11-1992

Overcompensating: The Corporate Lawyer and Executive Pay

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BOOK REVIEW ESSAY

OVERCOMPENSATING: THE CORPORATE LAWYER AND EXECUTIVE PAY

IN SEARCH OF EXCESS. By Graef Crystal. New York: W.W. Norton & Co., Inc., 1991. Pp. 272. $19.95.

*By Charles M. Yablon**

Sometimes corporate lawyers are too smart for their clients' own good. The corporate lawyer's basic stock in trade, after all, is his ability to provide corporate managers with a legal way to accomplish whatever it is the managers want to do. The structure of corporate law is quite amenable to such demonstrations of legal expertise. Corporate law is predominantly facilitative law, designed to foster the creation of business associations among private individuals and groups in accordance with whatever private ordering they desire. Corporate law statutes are generally suppletive, and their effect can often be altered or avoided by careful drafting of the relevant corporate documents. Corporate case law, particularly the business judgment rule, creates a powerful presumption in favor of managerial decisionmaking that tends to render all but the most clearly self-interested or fraudulent managerial conduct immune from serious legal attack. The result is that, under the current legal regime, most any action that corporate managers are likely to desire can be accomplished with some clever and careful advice from counsel.

But the corporate lawyer's identification with the goals of corporate management and her skill in achieving those goals can sometimes backfire. Something along these lines arguably occurred in the later part of the 1980s, when some of the most accomplished and respected corporate lawyers in America, relying on the traditional deference of Delaware courts to most forms of managerial decisionmaking, structured and approved a series of innovative transactions designed to thwart unwanted takeover attempts. These defensive tactics eventually became so extreme, so absolute in the power they conferred on incumbent managers to prevent takeovers, including takeovers clearly favored by the vast majority of shareholders, that they engendered substantive criticism from academics and shareholders, including calls for new federal legislation restricting such defensive tactics.[1] Eventu-

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1. See SEC Issues Concept Release on Poison Pills, Other Takeover Issues, BNA

ally, even the normally cooperative Delaware courts began, in their published decisions, to change corporate law doctrine in ways that limited managerial discretion and power to thwart unwanted takeovers. Whereas in 1980 it could be stated with confidence that under Delaware case law, absent bad faith or self-dealing, managers could adopt defensive tactics whenever they determined it was in the "best interests" of the corporation to do so,[2] by 1992, it is equally clear tbat such tactics may only be adopted to the extent they are "reasonable in relation to the threat posed" and that, in certain limited circumstances, there is an affirmative duty on managers to refrain from defensive tactics altogether.[3]

Professor Graef Crystal's new book, *In Search of Excess*, focuses on and substantiates the growing concern that excessive amounts and inappropriate forms of compensation are currently being paid by American public corporations to their top executives, particularly the chief

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Daily Report for Executives, Aug. 15, 1986, at A21; Dennis Block & Jonathan Hoff, Legislators Focusing on Reform of Takeover Regs, Legal Times, Nov. 19, 1984, at 16; Nina Easton, Interest in Takeover Reform Picks Up, Legal Times, Nov. 19, 1984, at 1.

2. See Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); see also Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 703–04 (2d Cir. 1980) (holding that tender offeror could not obtain injunction preventing target's merger with third corporation if the merger is believed by target's director to be in its best interest); cf. Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.) (holding that unless desire to fend off would-be acquiror is sole motive for board in making acquisitions, its actions are protected by the business judgment rule), cert. denied, 454 U.S. 1092 (1981).

3. See, e.g., Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) (action of board of directors in face of takeover attempt must be reasonable in relation to threat posed); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (once sale of the company appears inevitable, managers' sole obligation is to obtain highest possible price for shareholders); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available."); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (same); City Capital Assocs. v. Interco Inc., 551 A.2d 787, 796–97 (Del. Ch. 1988) (action of board of directors in face of takeover must be reasonable in relation to threat posed); Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049, 1055–56 (Del. Ch. 1988) (same).

Some might argue that the Delaware Supreme Court's decision in Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) represents a return to greater tolerance of managerial discretion in this area. This is to some extent true, in that it represents at least an attitudinal shift in the recent Delaware decisions. Yet doctrinally, *Time* was about delimiting the appropriate scope of the *Unocal* and *Revlon* standards. I doubt many corporate lawyers would argue that after *Time*, the defensive tactics found to violate Delaware law in cases like *Revlon*, *Interco*, *MacMillan*, or *Pillsbury* are now permissible. Rather, *Time* has added to the uncertainty of Delaware law by indicating that a large number of factors may be relevant to the court's determination that an auction duty under *Revlon* has arisen. This is very much in keeping with the basic dynamic of Delaware law. See Charles M. Yablon, Poison Pills and Litigation Uncertainty, 1989 Duke L.J. 54, 72–81; see also William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261 (forthcoming 1992) (as a conception of the business corporation, the "Time-Warner decision [] should itself be seen as provisional, not final").

executive officer, or "CEO." Executive compensation is another area in which corporate managers have been pretty much free, as a matter of traditional corporate law doctrine and practice, to do whatever they liked. Recent expressions of concern from both politicians and representatives of the investing public, however, indicate that executive compensation may now have reached such levels of outrageousness that some form of legal reaction is likely to occur.[4] The purpose of this review essay is to explore the possibility that, just as shareholder and public concern over managerial abuse of defensive tactics eventually led to increased legal restrictions on their adoption and use, the growing public and institutional investor concern about the amount and structure of executive compensation may lead to a tightening of the legal rules governing such compensation.

