relatively unadventurous investments . . . only a fraction has been invested in start-ups.

Brian F. Lavoie & Ian M. Sheldon, *The Source of Comparative Advantage in the Biotechnology Industry: A Real Options Approach*, 16 *AGRIBUSINESS* 56, 58-59 (2000).

298. Mike Wright et al., *Corporate Restructuring, Buy-outs, and Managerial Equity: The European Dimension*, 3 *J. APPLIED CORP. FIN.* 47, 47 (1991).

299. As of 1989, the U.K. had "experienced more restructuring activity (both in terms of numbers and value of transactions) than all other European countries combined." *Id.* at 48.

300. *Id.* at 50.

301. *Id.* at 51.

302. Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 *NW. U. L. REV.* 865, 874 (1997) ("To summarize the differences . . . U.S. venture capital funds are larger and more independent, hold larger equity stakes and take a more active role in the management of portfolio companies, make more early-stage investments, and invest more heavily in new technologies than their Japanese counterparts.").

303. Moffett, *supra* note 296.

304. *Id.*

305. Milhaupt, *supra* note 302, at 878-79. In recent years, there is some evidence that this is changing, and more venture capital is flowing into start-up companies. Lisa Bushrod, *Western VC's Breed Asia's Entrepreneurial Culture*, *EUR. VENTURE CAP. J.*, Mar. 1, 2001 (stating that "investment activity in the Asian market centres on high-growth sectors in which young companies need equity finance to sustain rapid expansion since bank debt is either too expensive or not available . . . although buyout activity seems to be more prominent."), 2001 WL 13626710.

In addition, Japanese regulations impose many burdensome requirements on start-ups in that country, so that many new firms have shifted their situs to Hawaii.³⁰⁶ In recent years, these high hurdles for start-ups have contributed to the trend of more firm closures than start-ups in Japan.³⁰⁷

Management buyouts have also not been nearly as widespread in Japan as in the United States. To date, MBOs in Japan appear to be most popular for aging entrepreneurial founders of companies to turn over management to the next generation.³⁰⁸ Obstacles such as the lack of managers with the requisite entrepreneurial and management skills hinder MBO activity in Japan.³⁰⁹ MBOs have recently been on the rise in Japan.³¹⁰ In 2001, the number of MBOs tripled because large parent companies, spurred by new group accounting rules, began selling units that were not a core part of the business. However, overall activity is still a tiny fraction of that found in the United States.

2. Do Foreign Executives Have Fewer Job Options?

One implication of the Opportunity Cost Theory is that the size of the relevant labor market for executives will have an important impact on their opportunity costs and therefore compensation. In a small labor market, firms should have more power over their executives since those managers will have fewer alternative job options, other things being equal, if they leave an established firm. For example, in the past the continental European countries offered relatively small job markets compared to the United States because of the comparatively small size of their national economies. As we will see below, however, international migration and the growth of multinational businesses may be expanding the number of potential jobs available to top executives. The Opportunity Cost Theory suggests that this increased job availability could create pressure on the international pay gap.

306. Moffett, *supra* note 296 (citing requirements for minimum capital requirements, registration fees, and appointment of corporate officers).

307. *Id.* (citing data for 1996-1999 showing higher percentage of closures than start-ups).

308. Kaoru Morishita, *Buyouts Allow Large Firms to Get Back to Basic Business*, NIKKEI WKLY., Mar. 5, 2001.

309. *Id.* But see Patrick McCurry, *Asia-Europeans Look for Eastern Promise*, EUR. VENTURE CAP. J., May 1, 2000 (noting that many current managers have had exposure to Western business practices through working or studying abroad, which may result in these managers being more amiable to MBOs), 2000 WL 13713138.

310. Morishita, *supra* note 308; see also *Management Buyouts Gain in Popularity in Japan*, ASIA PULSE, Aug. 18, 2000 (citing a 400 percent increase in MBOs in 1999 from 1998).

a. Cross-Border Hiring

The market for skilled labor is becoming increasingly international. Businesses, such as the high tech industries, can look to hire foreign talent if the domestic market cannot meet their needs. U.S. technology companies have made extensive use of foreign workers,³¹¹ so much so that the U.S. Congress responded to the demand in 2000 by increasing the number of visas available for professionally trained foreign workers, commonly known as H-1B visas.³¹² The United States is not alone in relaxing its rules in this regard; Germany, Canada, Australia and the United Kingdom have also followed suit.³¹³

As the U.S. economy cooled, the use of new H-1Bs plummeted from 164,000 in 2001, to 79,000 in 2002 and 2003.³¹⁴ In the fall of 2003, labor unions, concerned about the influx of highly skilled foreign workers, persuaded Congress not to renew the 2000 expansions to the H-1B program.³¹⁵ This reduced the number of available visas to a mere 65,000.³¹⁶ However, the success of union efforts should not be interpreted as a sign of declining interest in skilled foreign labor. Over the last three years, more than 200,000 service jobs, primarily in information technology, have been transferred from domestic corporations to their U.S. foreign affiliates.³¹⁷ This trend suggests employers are accomplishing through outsourcing what once could only be done through immigration.

Cross-border hiring is also becoming a potentially important phenomenon with senior executives. Some optimists have even claimed that "(t)he dawn of the millennium is ushering in a true global marketplace for CEO's, with a record number of foreign CEO's

311. Lawrence A. West. & Walter A. Bogumil, *Foreign Knowledge Workers as a Strategic Staffing Option*, ACAD. OF MGMT. EXECUTIVE, Nov. 2000, at 71, 71-72.

312. Cindy Rodriguez, *Foreign Workers Bill Approved: High Tech Firms, Colleges See Gains*, BOSTON GLOBE, Oct. 4, 2000, at D2. Demand may, however, be drying up. Rachel Silverman, *For Foreign Workers Here on Special Visas, Tech Bust Hits Hard*, WALL ST. J., June 21, 2001, at A1.

313. G. Pascal Zachary & Cecile Rohwedder, *Germany Widens Door for Immigrants*, WALL ST. J., July 2, 2001, at A8.

314. Michael Schroeder, *U.S. May Ease Entry for High Tech Workers*, WALL ST. J. ONLINE, at 2, available at <http://www.ibmemployee.com/PDFs/WSJ.com> percent20- percent20 percent20U.S. percent20May percent20Ease percent20Entry percent20For percent20High-Tech percent20Workers.pdf (last visited Apr. 13, 2004).

315. Michael Schroeder, *India Aims to Calm U.S. Outsourcing Fears*, WALL ST. J., Nov. 13, 2003, at A4.

316. *Id.*

317. *Id.*

running major companies in the U.S., the U.K., and several other countries around the world.”³¹⁸

There are plenty of examples where companies have hired globally. The pharmaceutical company Eli Lilly & Co., which has its worldwide headquarters in Indianapolis, is an interesting illustration of this phenomenon. The company’s CEO, himself a foreign national from Morocco, has begun a program to “globalize the company and tap all talent wherever it comes from.”³¹⁹ The CEOs of the American corporations Goodyear, Alcoa, and Pharmacia & Upjohn are originally from Egypt, Morocco, and Pakistan, respectively.³²⁰ In a similar vein, 40 of Europe’s largest 200 companies are currently run by foreign nationals.³²¹

While cross-border executive hiring may be surging, the market for executives is a long way from being truly global. For foreign executives trying to move to the United States, several potential barriers exist. For example, immigration regulations constitute a potentially significant obstacle.³²² Even if immigration issues can be addressed, many foreign executives lack the experience working in the industries where American firms need them most. For instance, skeptics claim that there are only a handful of English managers who could move to the United States in search of a highly lucrative pay deal.³²³ Similarly, in Canada the prevailing view is that while executives at companies that compete successfully for business in a North American or global marketplace might be able to move,³²⁴ most Canadian CEOs are “landlocked” because they work for small companies that only service the domestic market.³²⁵ Nevertheless, in

318. Denis B.K. Lyons & Spencer Stuart, *International CEOs on the Rise*, CHIEF EXECUTIVE, Feb. 2000, at 51, 2000 WL 12374732.

319. L.J. Sellers, *Executive Profile: Lilly’s International Family*, PHARMACEUTICAL EXECUTIVE, Mar. 2001, at 40, 41-42.

320. See *id.* at 51.

321. See Carol Matlack & Kerry Capell, *Managers Without Borders: Europe’s Companies, Executives, and Workers Are Becoming More Mobile, Flexible, and Transnational*, BUS. WK., Nov. 20, 2000, at 58.

322. One commentator suggests that U.S. managers are effectively shielded from “foreign made competition.” Jan Hack Katz, *Competition Breeds Efficiency? Then Open the Executive Suite to the Free Market*, L.A. TIMES, May 16, 1997, at B9.

323. See *Look Out, There’s a Monster Coming to Your Annual Meeting*, TELEGRAPH, Jul. 25, 2000, at 27; Sally Patten & Jon Ashworth, *U.K. Fat Cats Look On in Envy at Their American Cousins*, TIMES, July 15, 2000, at 29; *Random Numbers*, ECONOMIST, June 3, 1995, at 62; Simon Targett, *Heat May be Turned Up*, FIN. TIMES, Nov. 17, 2000, at 7.

324. David Berman, *A Bad Place To Be Boss*, CANADIAN BUS., July 1997, at 17; Katherine Gay, *Canadian CEOs Pay Makes It Hard To Attract Top Talent*, FIN. POST, Apr. 20, 1996, at 32; Janet McFarland, *Managing Compensation*, GLOBE & MAIL, Nov. 5, 1996, at B17.