According to Professor Crystal, there are now virtually no effective limits on either the amount or forms of compensation that CEOs of public corporations may choose to pay themselves. His book makes a powerful case that a CEO, assisted by a good compensation consultant, can get his board of directors to adopt virtually any compensation package. Crystal was himself a compensation consultant for many years, and he is able to provide names, dates, and companies in which corporate executives have been able to obtain enormous amounts of compensation, often for average or below-average performance. He also shows that such compensation, while ostensibly tied to corporate performance, often is essentially risk-free income to the CEO.

When one looks at the world of the corporate executive, it is easy to see both the incentives and the means whereby corporate compensation gets ratcheted ever upward. As Crystal points out, no CEO ever feels he deserves a lower salary; the CEO's compensation consultant has strong incentives to tell him he is underpaid, and the outside directors on his[5] compensation committee are unlikely to disagree. One searches the corporate landscape in vain for a voice of restraint, someone whose job it is to caution the corporate executive to go slow on the salary increase, that too bloated a bonus could lead to problems.

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4. Indeed, the publication of Professor Crystal's book was followed by his testimony before a Senate committee and the introduction of a number of draft bills relating to the subject of executive compensation. They are discussed infra notes 48-51 and accompanying text.

5. Throughout this essay I will be talking a great deal in hypothetical terms about CEOs, corporate counsel and compensation consultants. The structure of the English language is such that I must often assign gender to these hypothetical folk. While I am tempted to follow current academic custom and vary their gender randomly from paragraph to paragrapb, I find this disingenuous, and fear it may disguise the reality that virtually all CEOs of American public corporations are men. See, e.g., Women in Management: The Spare Sex, The Economist, Mar. 28, 1992, at 17 (there is only one female chief executive of a Fortune 500 company, and she shares the post with her husband). My somewhat arbitrary compromise is to envision lawyers and compensation consultants of varying gender, but to keep overcompensated CEOs, as they are in fact, exclusively male.

This brings us once again to the corporate lawyer, both inside and outside counsel, and her potential role in controlling and limiting managerial excesses. One of the striking things about Professor Crystal's book is the *absence* of any serious consideration of the role of corporate lawyers in determining or controlling corporate policy on compensation. This is not, I think, because he has overlooked that aspect of the process, but because he accurately depicts the current situation, in which corporate lawyers *do not play* any significant role in determining or controlling managerial compensation. This in turn reflects that, under existing corporate law doctrines, a good corporate lawyer rarely, if ever, has to tell her client that any compensation scheme, no matter how outrageous, will entail any serious legal difficulty. The current outcry over executive compensation may well change this state of affairs. This essay argnes that such a change is overdue and that appropriate modifications in the law of executive compensation can help curb the more outrageous behavior by corporate executives that Professor Crystal details.

This essay is divided into two parts. The first examines and seeks to define the problem of executive compensation. It shows that the ability of executives to pay themselves huge amounts of compensation is the result not only of managerial greed and compliant boards of directors, but also of a certain indeterminacy in compensation arguments. Such indeterminacy makes it possible for a good compensation consultant to justify almost any pay scheme as beneficial to the company. A legal regime that effectively insulates board decisions in this area from judicial review is another major factor contributing to the ability of executives to overcompensate themselves.

The second part considers the possibilities for change in the law of executive compensation. It argues against attempts to impose strict limits on types or amounts of executive compensation, or proposals to rely exclusively on increased monitoring by institutional investors. Instead, it argues that changes in the current corporate law of executive compensation can and should occur—changes similar to those recently made in the Delaware law of defensive tactics—that would remove some of the deference courts give to boards' decisions on executive compensation. The salutary effect of such doctrinal change would not be so much to increase litigation as to enable corporate counsel to raise fears of potential litigation with their clients and give them reasons to argne for some restraint and against the more egregious compensation schemes described by Professor Crystal.

I. Defining the Problem

A. *Do Corporate Executives Make Too Much Money?*

No one denies that chief executive officers of major public corporations make a lot of money. The debate over executive compensation, however, hinges on the *prescriptive* claim that the chief executive officers of major public corporations make *too much* money, and that is a far more controversial claim.

There are two basic arguments supporting the proposition that CEOs make too much money—the "unfair price" and the "unfair process" arguments. Proponents of the unfair price argument assert that current levels of executive compensation are dramatically out of line with some relevant basis of comparison. Crystal utilizes two such bases for judging salary levels: the comparison of salaries of American executives and workers, and of American executives and their counterparts in Europe and Japan (pp. 23–27).

Crystal states that the average American CEO makes 120 times the compensation of the average manufacturing worker and 150 times the average compensation of workers in both manufacturing and service industries (p. 27). Moreover, the trend has been toward greater disparity.[6]

A look overseas confirms that the levels of compensation available to American CEOs have no parallel in the rest of the world. Crystal constructs an average annual compensation of $2.8 million for American CEOs in 1990 (p. 28)[7] and compares it to the average Japanese CEO's cash compensation of $310,000 per year, sixteen times the pay of an average Japanese industrial worker. The average German CEO makes about $735,000 per year, twenty-one times the pay of the average German factory worker (pp. 206–09).[8]

Can such high levels of compensation be defended? There are other comparisons under which current CEO compensation levels do not appear so outrageous. Michael C. Jensen and Kevin J. Murphy, while confirming Crystal's observation that compensation for CEOs in public corporations has increased over the last fifteen years in the United States, note that this is a return to levels that existed in the 1930s.[9]

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6. In 1974, the average CEO earned only 35 times as much as the average manufacturing worker (p. 27). The growth of the gap is the result of both a drop in the real earnings of the average American worker in the subsequent 18 years and a fourfold increase in executive compensation.

7. This number includes long-term incentives as well as salary and bonus.

8. Admittedly, Crystal's figures for overseas compensation seem to be based on off-the-cuff estimates by a few foreigu authorities (his figures for American executives are compiled from proxy statements (p. 265)). The fact remains, however, that American compensation levels for CEOs are of a different order of maguitude from those of their foreign competition, a fact the popular press made mucb of during President Bush's recent trip to Japan. See, e.g., Jill Abramson & Christopher J. Chipello, Compensation Gap: High Pay of CEOs Traveling with Bush Touches a Nerve in Asia, Wall St. J., Dec. 30, 1991, at A1.

9. See Michael C. Jensen & Kevin J. Murphy, CEO Incentives—It's Not How Much You Pay, But How, Harv. Bus. Rev., May-June 1990, at 138, 138–39. Jensen has compiled data that show that the cash compensation for CEOs of public companies in the period 1934–1938 was at approximately the same level as that achieved in

Another basis, discussed by both Crystal and Jensen and Murphy, compares American executive compensation to the earnings of highly paid actors, sports figures, law firm partners and investment bankers (pp. 31–41).[10] It is possible to put together a group of individuals in any of these fields whose compensation in the late 1980s made the salaries of most CEOs seem positively miserly.

The significance of any of these comparisons is open to question. For example, many CEOs argne that the Japanese management structure and business culture are too different from their American counterparts to provide useful comparisons of CEO compensation, while Crystal argues that payments to actors and sports figures, obtained after arms-length bargaining, have little relationship to executive compensation schemes (pp. 36–38). To evaluate these arguments properly, however, requires some *prescriptive* argument about what it is that makes a compensation level fair or unfair, appropriate or inappropriate.

In late 20th century capitalist America there is one preeminent argument to demonstrate that a given price or payment is fair and appropriate—that it is the product of arms-length bargaining between a fully informed buyer and a fully informed seller.[11] The lack of resemblance between the way CEO compensation is set and the process of arms-length negotiation provides the more telling argument against current compensation practices—the "unfair process" argument.

1982–1988. See id. at 139. Professors Jensen and Murphy do not state that these four years in the middle of the Great Depression provide an appropriate comparison with present day compensation levels, however, and there is some historical evidence suggesting that the mid-1930s represent a previous high point in executive compensation.

Professor Vagts recounts a history in which executive compensation in public corporations reached a peak in the late 1920s, held stable or even increased in the 1930s, and was not really reduced until the salary stabilization and higher tax rates of the early 1940s took effect. See Detlev Vagts, Challenges to Executive Compensation: For the Markets or the Courts?, 8 J. Corp. L. 231, 245–47 (1983). In 1983, Vagts stated that executive compensation was just approaching the *nominal*, not actual, levels of pre-1929 compensation. See id. at 254–55. An earlier commentator stated that executive salaries actually increased in 1930 and 1931, in part to make up for the executives' losses in the stock market. See George T. Washington, The Corporate Executive's Living Wage, 54 Harv. L. Rev. 733, 734 (1941).

In short, while these historical comparisons may not show that current levels of executive compensation are appropriate, they convincingly establish that it is false to call them "unprecedented."

10. See Jensen & Murphy, supra note 9, at 145–49.

11. The point of such arguments is to show that the price was arrived at under circumstances *approaching* perfect competition, a blessed state involving, among other things, perfect information, large numbers of buyers and sellers, and product homogeneity. See George J. Stigler, The Theory of Price 82–83 (4th ed. 1987). In such a market no individual buyer or seller has any power to influence price. See id. Of course, no market is perfectly competitive, but some markets approach this condition more closely than others. The market for CEO compensation exhibits hardly any features of a reasonably competitive, let alone perfectly competitive, market.