325. Bruce Gates, *Well-Paid Canadian Executives Facing a “Taxing” Problem*, FIN. POST, May 6, 1991, at 24; Gay, *supra* note 324.

both countries the argument that senior management might depart to the United States has been invoked to defend significant increases in executive pay.³²⁶

If existing barriers against international movements of labor persist, this will contribute to maintaining separate labor markets for executives. On the other hand, if international movement of executives continues to increase, two important implications exist for the international pay gap. First, a global market for executive talent could cause foreign firms to fear that their most talented executives will out-migrate to the United States to grab the more generous American remuneration packages. In order to keep their best managers in place, these companies would need to restructure managerial compensation along American lines to compete.³²⁷

Conversely, companies headquartered outside the United States may choose to hire an American as their chief executive, at least in those industries where the American talent pool has more impressive candidates than its local counterpart.³²⁸ Moreover, if a foreign company is seeking to hire a CEO who is well-versed in the concept of maximizing shareholder value, looking for an American manager makes sense because they have embraced the notion most strongly.³²⁹

If a foreign-owned company seeks to hire an American CEO, it will need to offer that person a compensation package comparable to those American companies provide.³³⁰ Thus, recruiting an American

326. On the U.K., see, for example, Peter Martin, *More than Their Job's Worth*, FIN. TIMES, May 15/16, 1993, at 8; *Thin Excuses for Fat Cats*, INDEP. SUNDAY, Mar. 6, 1994, at 20; John Waples, *Boardroom Bonanza*, SUNDAY TIMES, July 16, 2000, §§ 3, 9. On Canada, see *CEO Shortage Sends Executive Salaries Soaring*, VANCOUVER SUN, May 15, 1996, at D3; Gay, *Canadian Pay*, *supra* note 324; Ann Gihbon, *CIBC Opposes Executive Pay Limit*, GLOBE & MAIL, Jan. 17, 1997, at B4.

327. See, e.g., Tully, *supra* note 224, at 121; see *CEO Shortage Sends Executive Salaries Soaring*, VANCOUVER SUN, May 15, 1996, at D3; Martin Dickson, *Package Envy: Or the Curse of Keeping Up with the Yanks*, FIN. TIMES, Apr. 28/29, 2001, at 13; John Gapper, *Executives "Lose out Against U.S."*, FIN. TIMES, Mar. 27, 1997, at 10; Gihbon, *supra* note 326, at B4; see also Stephen Gates, *Aligning Performance Measures and Incentives in European Companies*, ACA J., 3D Q., 2000, at 19 (discussing a survey of large European companies that indicated 78 percent of those responding cited attracting and retaining executives as among the forces driving change in European executive compensation).

328. Luiza Chwialkowska, *How to Land an American Boss*, NAT'L POST, Sept. 6, 1999, at A3; John Plender, *Cult of the U.S. Manager*, FIN. TIMES, April 14, 1999, at 19.

329. Plender, *supra* note 328.

330. Delroy Alexander, *U.S. Bosses in the U.K.: Over-Hyped, Overpaid and Over Here*, INVESTORS CHRON., Nov. 24, 1995, at 20; Chwialkowska, *supra* note 328, at A3; Derek Matthews, *Fat Is a Relative Issue*, MGMT. TODAY, June 1996, at 50, 53.

executive will often trigger a change in approach to executive pay.³³¹ In theory, therefore, the emergence of a global market for executive talent could foster key changes to managerial compensation.

b. The Growth of Multinational Enterprise

Another source of greater job opportunities for domestic executives, and therefore of potentially higher opportunity costs, is the ever expanding number of multinational companies. In recent years, there has been a dramatic increase in the size and scope of multinational companies.³³² United Nations data show that between 1988 and 1997 the number of companies operating as multinationals tripled to 60,000, and that these firms had over 500,000 affiliates.³³³ Cross-border corporate growth raises important issues about internal pay structures.

Corporations with managers in several different countries have split over whether to coordinate pay arrangements around a universal standard.³³⁴ Some multinationals make "executive pay decisions on a worldwide level, and more uniform executive pay structures are the result."³³⁵ Companies using this approach can promote people internally on fairly straightforward terms and organize incentive pay on an international basis.³³⁶ As we will see, though, local laws and cultural differences can frustrate attempts to implement a fully uniform compensation policy for executives.³³⁷

When U.S.-headquartered multinationals establish uniform executive pay practices internationally, host-country nationals will see their pay Americanized, usually increased to the levels prevailing in the United States.³³⁸ This impacts the market for managerial talent

331. Alexander, *supra* note 330, at 20; Parker-Pope, *supra* note 193; S. Karene Witcher, *Australia Looks Abroad in CEO Searches*, ASIAN WALL ST. J., July 28, 1998, at 6; cf. Michael Cave, *I'm Worth It, Baby*, AUSTL. FIN. REV., Dec. 2, 2000, at 21 (arguing that the effect for a company of hiring an American executive will be transitory unless it has to go back to the international marketplace to find a replacement).

332. Douglas M. Branson, *Teaching Comparative Corporate Governance: The Significance of "Soft Law" and International Institutions*, 34 GA. L. REV. 669, 669 (2000).

333. Gary M. Quinlivan, *The Multilaterals*, WORLD & I, Nov. 2000, at 267.

334. Robertson, *supra* note 216, at 604-05.

335. J.E. Richard, *Global Executive Compensation: A Look at the Future*, COMPENSATION & BENEFITS REV., May/June 2000, at 35.

336. Fung, *supra* note 223, at 40; Mazur, *supra* note 43.

337. Fung, *supra* note 223, at 40; Gross & Wingerup, *supra* note 216, at 25.

338. DERESKY, *supra* note 217, at 366-67; Mazur, *supra* note 43 (making the same point by referring to a U.K. parent company). Still, it is fairly common for multinationals to use parent-company nationals for top management positions in foreign subsidiaries. DERESKY, *supra* note 217, at 348-50. In such instances, the top executives can often be segregated in terms of their pay. Fung, *supra* note 223, at 41.

in the countries where the U.S.-based multinationals carry on business. If American firms hire locals to top posts, their domestic competitors will need to offer their top managers larger compensation packages to avoid losing them and to attract new talent.³³⁹ This is most apparent with stock options: American multinationals have been awarding growing numbers of stock options to managers working outside the United States, placing pressure on domestic firms to do likewise.³⁴⁰

Other multinationals prefer to tailor their pay systems to local conditions.³⁴¹ These firms look to the domestic market to determine compensation structures, taking into account cultural factors, tax considerations, and other local conditions. The net result is that, regardless of where this sort of multinational is headquartered, executives will be paid differently depending on where they work. Consequently, even with a multinational based in the United States, American compensation levels should not have a strong impact elsewhere.

Companies that use divergent executive pay structures have experienced some recurrent problems. For instance, "[m]any top people at Germany's best multinational corporations line up for assignments in the United States, partly because they are entitled to American-style pay packages, which means a substantial pay raise for many."³⁴² These same expatriate executives then often insist on continuing to receive American levels of pay when they return home to Germany.³⁴³ Foreign multinationals with substantial U.S. operations face a dilemma: they need to offer their American executives a competitive pay package to recruit or retain talented American managers,³⁴⁴ yet, if they do so, their home country top executives may wonder why their subordinates in the United States have compensation packages that are more lucrative than their own.³⁴⁵

339. See Murphy, *supra* note 1, at 2497 (noting that when U.S. companies export their pay practices it pressures local competitors).

340. TOWERS PERRIN, STOCK OPTIONS AROUND THE WORLD 3 (2001).

341. Fung, *supra* note 223, at 40; cf. Brown, *supra* note 235, at 15 (saying that country-based variations in remuneration remain prevalent in Europe but there are signs of companies evolving towards hybrid pay systems).

342. Zachary & Rohwedder, *supra* note 313.

343. *Id.*

344. Vikas Bajaj, *Foreign Firms Attracting Talent with Stock Options*, DALLAS MORNING NEWS, Sept. 19, 1999, at D23.

345. David Berman, *A Bad Place To Be Boss*, CANADIAN BUS., July 1997, at 17; Johnston, *supra* note 226; Lublin, *supra* note 233 (focusing on the jealousies that high U.S. pay can generate).

3. CEO Turnover Does Not Explain International Pay Differentials

One final factor to briefly discuss is whether American CEOs have greater opportunity costs because turnover is higher for U.S. CEOs than for foreign CEOs. The argument could be that if American CEOs are more likely than the CEOs of foreign firms to be terminated by their companies, they must be paid more to compensate them for these risks. This might be true if top management at foreign firms is less subject to discipline because of those firms' stakeholders' allegedly long term perspective on firm performance, while American managers are held accountable for every quarterly change in earnings.

While the concept that the likelihood of job loss should impact pay levels makes much sense, the real question is an empirical one: do foreign CEOs experience less turnover than American CEOs? The empirical work done to date suggests otherwise. The most comprehensive work has been done by Kaplan on Japan³⁴⁶ and Germany.³⁴⁷ His study of Japanese data revealed that the "level of [top executive] turnover is substantially higher at 14.9 percent (per year) in Japan than the 10.4 percent in the United States."³⁴⁸ He found that top executive turnover at Japanese firms is negatively correlated to earnings, stock price, and sales performance, just as it is in the United States, and that "boards in both countries focus on similar performance objectives."³⁴⁹ Kaplan further concluded that, while executive compensation levels are lower in Japan, they respond to the same factors that seem important in the United States: earnings, earnings changes, stock price, and sales performance.³⁵⁰ Finally, he determined that executive turnover in Japan is more sensitive to negative earnings, which he attributed to Japanese banks taking an active role in firms where their loans are at risk. In sum, higher turnover does not seem to be an explanation for the difference between American and Japanese executive pay levels.

Kaplan's German study focuses on turnover on the management³⁵¹ and supervisory boards³⁵² at a sample of the largest

346. Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States*, 102 J. POL. ECON. 510 (1994).

347. Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J.L. ECON. & ORG. 142 (1994).

348. Kaplan, *supra* note 346, at 522.

349. *Id.* at 512, 528-29.

350. *Id.* at 542.

351. The management board is "the equivalent of the top seven or so operating executives of the firm." Kaplan, *supra* note 347, at 143.

352. "The supervisory board represents shareholders and employees in appointing and overseeing the management board." *Id.*

German firms. Management board turnover increases with earnings losses and poor stock price performance, but is not correlated with sales growth or earnings growth.³⁵³ For the chairman of the management board, Kaplan's results show that turnover increases by a statistically significant amount if the firm suffers losses of net income, but not if the firm suffers poor stock price performance.³⁵⁴ These relationships are very similar both in direction and magnitude to those that he finds exist in Japan and the United States. Again, these results suggest that higher executive turnover is not a satisfactory explanation for the international pay gap.