According to Professor Crystal (who, it must be remembered, spent many years helping to set the compensation of various CEOs (pp. 9–10)), the negotiations between a CEO and the outside directors who sit on the compensation committee can hardly be called negotiations at all. Crystal tells us that the directors who compose such committees "are, for the most part, not very adept at statistics and corporate finance" (p. 50), nor do they have the benefit of either their own compensation consultant or independent counsel. Moreover, "many of the compensation committee members may be the personal friends of the CEO" and "it is the CEO who suggests to the board members how much they should pay themselves" (p. 50).[12] The scenario Crystal paints is one in which CEOs, aided by a smart compensation consultant, can generally name their price with little fear of contradiction or refusal from the outside directors with whom they are negotiating.

Not only does Crystal's direct experience of the compensation-setting process fail to reveal any arms-length bargaining, but the results of that process fail to resemble the results that would be expected from arms-length transactions in a relatively competitive labor market. Studies by Jensen and Murphy show that the compensation of corporate CEOs is affected only slightly by changes in corporate performance.[13]

12. The subject of outside director compensation is just beginning to get the attention it deserves. According to a recent study, the average outside director earned $33,133 in total annual compensation in 1991. Average outside director pay increases over the last 5 years have outpaced the Consumer Price Index by 5%. See Number of Women Directors at All Time High; Retailers Have Highest Paid Directors; CEOs Lose Confidence in EEC to Market Their Products, P.R. Newswire, June 29, 1992, available in LEXIS, Nexis Library, Wires File. Crystal points out that some companies, like Coca-Cola, pay their outside directors substantially more than that, and that the relatively low director fees do not include other forms of compensation directors receive, like pension funds and stock options (pp. 228–29). More than half the directors of the 100 largest companies listed by Fortune magazine were provided with some type of benefit coverage. See Fran Jeffries, Board Room Benefits: Outside Directors Fees—and Responsibilities—Rise, Courier J., Apr. 1, 1990, at E1.

Crystal claims that because directors' pay is set by the CEO, and the outside directors in turn set the CEO's pay, an "almost incestuous relationship" exists, and that there is a positive statistical correlation between the pay of CEOs and that of the outside directors on their boards (pp. 228, 230). Academic commentators have argued, on the other hand, that outside director compensation is low, even on an hourly basis, perhaps to low. See Melvin Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. Pitt. L. Rev. 945, 971 (1990); Tamar Frankel, American Law Institute's Corporate Governance Project: Duty of Care, 52 Geo. Wash. L. Rev. 705, 712 n.23 (1984).

13. In an efficient market for executive talent, one would expect that the price (compensation) for the services of corporate managers would be dependent primarily on the value of those services as measured by the historical performance of the businesses they ran. In fact, there seems to be little correlation between managerial pay and corporate performance. Jensen and Murphy found that for the median CEO in the 250 largest companies, a $1,000 change in corporate value corresponded to a change of just 6.7 cents in salary and bonus over two years. If all monetary sources of CEO compensation are considered, including the various forms of "incentive" payments, a $1,000 cbange in corporate value still resulted in a change of only $2.59 in CEO

Crystal recounts similar studies (p. 181).[14]

In short, there is strong evidence that the current compensation of American CEOs is high by both recent historical and international standards and that the processes by which it is set are relatively unconstrained by market forces or arms-length bargaining.[15] Accordingly, Crystal and others make a powerful case that many American CEOs are indeed paid too much.[16]

B. *Dangers of Overcompensation*

But is such overcompensation a *problem*? The dominant perspective in the press and among many politicians is to assume that there is something deeply wrong when corporate CEOs pay themselves millions in salaries while closing plants and laying off thousands of workers.[17] But this is fundamentally an argument about appearances. Nobody seriously believes that cutting Robert Stempel's salary to zero would alleviate General Motors' difficulties or permit the reopening of shut-down plants.

While it is hard to find anyone in public life willing to respond with a hearty "So what?" to the evidence that American CEOs are grossly

compensation. See Jensen & Murphy, supra note 9, at 139. Jensen and Murphy also noted that compensation for CEOs is no more variable than compensation for hourly and salaried employees. See id. at 140.

14. Crystal states that in a survey of 14 companies in 1988, the median increase in return on equity was only 9%, but median executive pay was 56% higher (p. 181). In a recent study, Crystal found that 30% of the variation in CEO salary is related to the size of the company, and only 4% is related to company performance. See Jill Lyons, Institutional Executive Compensation: Pay, Performance, and the 1992 Proxy Season 17 (1992) (citing Graef S. Crystal, Executive Compensation in Corporate America 1991 3).