VII. BARGAINING POWER THEORY

The fourth theory offered to explain the pay gap between American and foreign CEOs is the Bargaining Power Theory. It begins with the proposition that American CEO pay has grown rapidly since the mid-1980s because of both the increase in the relative bargaining strength of American CEOs in hostile takeovers of their corporations and the simultaneous acceptance of the idea of pay-for-performance by domestic institutional investors. American CEOs gained power to stop hostile takeovers of their firms during this time period when there was a shift in the legal entitlement to approve hostile takeovers from a target company's shareholders to the target firm's board of directors and management. Around the same time as the legal rule was shifting, institutional shareholders, who have come to dominate American equity markets, pushed for executive pay-for-performance systems. This led to a surge in the use of stock options and restricted stock, which combined with a bull stock market, created enormous pay packages.³⁵⁵

The pay gap between American and foreign managers grew because the latter did not enjoy the same increase in bargaining power. Internationally, control shareholder ownership structures are more prevalent, and professional managers do not have the power to determine whether or not to sell the company. Nor have pay-for-performance schemes caught on rapidly, as they do not perform some of the same functions as in the U.S. dispersed ownership situations.

353. *Id.* at 143-44; see JULIE ELSTON & LAWRENCE GOLDBERG, EXECUTIVE COMPENSATION AND AGENCY COSTS IN GERMANY (Working Paper, 2001) (finding that for German executives, sales and return on equity are positively correlated with compensation and that greater dispersion of share ownership leads to higher executive pay).

354. Kaplan, *supra* note 347, at 149; see also JULIAN R. FRANKS & COLIN MAYER, OWNERSHIP AND CONTROL OF GERMAN CORPORATIONS (Ctr. For Econ. Policy Research, Discussion Paper No. 2898, 2001), <http://www.cepr.org/pubs/dps/DP2898.asp>.

355. See Kahan & Rock, *supra* note 10, at 871.

Pay convergence will therefore occur, according to this theory, only if dispersed ownership structures develop that create more negotiating power in the hands of foreign executives, and make pay-for-performance systems more necessary. The remainder of this section develops these points more fully.

A. U.S. CEO Pay Has Increased with Their Greater Power To Stop Takeovers and As Institutional Investors Have Accepted Pay-for-Performance

Large public American corporations began experiencing hostile takeovers beginning in the 1960s, with a huge wave of them striking in the 1980s.³⁵⁶ For the first time, unsolicited tender offers were being successfully directed to target firm's shareholders. In the 1960s and 1970s, corporate management had lobbied strenuously to change the system with limited results.³⁵⁷ For instance, in 1968, the U.S. Congress had passed the Williams Act, compromise legislation creating greater disclosure obligations for acquirers and delaying the closing of tender offers.³⁵⁸ But this bill did not fundamentally alter the allocation of power between bidders and targets. Similarly, state legislatures passed a barrage of first generation anti-takeover statutes, designed to provide target company management with the power to stop unfriendly deals. However, judicial hostility to them rendered them ineffective.³⁵⁹

The resulting vacuum left matters to the state courts. Years before, the Delaware Supreme Court had adopted a toothless judicial standard of review for management defensive tactics in takeover situations.³⁶⁰ Hostile acquisitions continued to occur, though, despite

356. BENGT R. HOLMSTROM & STEVEN N. KAPLAN, CORPORATE GOVERNANCE AND MERGER ACTIVITY IN THE U.S.: MAKING SENSE OF THE 1980S AND 1990S 1 (MIT Dep't of Econ., Working Paper No. 01-11, 2001), http://papers.ssrn.com/abstract_id=261112. Hostile transactions are commonly defined as those "bids pursued without the acquiescence of target management." *Id.* at 6. About 30 percent of the Fortune 500 received bids during the 1980s. "This is an extraordinary number, indicating that shareholder power via takeover bids had to be on the minds of all large firm managers . . . Hostile takeovers were, and despite the rise of the poison pill still are, an engine of shareholder wealth maximization." Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2074 (2001).

357. Prior to 1980, corporate "management was loyal to the corporation, not to the shareholder." HOLSTROM & KAPLAN, *supra* note 356, at 3. Existing corporate governance structures gave executives little reason to worry about shareholder value. *Id.*

358. 17 C.F.R. 240.13d-1 et seq., 14d-1 et seq., 14e-1 et seq.

359. The unconstitutionality of these statutes was established when the U.S. Supreme Court struck them down in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

360. *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (noting that such tactics are considered within business judgment).

such innovative tactics as the defensive self-tender offer and dual class voting structures.³⁶¹ Pressure built on this court to do something to stop the onslaught.

Finally, in the mid-1980s, the Delaware courts found an answer to target company's continued demands for action. In *Moran v. Household International*, the Delaware Supreme Court upheld the validity of the Shareholder Rights Plan, or poison pill, as a method of blocking hostile tender offers.³⁶² This single defense, especially when used in combination with a classified board, gave the management of target companies the ability to stop its shareholders from accepting a bidder's tender offer, and could even impede dissidents' success in a proxy contest to remove the incumbent directors.³⁶³

The early case law, however, only permitted the target company to use the Rights Plan to temporarily bar the closing of tender offers. After target company management had sufficient time to attempt to find a third party bidder, or to propose an alternative transaction, shareholders needed to be permitted the chance to tender their shares to the bidder.³⁶⁴ Although praised by legal academics as sound judicial decisions, these cases had a very brief life: by the end of the decade, the Delaware Supreme Court had overruled them and gone on to permit boards of directors to "Just Say No" to most hostile takeovers.³⁶⁵ The U.S. Supreme Court added to target management's powers, too, by reversing earlier prohibitions on stringent state anti-takeover laws.³⁶⁶

These new legal rules did not stop acquisitions, though. As the Coase theorem predicts, when two parties face a legal rule, they bargain around it to reach the efficient outcome, subject to overcoming

361. "In fact, it is said that almost 10 percent of American corporations included in the Fortune 500 in 1980 have since been acquired in a transaction that was hostile or started off as hostile." Katsuhito Iwai, *Persons, Things, and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance*, 47 AM. J. COMP. L. 583, 609 (1999).

362. 500 A.2d 1346 (Del. 1985).

363. Randall S. Thomas & Kenneth J. Martin, *The Impact of Rights Plans on Proxy Contests: Reevaluating Moran v. Household International*, 14 INT'L REV. L. & ECON. 327 (1994).

364. See, e.g., *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988).

365. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). There, "the court permitted the board of Time, faced with a hostile, conditional tender offer by Paramount, to proceed with its own tender offer for Warner Brothers and to retain its poison pill . . . Most commentators have read *Time-Warner* to fortify the power of a board to 'just say no.'" Kahan & Rock, *supra* note 10, at 877-78. According to the court, "[d]irectors are not obligated to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Id.* at 877 (quoting *Paramount*, 571 A.2d at 1154). When *Time-Warner* was handed down, "[m]erger and acquisition activity declined sharply," with the decline in hostile acquisitions "particularly pronounced." *Id.* at 878.

366. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (upholding constitutionality of second generation of state antitakeover statutes).

any transaction costs that stand in the way.³⁶⁷ Whether or not the Delaware courts' approval of strong defensive tactics was an efficient decision is a hotly contested question,³⁶⁸ and not one this Article needs to resolve. For my purposes, what is important is that, while hostile transactions were greatly diminished by these new rules,³⁶⁹ deals continued.³⁷⁰

Most of these acquisitions were friendly transactions³⁷¹ where, as part of the negotiations, the target company's management was rewarded with long term employment agreements, or equivalent compensation, as part of the acquisition agreement. Even with transactions that began on a hostile note, target company executives' holdings of stock options gave them strong incentives to consider eventually proposing a friendly sale of the company.³⁷² In almost all of these cases, members of target company management were also awarded severance packages as part of selling the company to any bidder.³⁷³ Now, when the company was sold to a bidder that did not intend to retain target management, these executives could exit the firm with large cash payments apparently part of the price for agreeing to the deal.

This illustrates another aspect of the Coase theorem that is frequently neglected. While the theorem speaks eloquently about the

367. See generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

368. See Kahan & Rock, *supra* note 10, at 874-75 n.7 (providing summary of the law review debate over this question); see also BENGT BERGSTROM AND STEVEN N. KAPLAN, CORPORATE GOVERNANCE AND MERGER ACTIVITY IN THE U.S.: MAKING SENSE OF THE 1980S AND 1990S 44 n.3 (Working Paper, 2001) (listing empirical studies investigating the question).

369. Bergstrom & Kaplan, *supra* note 368, at 15.

370. *Id.* at 6, 36. Kahan and Rock argue that

market participants reacted to the challenges presented by hostile takeovers in general and the judicial validation of the poison pill in particular . . . by adopting informal adaptive devices [such as] . . . boards became more independent and the executive compensation regime changed to provide managers with substantial benefits in the event of a change of control.

Kahan & Rock, *supra* note 10, at 915.

371. "[T]he number of successful hostile acquisitions of U.S. targets [fell] dramatically . . . [from] 163 between 1981 and 1989 . . . to fifty-six between 1990 and 1998." Michael Bradley et al., *Challenges to Corporate Governance: The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, LAW & CONTEMP. PROBS., Summer 1999, at 9, 72. M&A deals plummeted from \$247 billion in 1988 to \$71 billion in 1991; hostile deals fell 90 percent. *Id.* The total value of deals began rising again in 1992 and had surpassed 1988 levels by 1995. *Id.* at 12, 60. Although hostile bids "continued to be made," "the vast majority of takeover bids in the second part of the 1990s were nominally friendly." Kahan & Rock, *supra* note 10, at 880.

372. BERGSTROM & KAPLAN, *supra* note 368, at 15-16.

373. See, e.g., JAY HARTZELL ET AL., WHAT'S IN IT FOR ME? PERSONAL BENEFITS OBTAINED BY CEO'S WHOSE FIRMS ARE ACQUIRED (Working Paper, 2000) (noting that target company CEOs receive \$8-11 million average wealth increases in completed mergers and acquisitions).

parties' ability to reach the efficient result, assuming that transaction costs are not too high, it also tells us that which party holds the legal entitlement, in this case the entitlement to decide whether to sell the company, will have distributional consequences.³⁷⁴ In this instance, the entitlement shifted to target company management and with it came the ability to extract more rents from the firm's shareholders. Executive pay in the United States, in other words, increased so rapidly from the mid-1980s until the present at least in part because managers used their new powers to get a better deal for themselves when they agreed to sell their firm.³⁷⁵

While this bargaining may have affected only a small percentage of firm value, say 1 percent, a wealth transfer on this order of magnitude to target company management would have an enormous impact on executive compensation. A serious issue arose over how such large payments to managers could be made without creating an uproar among investors.³⁷⁶

One important form of transfer payment already mentioned is the golden parachute agreement. Such contracts, while initially controversial, were quickly accepted by the investor community and target boards of directors as a necessary mechanism to balance target company management's incentive structure: selling the company meant giving up their jobs and power, so the management needed to be put back in the same position after a sale as they would have been in without the sale.³⁷⁷ The problem with golden parachutes from executives' perspectives is that they only pay off if the company is sold.³⁷⁸

What target company executives needed was a way to raise their pay without giving up their positions. Although they had leverage in any pay negotiations with their boards of directors and Compensation Committees in structuring executives' pay packages,³⁷⁹ they needed a way to get shareholders to bless their greater pay

374. See Coase, *supra* note 367.

375. Kahan & Rock, *supra* note 10, at 896-97.

376. Brian Hall & Jeffrey Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 112 Q.J. ECON. 653, 684 (1998) (offering two complementary explanations for the rapid increase in the use of stock options in recent years: first, that boards wanted to increase CEO pay and option grants were a less visible vehicle for paying them than salary and bonus; and second, that boards wanted to increase the relationship between pay and performance to improve corporate performance). Both of these claims are consistent with the argument made here.

377. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 74-76 (1986).

378. One problem with them from the target company shareholders' point of view is that they may overincentivize managers to sell the company, thereby leading to sales at too low a price.

379. CRYSTAL, *supra* note 74.

packets. The idea of pay for performance, tying manager compensation to stock price performance, served this function.

Stock option compensation had become popular with the leveraged buyout wave of the 1980s. LBOs were a very successful way of taking companies private during this time period. One of their great attractions was that they directed managerial incentives toward the maximization of shareholder value by giving them large equity stakes in the companies they managed. One study found that CEOs of these companies raised their ownership stakes from an average of 1.4 percent prior to the buyout to 6.4 percent of the company after the LBO.³⁸⁰ This novel approach quickly won acceptance among academic commentators as an important change in corporate governance structures because it aligned management and shareholder objectives more closely.³⁸¹

At roughly the same time, institutional investors grew increasingly powerful and activist.³⁸² From 1980 to 1996, the biggest institutions roughly doubled their percentage ownership of U.S. corporations from less than 30 percent to over 50 percent of all outstanding equity securities in the U.S.³⁸³ These investors were more supportive of takeovers, viewing them as a mechanism for maximizing their returns on their investments. The SEC's proxy rule reforms in 1992 further bolstered their strength by reducing some of the collective action barriers that had previously existed in voting contests.³⁸⁴

These institutional investors had realized large profits from their stakes in many LBO funds. They were enthusiastic about the benefits of incentive-based pay because it had been accompanied by operating performance improvements at these newly privatized firms,³⁸⁵ lending credence to the notion that these incentives produced tangible benefits for shareholders. Furthermore, the SEC's new executive pay disclosure requirements in 1992 made equity-based compensation packages "defensible, if not desirable."³⁸⁶

380. Steven Kaplan, *The Effects of Management Buyouts on Operations and Value*, 24 J. FIN. ECON. 217 (1989).

381. See, e.g., Michael Jensen, *The Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

382. Bergstrom & Kaplan, *supra* note 368, at 18.

383. Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229 (2001).

384. RANDALL THOMAS & CATHERINE DIXON, ARANOW AND EINHORN'S PROXY CONTESTS FOR CORPORATE CONTROL 1-17 (3d ed. 1999).

385. BERGSTROM & KAPLAN, *supra* note 368, at 8-9.

386. STEVEN KAPLAN, THE EVOLUTION OF U.S. CORPORATE GOVERNANCE: WE ARE ALL HENRY KRAVIS NOW 14 (Working Paper, 1997).

Institutions were successful in pushing for greater use of pay-for-performance. Studies have shown that increases in institutional investor stock ownership are a strong predictor of the share of compensation paid as stock options.³⁸⁷ One empirical analysis estimated that institutional ownership alone can explain 6 percentage points of the 23 percentage point increase in the median share of compensation paid in options that occurred in the 1980 to 1994 time period.³⁸⁸

While the cause and effect relationship between the increased acceptance of huge incentive based pay awards and the success of the LBOs, especially in the early 1980s, may never be completely established, "[it] is arguably the case that the large payoffs earned by LBO sponsors and, more importantly, by the top executives of LBO companies made it more acceptable for top executives of public companies to become wealthy through equity-based compensation."³⁸⁹ In any event, it is clear that the widespread use of LBOs and their emphasis on equity compensation for the managers of the newly private firms had accustomed investors and managers to the idea of executive pay packages containing substantial components of stock and stock options. Thus, the market was well-conditioned to the concept of equity-based compensation.

What happened next is clear. The usage of options soared: in 1980, CEOs received less than 20 percent of their compensation in forms tied to stock price performance, whereas by 1994, this percentage had gone up to almost 50 percent.³⁹⁰ Throughout the rest of the 1990s, these trends continued. Institutional investors continued to press for equity-based compensation schemes. Activist shareholders would sporadically complain about perceived abuses of executive pay, but no concerted pressure existed for changes.³⁹¹ In the end, boards made increasingly large stock options awards to executives and CEOs in particular.³⁹²

The bull stock market had a dramatic effect on the value of executives' stock option awards. From 1980 to 1994, the average value

387. Hall & Liebman, *supra* note 376, at 653; see also JAY C. HARTZELL & LAURA T. STARKS, INSTITUTIONAL INVESTORS AND EXECUTIVE COMPENSATION (Working Paper, 2002) (finding that increased concentration of institutional investor shareholding is positively correlated with increased use of pay-for-performance).

388. Hall & Liebman, *supra* note 376, at 662-63.

389. HOLMSTROM & KAPLAN, *supra* note 356, at 16.

390. Hall & Liebman, *supra* note 376, at 661.

391. Randall Thomas & Kenneth Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 31-32 (2000).

392. Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 131 (2000).

of stock option grants went up 682.5 percent!³⁹³ In real dollar terms, CEO average total pay went from \$809,973 in 1980 to \$2,505,469 in 1994, an increase of 209.3 percent, in large part because of the value of CEOs' stock options. For the rest of the 1990s, stock options raised CEO pay rapidly as the stock market rose spectacularly.

These option awards help shareholders persuade managers to drop their resistance to selling the company to a hostile bidder (or someone that would have otherwise been viewed as hostile).³⁹⁴ Now managers have much to gain from selling the company at a premium price, especially since their options immediately vest upon completion of the transaction. Thus, while management enthusiastically endorsed the idea of maximization of shareholder value, they were "[h]elped along by generous stock option programs."³⁹⁵

In the wake of the collapse of Enron and WorldCom, stock-based pay has been subject to widespread criticism. Some of these criticisms have focused on the "structural deficiencies" of many option-laden compensation packages, such as the ease of meeting any performance requirements, the lack of linkage between pay and performance, and the absence of any downside risk for stock options.³⁹⁶ Other critiques have pointed to the unclear connection between options and improved performance,³⁹⁷ and a host of other technical and strategic problems with stock options as they are currently used in the United States.³⁹⁸

Furthermore, it is unclear whether option-based pay will continue to dominate American executives' pay packages after the disappearance of the bull stock market in 2000. If the stock market decline continues, then options may have little value to executives.³⁹⁹ For example, one study finds that fifty Fortune 1000 companies cut

393. Hall & Liebman, *supra* note 376, at 661.

394. Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love The Pill: Adaptive Responses to Takeover Law*, 69 CHI. L. REV. 871, 884, 896-97 (2003). *But see* JOHN C. COATES IV & REINIER KRAAKMAN, CEO INCENTIVES AND MERGER ACTIVITY IN THE 1990S: STOCK OPTIONS AND REAL OPTIONS (Working Paper, 2003) (rejecting hypothesis that increased level of option compensation explains level of overall merger activity).

395. BERGSTROM & KAPLAN, *supra* note 368, at 15.

396. Hill & Yablon, *supra* note 249, at 11-12.

397. *See, e.g.*, SIMI KEDIA & ABON MAZUMDAR, PERFORMANCE IMPACT OF EMPLOYEE STOCK OPTIONS (Working Paper, 2002) (finding little evidence that option grants at high growth firms result in better performance); *see also* Hill & Yablon, *supra* note 249, at 12 (summarizing other studies).

398. Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437, 437-40 (2003).

399. BERGSTROM & KAPLAN, *supra* note 368, at 28.

option awards to CEOs by an average of 76 percent in 2001.⁴⁰⁰ This suggests that option usage may be highly sensitive to stock market trends.

However, other reports indicate an increase in the size of option awards, perhaps to make up for the lower probability of sustained stock price increases. A recent study of option compensation at 287 of the 500 corporations in the S&P 500 index found that option compensation expense grew 36 percent in 2001.⁴⁰¹ By comparison to 1999, option compensation expense for this group of companies had doubled. Thus, any conclusion that there will there a decline, or levelling off, in the levels of option-based compensation in the United States seems premature.

B. Control Shareholder Systems Already Have Strong Anti-takeover Protections and Less Need for Option Pay

What does the bargaining theory have to tell us about the likelihood of other countries adopting American pay systems, especially stock-option-based compensation schemes? First, hostile takeovers in most foreign countries are rare. This does not mean, however, that foreign CEOs have the same kind of leverage that their American counterparts do to extract higher pay in return for agreeing to a friendly deal. Large foreign companies are much more likely than American firms to have control shareholder ownership structures, where all major decisions about the future of the company are in the hands of these owners, and even the company's CEO may have little say.

Ownership structures in most foreign countries differ significantly from those in the United States. With the exception of the United Kingdom, Canada, and perhaps Australia,⁴⁰² control shareholder ownership remains the general rule abroad.⁴⁰³ In corporations with this type of ownership, major decisions, such as the decision to sell the firm, are made by the owners, not their managerial employees.