15. Another study that provides indirect support for this view is Edward A. Dyl, Corporate Control and Management Compensation: Evidence on the Agency Problem, 9 Managerial & Decision Econ. 21, 21–25 (1988). This study, which found a significant negative relationship between the degree of shareholder concentration aud management compensation, was viewed by its author as casting empirical doubt on the suggestion of Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288, 292–306 (1980), that an efficient labor market for executives would operate to compensate managers in accordance with past performance.

16. Jensen and Murphy argue that, in a sense, CEOs might be considered underpaid, but only in relation to the pay scales that might exist under the strongly incentivized system they advocate. They argue that such a system would drive out poor managers (who would earn next to nothing), thereby improving managerial performance and, in turn, improving corporate performance. The managers of these new and improved corporate performers, it is argued, as well as improved performance by the most competent of the old managers, would eventually increase average CEO pay. See Jensen & Murphy, supra note 9, at 139.

17. See, e.g., Linda Grant, SEC's Proposals on CEO Pay Win Praise, L.A. Times, June 24, 1992, at D3 (jabs at high U.S. executive pay "hit home with Americans suffering from a recession and staguant personal income"); Robert J. McCartney, Executive Pay Rises as Profits Fall, Wash. Post, Apr. 25, 1992, at C1 (quotation from Representative Martin Sabo to this effect).

overcompensated, there is much economic literature to support precisely that position. Economic theory has long recognized that whenever there is a separation of ownership and control in a firm, a potential conflict of interest is created between the owners of the firm and the agents they hire to run the business.[18] This problem of agency cost is exacerbated in the public corporation, no single owner of which has a sufficient incentive to monitor corporate management and to seek the reduction of such agency costs.[19] It is perfectly plausible to argue, and many economists do, that a certain amount of self-serving behavior by corporate managers—including payment to themselves of excessive compensation—is simply the cost of doing business and part of the costs inherent in the use of the public corporation as the primary vehicle for carrying on economic activity in the United States.[20]

It should also be recoguized that the absolute dollar amounts of CEO compensation, while quite large as payments to individuals, are merely a drop in the bucket to most corporate treasuries.[21] Even a mil-

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18. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308–13 (1976).

19. See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 66, 84 (1932); Harold Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J.L. & Econ. 375, 375 (1983); Fama, supra note 15, at 296; Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 312–13 (1983).

20. See Jensen & Meckling, supra note 18, at 357; Jensen & Murphy, supra note 9, at 141 (giant companies that will never be able to grant their senior executives a meaningful share of outstanding equity should understand that this limitation is a real cost associated with bigness).

Until recently, it was assumed that the benefits associated with large publicly held enterprises including managerial expertise and specialization as well as economies of scale far outweighed these costs. But see Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.–Oct. 1989, at 61.

Even if one accepts the idea that a certain level of agency costs is inevitable when control is separated from ownership, the well-documented increase in executive compensation levels over the last 15 years must still be a major source of concern. Agency costs, after all, decrease investment returns. If such costs are growing, then the returns of investors are concomitantly decreasing. This is especially troubling if, as it appears, these costs are increasing faster and more substantially for American companies than for their European and Japanese competitors.

21. This is not always the case. Crystal points out that in fiscal 1990, Jeffrey Steiner of Fairchild Corporation received $1.4 million in salary and another $4.4 million in bonuses (plus additional compensation from the exercise of stock options) (p. 93). That same year, Fairchild (then called Banner Industries) reported a $5 million pre-tax loss. See Banner Industries, 1990 Annual Report to Stockholders 29 (1990) [hereinafter 1990 Annual Report]. Accordingly, one could well argue that it was Steiner's bloated compensation that actually put Fairchild in the red that year. However, it should be noted that Fairchild reported total shareholders' equity of $114 million in 1990, see 1990 Annual Report, supra, at 30 (of which a $6 million payment to the CEO still represents a hefty chunk), and Crystal notes that even in the world of executive compensation, Steiner is a particularly egregious offender (pp. 92–93). Moreover, after extraordinary items, Fairchild did report a small profit in 1990 (pp. 92–93).

In 1990 Paul Fireman, CEO of Reebok International Ltd., received over $33 million

lion dollar overpayment here or there is not a matter of grave national concern. Crystal is aware of this argument, and a number of answers to it may be found in his book.

Crystal first responds that CEO compensation is merely the tip of the iceberg of executive overcompensation. He argues that overcompensation of CEOs also raises the compensation for other senior executives to inappropriate levels.[22] Thus, compensation payments can snowball to the point that total executive compensation plans and perquisites can become a real drain on corporate earnings.[23]

In a second argument for treating CEO compensation as a serious problem, Crystal asserts that current compensation methods are not creating the appropriate incentives for management (pp. 96–109, 181).[24] A CEO who can effectively set his own salary has less incentive to perform well than an executive who knows that his future salary increases are contingent on meeting well-defined management goals.