It is not surprising that hostile takeovers abroad are rare, because without the consent of the control shareholder, a sale cannot

400. Kemba J. Dunham, *The Jungle*, WALL ST. J., Jan. 2, 2002, at A13 (summarizing results of study by Executive Compensation Advisory Services, a research firm).

401. Gretchen Morgenson, *Options' Costs Revealed*, INT'L HERALD TRIB., May 20, 2002, at 9 (reporting results of study by Patricia McConnell, an accounting analyst at Bear Stearns & Co.).

402. These countries have also been the most receptive to the idea of performance-based compensation. Towers Perrin, *supra* note 22, at 20, 26.

403. See *supra* Part II.B.

take place.⁴⁰⁴ For example, until the successful hostile takeover of Mannesmann AG⁴⁰⁵ by Britain's Vodafone Airtouch in 2000, there had been just three completed hostile takeovers in Germany since World War II.⁴⁰⁶ There are essentially no hostile takeovers in Japan.⁴⁰⁷

404. In Italy, France, Germany, Belgium, the Netherlands and Spain, hostile takeovers are de facto impossible because of the existence of intensely concentrated patterns of ownership. For example, in Italy, around five percent of the companies listed on the Milan Stock Exchange have more than fifty percent of their common stock in public hands. Of this five percent, five companies are controlled by a holding company owned by a single family. For this reason, as Professor Ronald Gilson has observed, "only two companies in the entire Italian economy are even theoretically subject to hostile take-over."

Clas Bergstrom et al., *The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform*, 1995 COLUM. BUS. L. REV. 495, 505-06.

405. AG stands for Aktiengesellschaften, meaning "stock corporation." Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. L. 555, 555 & n.1 (2000).

406. Michael Bradley et al., *Challenges to Corporate Governance: The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, LAW & CONTEMP. PROBS., Summer 1999, at 9, 56 n.277. The exact number of hostile takeovers between the Second World War and Vodafone-Mannesmann is somewhat in dispute. The Bradley article cites JULIAN FRANKS & COLIN MAYER, OWNERSHIP, CONTROL AND THE PERFORMANCE OF GERMAN CORPORATIONS 1 (London Bus. Sch., Working Paper, 1997). Franks and Mayer point to "the bid for Feldmühle Nobel AG by the Flick Brothers in 1988 and then by Veba AG in 1989; the bid for Continental AG by Pirelli AG in 1990 and 1991; and the bid for Hoesch AG by Krupp AG in 1991 and 1992." Julian Franks & Colin Mayer, *Bank Control, Takeovers and Corporate Governance in Germany*, 22 J. BANKING & FIN. 1385, 1387 (1998). Another source claiming three takeovers is Scott Mitnick, Note, *Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers*, 2001 COLUM. BUS. L. REV. 683, 704. One source claims there have been none, but restricts the claim to tender offers. Andre J. Thomas, *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies in Germany*, 73 TUL. L. REV. 69, 119 (1998) (citing *Bankers' Indecent Proposal*, EUROMONEY, Apr. 30, 1997, at 10). Tim Jenkinson and Alexander Ljungqvist acknowledge that "Krupp's recent (ultimately unsuccessful) bid for rival steel producer Thyssen was possibly Germany's first ever truly Anglo-US tender offer." Tim Jenkinson & Alexander Ljungqvist, *The Role of Hostile Stakes in German Corporate Governance*, 7 J. CORP. FIN. 397, 398 n.2 (2001). They find 17 cases of "hostile stakebuilding," however. *Id.* at 398. Franks and Mayer acknowledge the possibility of stakebuilding, but claim that what "distinguishes the three cases of hostile bids is that they involve companies whose shares are widely held and where a change in control could not be secured by agreement between a small number of large blockholders." Franks & Mayer, *supra*, at 1387. In any event, the point here is that very few hostile deals occur in comparison with the United States.

407. See J. Robert Brown, Jr., *In Defense of Management Takeovers*, 65 TUL. L. REV. 57, 83 (1990) ("Hostile takeovers as a means of acquiring control [in Japan] essentially do not exist"); Dan F. Henderson, *Foreign Acquisitions and Takeovers in Japan*, 39 ST. LOUIS L.J. 897, 903 (1995) ("for practical purposes, hostile takeovers do not exist [in Japan]"); Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 20 (1996) ("[H]ostile takeover attempts are rare, and the market for corporate control does not function as a mechanism to discipline and monitor management."); Mark G. Robilotti, *Recent Development: Co-Determination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad*, 38 HARV. INT'L L.J. 536, 554 (1997) ("Hostile takeovers are virtually nonexistent in Japan.").

Furthermore, although takeover defenses in the Anglo-American tradition are largely absent, "[t]he market for corporate control as a credible disciplining device is largely absent in both Japan and Germany, as is the need for takeover defenses. The governance system itself may be considered a de facto poison pill."⁴⁰⁸

Professional managers do not have the power to sell the company, and therefore, despite the fact that hostile takeovers are difficult to accomplish, have not gained any bargaining power with which to demand greater pay. Foreign executive pay levels should therefore not be expected to rise toward American levels unless something changes.

The most obvious place for such a change to occur is if companies shift from the control shareholder system to the dispersed shareholder system.⁴⁰⁹ In this event, their CEOs will gain more power as there is less monitoring by the control group. Foreign CEOs will assume more duties and responsibilities that were formerly handled by the control shareholder. Hostile takeovers would become more feasible,⁴¹⁰ and if managers can credibly threaten to successfully oppose them, then this would give them greater leverage in pay negotiations. If such changes happen, we would expect that the CEOs' value to their firms will increase, that their bargaining strength will increase, and that they will receive higher pay.

The U.K. situation can also be well-explained with this theory. Its takeover market is the most active in Europe, in large part because of its permissive takeover rules and concentrated institutional investor shareholding patterns. Under the City Code on Takeovers and Mergers, a target company is precluded from engaging in defensive tactics once a bid has been launched.⁴¹¹ Rule 21 of the City Code on Takeovers and Mergers makes it very difficult for target

408. Bradley et al., *supra* note 406, at 61.

409. As discussed *supra* notes 196-206, there is some evidence that several European countries are developing less concentrated share ownership structures in recent years.

410. There is some evidence that hostile takeovers have become more common in Europe in recent years. RICK ESCHERICH & PAUL GIBBS, J.P. MORGAN, GLOBAL MERGERS & ACQUISITIONS REVIEW (2000) (reporting that in 1999, 34 hostile bids with a total value of \$406 million were announced versus a total of 52 bids valued at \$69 billion over the entire period from 1990 to 1998). For instance, in Japan and Germany, "companies are increasingly turning to the stock market to raise funds, the hostile takeover bid is gaining a foothold, formerly omnipresent banks are in retreat and implicit guarantees of continued employment are being redefined (albeit slowly)." Cheffins, *supra* note 170, at 503.

411. Peter Lee, *Takeover Regulation in the United Kingdom*, in EUROPEAN TAKEOVERS: LAW AND PRACTICE 133, 135 (Klaus J. Hopt & Edy Wymeersch eds., 1992). The Code imposes two additional requirements to protect target company shareholders: equal treatment for all shareholders holding the same class of shares and strong disclosure rules. Mitnick, *supra* note 406, at 702.

company boards to implement defensive tactics to defeat a proposed acquisition, although they are permitted to search for alternative bidders in order to give shareholders more options.⁴¹² Effectively, this gives the target company's shareholders the power to decide the fate of the bid. The result is that British chief executives have less bargaining power than their U.S. counterparts and, consistent with the Bargaining Power Theory, they are paid less as well.

In sum, in most foreign countries, control shareholders will make the decision whether or not to sell the company, while in the United Kingdom, shareholders will ultimately get to decide this issue in a takeover setting. In either situation, institutional investors will have little incentive to lobby for increased option compensation for foreign CEOs as a method of encouraging them to sell the firm. This is in contrast to the American setting, where incentivizing the CEO to sell the firm may be necessary to getting a deal done.

VIII. RISK ADJUSTMENT THEORY

Risk Adjustment Theory rests on the unverified, but intuitively plausible, assertion that American CEOs hold more of their wealth in the form of their company's stock and stock options than foreign CEOs, and therefore bear significantly more firm-specific risk than their foreign counterparts. If it is true that American CEOs have a greater proportion of their wealth tied up in their firms, then we would anticipate that they would need to receive a greater risk premium to compensate them for bearing this risk.⁴¹³ Foreign CEOs with smaller holding of their firm's stock and equity based instruments would expect to receive less compensation for their lower levels of firm-specific risk. Thus, higher American CEO pay could simply reflect the greater risk that U.S. CEOs bear from holding more of their wealth in company stock.

There is some evidence that American CEOs have more of their wealth invested in their firms. To begin with, as a theoretical proposition American CEOs should receive more of their pay in the form of equity-based instruments. First, firms with greater growth opportunities use more option-based compensation. External monitoring is difficult for firms with greater growth options, especially those associated with intangible assets.⁴¹⁴ These firms have "broader informational asymmetries that create a larger potential for

412. Mitnick, *supra* note 406, at 703.

413. John E. Core et al., *supra* note 186, at 30.

414. John Bizjak et al., *Stock-Based Incentive Compensation and Investment Behavior*, 16 J. ACCT. & ECON. 349 (1993).

opportunistic behavior by managers.”⁴¹⁵ To reduce the agency costs of equity, these firms therefore issue more option-based compensation.

Second, American firms are on average larger than foreign firms. Larger firm size increases the agency costs of equity because broader firm operations permit greater opportunism by managers and make external monitoring of managers less effective.⁴¹⁶ Thus we would expect, and empirical studies do find, that larger firms pay their executives with significantly greater relative amounts of equity-based pay.⁴¹⁷

Third, firms from market/equity based financial systems (the United States/United Kingdom) have different capital structures than companies that are based in debt-based financial systems (Japan/Germany). The orientation of national capital markets impacts on the relative importance of stock based compensation for executives: market/equity-based systems will have a preference for maximization of shareholder wealth that leads to the use of more equity-based compensation, whereas debt-based systems will tend to use more fixed compensation in their managerial compensation packages.⁴¹⁸ Moreover, larger and more liquid equity markets will be more informationally efficient, so that stock prices will “provide more accurate retrospective of managerial performance,” making equity-based compensation more effective.⁴¹⁹

Theory aside, the available data, discussed in Part II.A, confirm that American CEOs receive more stock options than their foreign counterparts in their annual pay packets. This does not, however, inevitably lead to the conclusion that American CEOs experience more firm-specific risk. For one thing, these data are based on annual flows of stock options. They do not include information about executives’ total holdings of stock options, or reflect the number of shares of the company’s stock that are owned by executives, or the executives’ net worth.

We have much of this data for American CEOs. Researchers have estimated that in 1998 the median dollar amounts of equity and stock options held by CEOs of S&P industrial and financial sector

415. STEPHEN BRYAN ET AL., *THE EQUITY MIX IN EXECUTIVE COMPENSATION: AN INVESTIGATION OF CROSS-COUNTRY DIFFERENCES* 9 (Working Paper, 2002).

416. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

417. David Yermack, *Do Corporations Award CEO Stock Options Effectively?*, 39 J. FIN. ECON. 237 (1995).

418. BRYAN ET AL., *supra* note 415, at 11.

419. *Id.* at 12.

companies were \$30 million and \$55 million, respectively.⁴²⁰ Other estimates show that these amounts swamp the amount of annual compensation that these same executives receive by a ratio of over 30 to 1 for the years 1993-1998.⁴²¹ Unfortunately, we lack this information for most foreign CEOs because their countries' disclosure laws concerning executive pay are much weaker in most cases. Moreover, what is missing for both types of CEOs is the amount of the CEOs' total wealth that is tied up in the company in order to decide how much company-specific risk that they are exposed to.

To test whether American CEOs are subject to more risk than their foreign counterparts, we would need data on each type of CEO's holdings of stock options, their ownership of stock in their firms, and their total wealth. Unfortunately, given the current lack of public information about CEO wealth, this question cannot be fully resolved at this point.

Suppose, though, as seems probable, that American CEOs do bear more firm-specific risk than foreign CEOs. Is there any reason to think that this gap will diminish by having foreign CEOs demanding grants of stock options approaching the levels seen in America? Will companies grant such requests if they are made?

For several reasons, it is highly unlikely that foreign CEOs will receive the same level of option awards as those received by U.S. CEOs. First, options do not perform the same function in debt-based financial systems as they do in equity-based systems, nor do foreign firms or executives want them as much. In debt-based systems, creditors care about minimizing the agency costs of debt. They do not want to align the incentives of managers with those of shareholders because this alignment of interests will increase the agency costs of debt.⁴²² Furthermore, most of these countries' firms have control shareholders already monitoring managers to insure that they do what is in (the controlling) shareholders' best interests, so additional alignment is unnecessary.

However, stock options are becoming more important in foreign executive pay. For example, the Towers Perrin 2001 study of stock

420. BRIAN HALL & KEVIN MURPHY, *THE TROUBLE WITH STOCK OPTIONS* (Nat'l Bureau of Econ. Research, Working Paper No. 9784, 2003).

421. JOHN CORE ET AL., *ARE PERFORMANCE MEASURES OTHER THAN PRICE IMPORTANT TO CEO INCENTIVES?* 38 tbl. 1 (Working Paper, 2000).

422. BRYAN ET AL., *supra* note 415, at 12 ("In a debt-dominated financial system, the institutional environment is designed to ensure that management does not reduce firm value too much (as opposed to equity-based systems structured to encourage shareholder value maximization). Accordingly, in a debt-based economy, the value of equity is of little importance when monitoring and motivating managers. It follows that firms operating in a debt-based economy should compensate managers with less equity and with more cash.").

option compensation shows that the percentage of companies worldwide offering their executives stock options has grown substantially from 1997 to 2001.⁴²³ Will this trend continue?

This Article argues that the scope for increased use of stock options by most foreign companies is very limited. This is best illustrated by looking at the different types of companies and the rationale for using options at each of them. First, it is unlikely that wholly private firms will lead the pack in offering options. If the firm is privately held with all of the equity in the hands of the control shareholders, there are no minority shareholders. The owners can get cash out of the business in a wide variety of ways, and tax laws will play a large role in determining if it is done through compensation or other methods. Furthermore, there are problems with using stock options in a privately held company. For example, determining the strike price and the exercise price will be potentially complex and divisive exercises. This may make options unattractive and require control shareholders to award managers direct grants of restricted stock to the extent that managers are paid with equity-based compensation.

The more interesting problems arise when the control group holds less than complete ownership, and minority shareholder interests come into play. Here we must consider four situations: the public corporation with professional managers; the public corporation with control shareholders acting as managers; private firms with professional managers; and private firms with family managers. Each of these cases raises different sets of questions about the appropriate role for stock options.

A. Case 1: Private Firms with Family Managers but Some Minority Shareholders

In these firms, we expect to see the same minority oppression problems as in close corporations in the U.S. The presence of a control shareholder can easily lead to rent-seeking activities at the expense of the minority investors. Excessive managerial compensation is one manifestation of this problem. In abusive cases, executive pay levels will be set to minimize distributions to minority shareholders.

From a corporate governance point of view, the key questions raised here concern what mechanisms minority shareholders have to bring about changes. In the United States, minority shareholders in public companies have relatively strong protections against majority

423. TOWERS PERRIN, *supra* note 340, at 333.

shareholder abuses.⁴²⁴ The combination of strong disclosure rules and legal protections for shareholders should prevent excessive compensation practices.⁴²⁵

In most foreign countries, minority shareholders in a private company are in a weaker position generally. We therefore expect relatively high executive pay levels, although if tax rates on personal income are higher than on capital distributions, this may lead to the allocation of firm income into payments to equity. Corporate law prohibitions on non-pro rata distributions may have the opposite effect, as controlling shareholders may funnel income into executive pay or engage in advantageous self-interested transaction in lieu of sharing any monetary benefits with minority shareholders.

Stock options are unlikely to play a major role in compensation for foreign companies' control shareholder managers. Such parties already have a control position in the firm, so that options are not necessary for consolidating the control shareholders' power, although they may have future value if the firm is taken public and they could be used to further dilute the interest of the minority shareholder. There is no alignment purpose to be served by option grants, and the control shareholder manager does not need to worry about retention or attraction of herself because she is the owner. Options could be used as incentive payments, but so could bonus payments based on accounting performance. In sum, while I cannot conclude that stock options will play no role in executive compensation for control shareholder managers, it seems likely that their role will be limited.

B. Case 2: Private Firm Dominated by Control Shareholder Employing Professional Managers

In this case, the control shareholder has a financial interest in keeping executive pay levels as low as possible, as these payments are funds that will come at least in part out of its pocket. However, professional managers must be hired in the executive labor market, and in order to attract and retain them the control shareholder will need to pay a market level of pay. Pay levels therefore should reflect the prevailing market conditions in that particular country.

424. See generally F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 2000).

425. Empirical research has found that American family controlled firms pay their non-family executives significantly less than other firms, and have much smaller proportions of these executive's compensation in stock options. BATES ET AL., *supra* note 191, at 11, 17. Furthermore, with the family child having excellent chances of being promoted to the top job, the internal tournaments for jobs at these firms have much lower prizes to offer outsiders.

The pay package is likely to be comprised mainly of fixed salary and accounting performance-based bonuses. Stock options and other long term incentive pay could be used, but have limited value. For example, stock options could be issued to professional managers as a means of aligning their interests with those of the control shareholder, but the control shareholder can engage in direct monitoring relatively easily, which lessens the need for options to act as an alignment device. Options can still serve incentive purposes, as can accounting performance-based bonuses, and attraction/retention functions if outside managers value them highly.

Furthermore, professional executives at privately held firms are unlikely to press hard for stock-based compensation. There is no public market for these shares and they are likely to have restrictions on them rendering them completely illiquid. Given these limitations, managers will attach a low value to these options, unless the control shareholder can create a valuation method for the shares that will allow the executives to realize an equivalent gain to what they would receive in a market. Finally, as with all option schemes, undiversified executives will discount their value to take into account the risk associated with them, thereby creating a gap between their cost to the firm and their value as compensation to the executive.⁴²⁶

Options might have particular value in a couple of cases. First, in certain circumstances, the control shareholder may be planning to take the company public through an IPO, or intend to sell the company to a third party buyer. In either situation, professional managers could sell their options, either to the public or the third party buyer, and recognize substantial gains. Of course, in these circumstances, we have moved out of the private firm scenarios and into the public firm case, which I discuss more fully below in cases 3 and 4.

A second scenario is a reverse LBO. Here a public company has been taken private, but there is an expectation that it will go public again. The control shareholder, usually an LBO investment fund, will provide professional managers with substantial equity interests in the firm that vest only over a long time period with the accomplishment of certain performance goals. As I discussed earlier, empirical evidence shows substantial productivity gains at these firms, as managers seek to get rich when the firm goes public or is sold to a third party.⁴²⁷

426. HALL & MURPHY, *supra* note 187.

427. Holmstrom & Kaplan, *supra* note 356; Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165 (1990); Abbie Smith, *The Effects of Leveraged Buyouts*, BUS. ECON., April 1990, at 19.

LBOs and reverse LBOs, however, while common in the U.S. during the 1980s, remain a rare occurrence in most foreign countries.⁴²⁸

To summarize, stock options may have a greater role to play in this case than in the first one, but this Article argues that they can still be expected to be a fairly modest part of executive compensation except in the last two circumstances discussed immediately above.

C. Case 3: Public Firm with Control Shareholder Managers

The control shareholder managers will, just as in case 1, have an incentive to pay themselves excessive compensation at the expense of the public minority. As outside investor monitoring is weak, we would also anticipate other forms of "rent extraction," such as violations of the duty of loyalty through self-dealing transactions and diversion of business opportunities. In addition to corporate law limitations on these practices, firms may also face corporate governance rules from the exchanges where they are listed, and securities law disclosure obligations once they sell stock to the public. Executive pay levels will adjust to a level that balances the control shareholders' interest in getting cash for themselves out of the firm, against the various corporate law, securities law, listing requirements, and tax preferences of the foreign firms' countries of origin. For example, if there are disclosure obligations for executive pay, outside investors may complain openly about high pay, and this may create pressure on control shareholders to use other methods of getting cash out of the company.