The ideal compensation arrangement, in this view, is for management to own 100% of the stock. Such an arrangement can indeed result in very high returns to management and is one that many managements sought to obtain in the late 1980s through leveraged buy-outs ("LBOs").[25] The relative advantages of companies taken private through LBOs and publicly held corporations are beyond the

in compensation, with his cash bonus alone totalling $14.5 million. If this bonus had been cut by $10 million to $4.5 million, it reportedly would have boosted Reebok's 1991 earnings by $.09 a share. See Michael Quint, Reebok Is Criticized About Pay, N.Y. Times, Mar. 20, 1992, at D3.

22. Crystal states that in a study of 200 companies, he found a high correlation between the CEO and the next highest paid executive, each $1 of CEO pay resulting in an additional 47 cents for the number two executive. Crystal estimates $1 of overpayment to the CEO can result in $40 to $50 in total costs to the company in executive pay (pp. 173, 256). Similarly, both for tax reasons and because of managerial generosity, grants of stock options or restricted stock to the CEO tend to become "stock option plans" in which large numbers of executives participate.

23. The degree to which CEO compensation is a rising tide that lifts all senior executive boats, however, is far from clear. Crystal notes that the structure of most corporate compensation schemes is strongly pyramidal (p. 40), and his own study shows that a $1 increase in CEO pay yields less than half that to the next-highest-paid executive (p. 173). If the effect of the increase continued to fall off at that rate, a $1 increase to the CEO would only cost $2 to the company. Crystal's estimate that it will cost $40 is, he admits, an assumption (p. 173).

24. See Dyl, supra note 15, at 21, 24; Jensen & Murphy, supra note 9, at 140, 150–54. Such statistics, however, with the exception of Dyl's suggestive but far from comprehensive study, do not indicate that companies are heing run inefficiently. They merely show that managerial compensation is not strongly reflective of corporate performance. To see this as a problem one must assume, as Jensen, Murphy and Crystal do, that managerial compensation *should* strongly reflect corporate performance. One wonders what these same statistical techniques would show in Japan, where, according to most accounts, there is little use of motivational compensation payments and executive compensation varies little from year to year.

25. Jensen and Murphy make this point explicitly. See Jensen & Murphy, supra note 9, at 141.

scope of this essay. The ideal, however, of the executive whose interests are aligned with the shareholders through extensive stock ownership has played a large part in the excesses of recent years, as Crystal's book documents and as I shall examine more closely in the next section of this essay.

A third problem, mentioned but not emphasized by Crystal, plays a major role in the thinking of various management gurus. They worry about the deleterious effect that such lavish compensation for the few on the top of the corporate pyramid will have on those lower down—both workers and middle management—who are under increasing pressure to work longer hours for less pay and whose own ability to make ends meet is in greater and greater jeopardy.[26]

C. *The Sources of Excess*

Why has there been such a substantial increase in executive compensation levels over the last fifteen years? CEOs had at least as much power to set their own salaries fifteen years ago as they do today.[27] Crystal does not describe the historical forces at work here, but he does describe a technique whereby the corporate compensation system, once it gets set in motion, generates higher and higher levels of executive compensation as each participant in the process acts in accordance with his or her own self-interest. This is the "ratcheting" effect.

One development on the corporate scene in the last fifteen years, according to Professor Crystal, is the emergence of a new type of expert advisor to the company, the "compensation consultant."[28] The

26. See Joani Nelson-Horchler, The Pay Revolt Brews, Indus. Wk., June 18, 1990, at 28, 29–30, 34 ('Managers won't put up with a 20-to-1 or more pay differential, and we're already seeing an exodus from Silicon Valley firms such as Apple Computer.') (quoting Sheridan Tatsuno, marketer of Japanese technology assessment); see also (p. 256) ("So the presence of huge CEO pay most likely creates greater pressure on the part of the workers for more pay."). These adverse morale effects are hard to quantify or study effectively. This does not mean, however, that they should be ignored. For a powerful analysis of the importance of conceptions of relative worth (and wealth) in explaining social phenomena, see Robert H. Frank, Choosing the Right Pond: Human Behavior and the Quest for Status (1985).

27. The governance structures Crystal describes, with outside directors who are generally personal friends of the CEO and are likely to be executives or retired executives themselves, were certainly as common 15 years ago as today. Similarly, the legal rules, notably the stringent business judgment rule applicable to compensation decisions, were as stringent 15 years ago as they are today. See Beard v. Elster, 160 A.2d 731, 736-38 (Del. 1960). Even the public concern over levels of executive compensation has been growing for some time. See Vagts, supra note 9, at 232. Indeed, many of the changes that have taken place during the last 15 years, like the increased threat of hostile takeovers, were generally seen as reducing possibilities for self-aggrandizing behavior by management. See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1169–70 (1981).