Stock option compensation is not necessary to align manager and shareholder incentives because control shareholders already have large stakes in the firm. Incentive pay could be in the form of accounting-based performance bonuses. Attraction and retention are not as serious a problem for firms where the control shareholders are acting as top managers themselves, although they may be a concern for lower level professional managers.⁴²⁹ Finally, given the likelihood that these control shareholder executives are overly invested in the company's stock, they may prefer to be compensated in the form of cash in order to diversify their portfolio.

Option pay can still have some role, however, in compensation packages at these firms. Options may be attractive to the control shareholder managers if there is a sufficiently liquid market for the

428. See *supra* notes 298-301, 308-310 and accompanying text.

429. Lower level professional managers may work harder if given stock-based incentive compensation, although the alignment effect is weak in this case as the control shareholder is actively managing the firm and monitoring these managers.

stock that they can sell newly acquired shares without a problem. Large option awards will allow them to accumulate more shares and thereby solidify their control of the company. Furthermore, the dilutive effects of options will only be partially borne by the control shareholders, as some fraction of these costs will be shifted to the public shareholders.

I should raise at least two cautionary notes about these conclusions. First, if the float in the company's stock is small, then the market for its stock may be dominated by noise and the connection between managerial performance and stock prices may be quite attenuated.⁴³⁰ This effect will weaken the link between pay and performance, and render the incentive effects of options much weaker. Second, control shareholders may not be as concerned about using options to increase their control, either because the firms' takeover defenses are so strong that a hostile offer cannot succeed or because the control shareholders' decision to take the company public indicates that they prefer liquidity to maintaining control.⁴³¹

To summarize, there is a more significant role for stock-based incentive pay systems in this situation than in previously discussed cases, largely because of the presence of a public market for the firm's shares.

D. Case 4: Public Firms Dominated by Control Shareholder Employing Professional Managers

Control shareholders will continue to try to maintain executive pay levels as low as possible because they bear at least part of the compensation costs. The executive labor market will set a floor, however, on managerial pay for professional managers. In order to attract and retain high quality executives, the control shareholder will need to offer market pay levels.

Fixed salary and accounting performance-based bonuses will continue to dominate the pay packet. Stock options and other long term incentive pay will be used if they are demanded by the market, but they have limited value as an alignment device. Options can still serve incentive purposes and attraction/retention functions and the public market for the stock makes professional managers attach a higher value to them.

430. This may create further opportunities for the control shareholders to enrich themselves though, as they may be able to manipulate the market price by virtue of their large stock position.

431. It may be the case that the control shareholder wants both liquidity and control, thereby reinforcing their interest in using options to accumulate a larger stake in their company.

Stock-based compensation can potentially weaken the control shareholders' grip on the company if the option plans are highly dilutive, although this effect may be dampened by the presence of strong anti-takeover defenses and a weak market for corporate control (frequently the case in these countries). The control shareholder, however, will bear a significant part of the economic costs of dilution.

As mentioned above, the executives will have a market for their shares, but if the float in the company's stock is small, this market may be dominated by noise trading. The more noise in the market, the weaker the connection between the managers' efforts and the stock price. Thus, one would expect that managers will discount the value of their stock options because of this effect.

Outside investors will have some voice on governance questions. If there are significant U.S. or U.K. pension fund investors in the company, they may seek to put into place incentive pay based systems as part of their corporate governance platform.⁴³²

This fourth case describes the most likely type of company to offer more stock options. Even in this case, however, the role for stock-based incentive pay systems is limited. The public market for the stock, and the need to make competitive offers to attract executives, may combine to make options most important in this situation.

E. Summary

At control shareholder dominated firms, options are less useful as alignment-enhancing devices, less valuable to the executives receiving them, and less desirable from the control shareholders' perspective. This Article argues that one should not expect to see stock options used as much in those economic systems where concentrated ownership is the norm. Neither will the legal rules, cultural norms, and soft laws be as favorable to their introduction as in the United States.⁴³³ If ownership structures become more dispersed, and the market for corporate control becomes more important abroad, then the Bargaining Power Theory would predict that CEOs and other executives would have more leverage in their pay negotiations. Option pay may also become more important as an alignment device and more valuable to executives as the size of the markets for their securities expand. In this scenario, we should anticipate seeing shifting patterns of legal rules, soft law constraints, and cultural norms, to make the use of incentive pay more acceptable.

432. See *supra* notes 200-203 and accompanying text.

433. Roe, *supra* note 169, at 41-43.

IX. SHOULD WE TRY TO ELIMINATE THE INTERNATIONAL PAY GAP?

Is the pay gap between U.S. CEOs and foreign CEOs a sign of American executive compensation run amok, or just an indicator of different underlying corporate management systems and economic forces? Board Capture advocates argue that American CEOs are vastly overpaid.⁴³⁴ They have suggested government intervention is needed to bring the “excessive” American executive pay levels down. Most recently, Bebchuk, Fried and Walker have proposed greater disclosure about executive pay as a solution to the international pay gap. In Part A below, I argue that Board Capture Theory should be rejected as a primary explanation of the pay gap, and that even if it is not rejected, Bebchuk, Fried, and Walker’s proposal for increased disclosure about executive pay will not reduce the pay gap.

In Part B, I argue that if the underlying economic forces, or different management structures, that are the foundations of the other theories discussed in this paper are primarily responsible for the pay gap, though, then the policy prescription is quite different. For any of the five alternative theories I have developed in this paper—the Marginal Revenue Product Theory, the Tournament Theory, the Opportunity Cost Theory, the Bargaining Theory, and the Risk Adjustment Theory—there is no need for government intervention. If foreign executive pay levels move in the direction of American pay levels, that change would reflect economic or strategic forces, with economically desirable, or at least neutral, characteristics. In short, market forces will dictate whether convergence will occur or not.

A. Board Capture Theory Should Be Rejected and Its Recent Proponents’ Policy Proposals Will Not Work

Board Capture theorists claim that policy makers should intervene in the market for corporate executives. They argue that

434. See, e.g., Linda J. Barris, *The Overcompensation Problem*, 68 IND. L.J. 59, 60-61 (1992) (noting that in the 1980s, executive compensation grew by 212 percent while factory workers’ wages only grew by 53 percent); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 5 B.C. L. REV. 937, 937-38 (1993) (arguing that American executives are grossly overpaid in comparison to their foreign counterparts); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 650-51 (1995) (noting that the problem of executive compensation is directly related to a passive board and effects the entire system of corporate governance); Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 142 (1995) (noting the general American view that executive compensation is much too high); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 201-02 (1996) (discussing the current debate over why U.S. executives are overcompensated).

American executive pay levels are too high, and that government intervention could serve to bring them down. However, as I showed *supra* Part III.C, Board Capture Theory does not offer a persuasive explanation of the international pay gap for many reasons. Moreover, it is hardly clear that the pay gap causes any economic inefficiencies. For example, what is the negative externality caused by American CEO pay levels that justifies government intervention into this market? In other words, why does the government have to help directors and shareholders set executive pay levels? The proponents of government intervention have not identified any product market inefficiencies, or shown that stock prices are too low because investors discount stock prices to take account of excessive management pay, or that managers could not commit to take less money so that everyone would be better off. Furthermore, if governments need to intervene to change international pay differentials between corporate executives, shouldn't they also need to take action on other workers' international pay differentials?

Even if we accept that Board Capture may explain some part of American executive pay levels, the policy conclusions that these theorists have proposed are unlikely to remedy the problem that is claimed to exist. While early proponents of Board Capture Theory argued for direct government intervention, more recently Board Capture theorists have focused on increasing disclosure on executive pay.⁴³⁵ To evaluate whether this is a sensible policy, we must address the question: what has been the impact of increased disclosure on international pay levels? Prior research shows that introducing executive pay disclosure regimes in foreign countries has had two effects: first, fostering an increased emphasis on incentive-oriented compensation,⁴³⁶ and second, facilitating a shift towards the U.S. pay paradigm by accelerating increases in executive remuneration.⁴³⁷ As to the first point, Anglo-American institutional investors are keen on remuneration schemes that give management incentives to maximize shareholder value and might want to promote this agenda on a global basis.⁴³⁸ Disclosure regulation could affect their ability to do so since

435. See BEBCHUK ET AL., *supra* note 20, at 74-76 (proposing increased disclosure, summarizing suggestions by others to directly regulate pay levels through caps or tax code changes). Bebchuk and his coauthors further claim that strong institutional shareholders are the most effective check on managerial remuneration.

436. Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 497-501 (1998).

437. For somewhat different versions of the thesis presented here, see Iacobucci, *supra* note 436, at 504-17; Mark J. Lowenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 23-24 (2000).

438. Cheffins & Thomas, *supra* note 164, at 308, 311-12.

the extent to which corporations are required to provide data that sheds light on the relationship between pay and performance will dictate to some degree the costs of shareholder monitoring.⁴³⁹ The comments offered by a former securities regulator when the Canadian province of Ontario bolstered disclosure regulation in 1993 makes the point well: "Good corporate governance relies on an informed and active investor community. In some respects, this legislation recognizes their legitimate need for information that enables them to relate management's performance to the performance of the company."⁴⁴⁰ The available Canadian empirical and anecdotal evidence suggests enhanced disclosure regulation had the effect predicted and helped to cause a shift towards incentivized managerial pay in publicly quoted companies.⁴⁴¹ Foreign CEO pay packages would therefore become more like those used in the United States if disclosure levels are raised overseas.

The second effect of increased disclosure may be to increase overall foreign pay levels. The catalyst here will be that those who manage a company and those who set executive pay on its behalf will be able to find out readily the "market rate" offered by competitors in the same industrial sector and by firms of a similar size. Assume that a company pays its top managers less than the norm. Due to disclosure, its executives will be fully aware of their inferior position in the compensation hierarchy and a perceived loss of social status could fuel their future pay demands.⁴⁴² Those who set executive remuneration will be sympathetic to such claims since the frugal compensation packages could be perceived as a tacit admission that the management team is "below average."⁴⁴³ Also, there will be fears that valued executives will defect to rivals offering more generous terms.⁴⁴⁴

Once those who set executive pay on behalf of a company discover that senior management is "underpaid," the obvious response

439. Iacobucci, *supra* note 436, at 497-501.

440. *Id.* at 497.

441. *Id.* at 502-03; Yun M. Park et al., *Executive Pay and the Disclosure Environment*, 24 J. FIN. RES. 347 (2001). Note, though, that research conducted in New Zealand, which bolstered executive pay disclosure somewhat in the early 1990s, does not reveal the same pattern. See ALEKSANDAR ANDJELKOVIC ET AL., PUBLIC DISCLOSURE OF EXECUTIVE COMPENSATION: DO SHAREHOLDERS NEED TO KNOW? (Working Paper, 2000); FAYEZ A. ELAYAN, EXECUTIVE INCENTIVE COMPENSATION SCHEMES AND THEIR IMPACT ON CORPORATE PERFORMANCE: EVIDENCE FROM NEW ZEALAND SINCE LEGAL DISCLOSURE REQUIREMENTS BECAME EFFECTIVE (Working Paper, 2001).

442. Thomas & Martin, *supra* note 104, at 1041-42.

443. *Room at the Top*, FIN. TIMES, Feb. 19, 1999, at 19.

444. Peter Rodgers, *The Greenbury Effect: Is It Pushing Pay Higher?*, INDEP., Apr. 26, 1996, at 21.

will be to offer more lucrative deals. If all companies ultimately follow this pattern and seek to match or exceed the "market rate," the inevitable result will be an upward "ratchet" in pay.⁴⁴⁵ Consistent with this line of reasoning, there has been much speculation in the United Kingdom, Canada, and Australia that the introduction of more rigorous executive pay disclosure requirements in the 1990s accelerated increases in managerial remuneration.⁴⁴⁶ Empirical work done on Canada indicates that such suspicions are well-founded.⁴⁴⁷

It is ironic that increased disclosure might contribute to an American-style executive pay spiral. Board Capture theorists and others who are concerned that top managers are paid "too much" are keen supporters of enacting these changes.⁴⁴⁸ For instance, when Ontario bolstered executive pay disclosure in 1993, a left-wing administration was in power that was concerned about the excesses of free-market economics. This led a columnist in a leading Canadian newspaper to suggest that the "real motivation" for reform "was to plunge the population into an egalitarian snit over the money paid to the capitalist scoundrels who run private-sector corporations."⁴⁴⁹ Matters did not quite work out as planned. As the same columnist observed in 2001, "[s]o far, the only impact of the disclosure has been to drive compensation higher as companies now compete more aggressively for talent."⁴⁵⁰

Nevertheless, the Board Capture Theory does highlight some aspects of the American executive pay process that are alarming. For example, it points out several important flaws in the current American practices in setting executive pay, particularly the pernicious effects of pay surveys and captive pay consultants.⁴⁵¹ There

445. *Room at the Top*, *supra* note 443; *How Greenbury Has Boosted Executive Excess*, INDEP., June 29, 1996, at 17.

446. On the UK, see COMM. ON CORP. GOVERNANCE, REPORT OF THE COMMITTEE ON CORP. GOVERNANCE ¶ 4.5 (1998) (Sir Ronald Hampel, Committee chairman); Rodgers, *supra* note 444. On Canada, see Iacobucci, *supra* note 436, at 512; Barbara Shecter, *Canadian CEOs Enjoy Average 8 percent Hike in Compensation*, FIN. POST, Sept. 25, 1996, at 5. On Australia, see Margot Saville, *Up, Up and . . . Execs Double Pay in 5 Years*, SYDNEY MORNING HERALD, Nov. 16, 2000, at 29.

447. PARK ET AL., *supra* note 191.

448. See, e.g., CHEFFINS, *supra* note 119, at 699; Rodgers, *supra* note 444; *Power Politics, American Style*, ECONOMIST, Feb. 25, 1995, at 67.

449. Terence Corcoran, *Executive Pay Is Not About Social Justice*, GLOBE & MAIL, May 14, 1994, at B2; see also Terence Corcoran, *Raestone Kops Storm Executive Suite*, GLOBE & MAIL, Oct. 16, 1993, at B2.

450. Terence Corcoran, *Executive Hunting Season*, NAT. POST, Apr. 3, 2001, at C19.

451. It should be noted that the empirical evidence on the influence of CEOs over Compensation Committees is mixed. Murphy, *supra* note 1, at 25 (summarizing studies).

is also empirical evidence that some boards of directors are subject to management capture.⁴⁵²

These facts fall short, however, of demonstrating that the present system suffers from a breakdown. As one commentator noted:

The work of those who criticize CEO pay, although appealing, simply does not "prove" that any particular CEO is overpaid, much less that an entire class of CEOs is overpaid. What is lacking in such work is some indication of what the CEOs would earn if the market for their services were more efficient. In the absence of evidence that the "overpaid" individuals would have been willing to accept less for their services, or that CEOs occupy some sort of monopoly position regarding executive services, it is difficult to accept the proposition as proven.⁴⁵³

In my view, economic forces are the most important factors in the determination of the market pay rate for CEOs and other top executives. The CEO's contribution to her firm's value, or the top executive's best alternative job opportunities, are powerful explanations of her relative pay scale. It seems unlikely that these values are fixed through some massive secret conspiracy to keep managerial pay levels high.

B. The Theories Developed in This Paper Support the Claim that Government Intervention in Executive Pay Markets Is Unnecessary

With each of the five theories advanced in this paper, government intervention to close the international pay gap is not desirable. If the Marginal Revenue Product Theory is an accurate description of how executive pay is set in the market place, then executive pay levels are set at (or close to) the amount that CEOs contribute to firm value. In this scenario, international convergence to U.S. pay levels would occur if, and only if, the economic value of foreign executives to their firms increased enough to entitle them to receive higher compensation. This type of change would arise only if foreign CEOs' decision-making powers increased, foreign firms grew larger, or foreign firms' growth opportunities expanded. No form of government intervention would therefore be desirable.

The Tournament Theory would lead to convergence if the position of CEO in a foreign company becomes as powerful as in the American firm, so that the prize to the victor is equally large. As with the first theory, higher foreign CEO pay seems justifiable only if these managers became more powerful. Cultural forces may constrain pay levels for a period of time, but ultimately underlying economic

452. John C. Coates, IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 844-45 (1999).

453. Loewenstein, *supra* note 437, at 205.

pressures will lead managerial pay toward levels that reflect the value of winning the tournament. Higher pay reflects the greater economic payoff of victory in the internal labor market sweepstakes. Again, government intervention seems unnecessary.

Opportunity Cost Theory leads to the conclusion that foreign firms will pay their executives on an American pay scale only if these executives can get alternative positions at that price. If foreign financial markets are making it easier for top managers from these countries to obtain financing to start up their own firms or to engage in leveraged buyouts of existing firms, or if the market for foreign executives is expanding outside of purely domestic frontiers, then foreign managers' opportunity costs of remaining at their current employers are rising. This change in their economic opportunities should lead to an increase in their pay levels. Again, convergence to higher (or lower) pay levels will depend on movements in economic forces, not government intervention.

Increased foreign CEO pay under the Bargaining Power Theory would be the result of a shift in CEOs' power to oppose takeovers and a rise in the use of stock options. More hostile takeovers abroad, accompanied by declines in concentrated ownership patterns, could move executive pay toward U.S. levels.⁴⁵⁴ If these changes make the foreign market for corporate control more efficient, then the resulting benefits may offset any increase in executive pay, so that the resulting outcome is at least wealth-neutral for shareholders in foreign companies. Although there are distributional consequences to increased executive power, policy makers would need to change their views on the desirability of hostile takeovers in order to change the underlying motivations for higher American executive pay.

If we look at convergence through the lens of the Risk Adjustment Theory, then international pay convergence will only occur if U.S. and foreign CEOs' firm-specific risk levels converge. Empirically, this is a difficult claim to test because of the paucity of data available on CEOs' individual wealth levels and stockholdings. The one component we can most easily observe, stock option usage, is presently quite different, with U.S. levels far exceeding those abroad. For the near future, this trend seems likely to continue, making it difficult to forecast convergence any time soon.

454. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 458 (2000).

X. CONCLUSIONS

The international executive pay gap is one of the great puzzles of executive compensation. In this paper, I have argued that the divergence between American and foreign CEO pay can be explained by a variety of market-based theories. I claim that such theories cast more light on the persistence of these wage gaps than sole reliance on board capture claims. Does the international pay gap constitute a crisis in corporate governance that requires government intervention? No. For one thing, international pay levels are largely determined by underlying economic forces, such as the marginal revenue product of executives, the difference in alternative job prospects, and the relatively larger size of American firms. These factors are dictated by markets and will adjust as markets adjust. The pay gap will disappear if these conditions move toward convergence.

Even if the pay gap is partially explained by differences in the relative bargaining power of American executives, it is unclear whether such differences arise from Board Capture or the Bargaining Power Theory. Which one is right leads to very different policy implications.

Finally, even if you believe that executive pay levels are just too high, so that they are in some sense of the word "unfair," there is evidence that they have stopped growing. The current economic slowdown has adversely affected executive pay levels both in the U.S. and abroad.⁴⁵⁵ Corporate boards are looking harder at all aspects of executive compensation, especially large stock option awards and severance packages, as their firm's stock prices drop. Much more work needs to be done in this area before scholars can confidently predict what policies, if any, governments, self-regulatory organizations, and firms ought to be adopting.

455. See, e.g., Joseph E. Barchelder, *Executive Compensation: Impact of Current Turmoil on Executive Pay*, N.Y. L.J., Oct. 30, 2002, at 3 (noting that long term incentives given to executives are hit the hardest by a slowing economy); Kathy M. Kristof, *Executive Pay Report: Working to Retire Overcompensation: Some Firms in Southland are Tying CEO Pay to Performance*, L.A. TIMES, Jun. 2, 2002, at 1 (noting that some firms' performance-based compensation plans are designed to cut executive compensation during economic downturns); Hope Yen, *CEOs Try to Restore Credibility: Gathering Reveals Misery, Frustration*, HOUSTON CHRON., Nov. 21, 2002, at 1 (noting that reducing executive pay is seen as a viable option for increasing performances of companies).