28. Compensation consultants have been around since the 1950s, but Crystal says they "came into their own" in the late 1970s (pp. 215–16).

compensation consultant's job is ostensibly to advise the corporation with respect to the compensation of its senior executives. As Crystal points out, however, it is a very dim compensation consultant who does not recognize that he has actually been hired by the corporate CEO and that his role is to find a way to justify a sizeable increase in compensation for the CEO (pp. 42–50).

The compensation consultant has available to her a great deal of information about compensation levels and methods at various companies. Much of this information is public, obtainable through proxy statements by anyone who has an interest in compiling and analyzing it. Crystal also implies that there is a fair amount of sharing of non-public information that goes on between compensation consultants (pp. 43–44).[29]

With the data at hand about compensation levels at other companies, the compensation consultant can easily compile figures that compare the compensation levels of the client company with compensation paid by "comparable" corporations. One would expect that in approximately 50% of the cases, the consultant will be able to inform the client that its CEO is receiving "below average" compensation.[30]

According to Crystal, 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. The able compensation consultant can buttress these concerns, in the minds of both the CEO and the outside directors who make up the compensation committee. If the company has been doing well, the argument can be made that the corporation's managers need to be rewarded for the good work they have done. If the company has been doing poorly, the argument is more likely to stress the need to avoid key executives' being stolen by other firms, or of the need to create incentives to improve managerial performance (pp. 45–48). It is not difficult to see how, in a world in which every CEO believes he should be paid at or around the seventy-fifth percentile of the range of compensation levels developed by the compensation consultant, a strong upward pressure on compensation will result.

A second useful tool of the compensation consultant is the indeterminacy of the argnments consultants can make to the board or compensation committee to justify a CEO pay raise. Crystal repeatedly shows just how easy it is to make such argnments on behalf of average or even below average CEOs. After all, any poor performance or reversal in corporate fortunes can be attributed to some external event: a down-

29. This should come as no surprise, since having accurate information about other companies' compensation levels helps all consultants do their jobs more effectively.

30. Indeed, with some care in selecting the comparable companies used to provide the comparison, and the inclusion of one or two well-known big spenders, it is likely that compensation consultants can plausibly discover that quite a large percentage of their corporate clients' CEOs are receiving below average compensation.

turn in the economy, undervaluation of the corporation's stock by the market, rising prices for needed raw materials, a weak dollar, a strong dollar, unfair foreign competition, for example. Given these unforeseen external events, and without questioning why they went unforeseen, the compensation consultant will argue that the real need now is to retain the company's "good people" during this difficult time. The way to do this, of course, is to pay them more.

Another powerful arrow in the compensation consultant's quiver of argumentation has been the increasing use of "motivational" compensation devices.[31] While some boards might balk at paying the CEO a whopping salary increase or bonus in a year when the company has done poorly, granting stock options seems a far wiser and more defensible move. After all, stock options only have value if the company's stock increases in price, and paying a substantial portion of executive compensation in the form of stock options insures that the CEO has the proper incentive to increase stock value for shareholders.[32]

Attractive as the idea of stock options may seem, however, everything depends on the details. For example, assume that a board, seeking to create appropriate incentives for management, grants the CEO options giving him the right to purchase 500,000 shares of the company's stock at the current market price of $20, and that the options are exercisable any time in the next five years. Such an option can be justified as providing the right incentives, since the CEO now has a strong interest in boosting the stock price over the next five years. It can also be characterized as costing the company nothing, and under current accounting rules would not involve any charge to earnings (pp. 233–35).

Let us assume the stock does extremely well in the next five years, rising in value from $20 to $50 per share. The company then winds up writing a check to the CEO for $15 million,[33] an amount far more than the CEO would have received in straight salary and bonus. Nonetheless, this is the easiest scenario to justify, as long as one is willing to credit the view that the CEO's policies played a substantial role in the rise in stock values, a view which may often be disputable. Moreover, if

31. See Amanda Bennett, Big Firms Rely More on Options but Fail to End Pay Criticism, Wall St. J., Mar. 11, 1992, at A1; Dana W. Linden & Vicki Contavespi, Incentivize Me, Please, Forbes, May 27, 1991, at 208, 209–10.

32. For example, in 1991 Lee Iacocca received $1.1 million in salary and incentive plan payments from Chrysler, but for agreeing to stay on until December 8, he also received 315,000 shares of common stock valued at $4.1 million, and options for an additional 720,000 shares. See Linden & Contavespi, supra note 31, at 210.

33. According to Crystal, this is quite literally the case, since most companies do not bother to have the CEO actually exercise the options and sell the stock in the open market (presumably because of the deleterious effect such a sale would have on share value). Instead, the company simply issues the CEO a check for the profit he would have made if such a transaction had been executed at the market price on the day the options were exercised (pp. 64–65).

the CEO can exercise the option at any time, he can sell during an abnormal spike in the stock price that may not reflect the average performance of the stock during his tenure.

Assume instead that the stock rose by the end of the five-year period, but only to $25 per share. At this point the CEO, upon exercise of the options, still gets a payment of $2.5 million, and does so for earning shareholders a 5% rate of return, less than they would have received by investing in a money market fund. This seems a much less justifiable result.[34]

Finally, let us assume that it is three years after the option grant and the stock has dropped to $15 per share. At this point, it looks quite likely that the options will finish out of the money (that is, the stock price will never exceed the exercise price of the options during the option period) and provide no value to the CEO. The able compensation consultant will point out that this situation is highly dangerous since (1) it is very likely that the motivational effect of the option has now been lost and (2) if the CEO is still trying to get value from those options he may be tempted to undertake risky ventures designed to boost the price of the stock in the next two years, which may not be in the long term best interests of the company or its shareholders. The solution to these dangers, as the consultant will point out, is to permit the CEO to exchange his old options for new ones, exercisable at the current market price ($15) and extending for another five years.[35]

In short, there are always argnments the good compensation consultant can make to support a higher pay package.[36] The *success* of

34. Another relevant comparison may be whether the company's stock exceeded the performance of the market as a whole. In 1991, the CEO of Ralston Purina received $16.2 million in incentive payments when the company's stock exceeded $100. But that price rise only matched the increase in the Dow Jones Average. See Bennett, supra note 31, at A6.

35. Another form of motivational compensation is restricted stock, actual stock issued to the CEO as part of his compensation, which he is not permitted to sell for some period of time. The compensation consultant will argue that such stock ownership brings the CEO's incentives in line with a favored group of investors: the long term shareholders of the company. Of course, as Crystal points out, if a company issues a CEO 500,000 shares of stock when the stock is selling at $20 per share, it has in effect given the CEO a $10 million dollar payment (p. 71) and diluted the other shareholders by that amount. Moreover, unlike a large payout on an option, this payment occurs even if the stock does not rise in value at all.

36. Crystal provides numerous examples of CEOs who have obtained large pay increases on the basis of poor or mediocre performance. He cites, as three of the worst offenders, Rand Araskog, CEO of ITT, whose salary and bonus rose 63% in 1990 (to $3.9 million) when the company's earnings (after extraordinary items) rose by only 11.7%, see infra note 61; Peter Grace, of W.R. Grace, who after he failed three times to meet performance goals under a Performance Unit Plan in the 1980s, was simply awarded $700,000 worth of restricted stock, and another $5,000,000 the following year; and Andrew Sigler, of Champion International, whose pay continually increased while his company's performance did not, most notably in 1984 when Champion lost $.36 per share but Sigler's pay doubled (pp. 96–109).

these arguments, however, reflects not merely the persuasiveness of the compensation consultant, but the fact that the audience for these arguments is highly persuadable and rarely hears any countervailing concerns. The outside directors who form the compensation committee at most corporations are people who have both personal (they are generally friends of the CEO) and professional (they usually are or have recently been executives at other major companies) interests in seeing that the CEO is "adequately" compensated. A compensation committee sympathetic to and predisposed to be "fair" with the CEO, which then hears a presentation by the compensation consultant as to how the CEO's compensation is "below average" and why additional "motivational" compensation is needed, is very likely to vote for such additional compensation. This is particularly true when, as is usually the case, there is no one, either on the board or advising the board, who has any duty or inclination to argue *against* an increased compensation package.

Finally, one cannot talk about the causes of increased executive compensation without considering the financial zeitgeist of the last few years. While it may be an oversimplification to call the eighties the "greed decade," there is no denying that it was a period when many people in the fields of law, finance, entertainment, and business found themselves able to achieve vast increases in their earnings. Moreover, the prevailing ethos at least condoned, if not extolled, the lifestyles of conspicuous consumption made possible by such compensation levels.[37] In a world in which a CEO discovers that his investment banker is making $5 million a year and his outside counsel is making $2 million, and in which the best tables at the country club are taken by movie stars, sports figures, or others making even more for a few months' work, it is not hard to comprehend why a hardworking CEO, pulling down a mere $1 million in salary and bonuses, might come to think of himself as underpaid.[38]

D. *The Role of Legal Rules*

Crystal does not talk at all about the legal rules currently governing executive compensation. Indeed, like many nonlawyers in the business world, he may assume that there are no legal rules governing executive compensation—that is, none that restrict or determine the way in which compensation decisions are made. This view is basically right in that board decisions conceruing executive compensation deci-

37. See generally James B. Stewart, Den of Thieves (1991) for a fascinating account of how investment bankers like Dennis Levine and Martin Siegel, people making well over $1 million per year, could conclude that they were being underpaid, and could take certain actions designed to increase their short-term earnings.

38. I am grateful to my colleagne, Elliot Weiss, for elucidating this point and noting its relationship to the theories expounded by Robert Frank in Choosing the Right Pond. See Frank, supra note 26, at 123–24.

sions are not now restricted in any substantial way by corporate law rules. This view fails to recognize, however, that such deference to managerial decisionmaking is itself a legal principle embodied in the current corporate law regime, and that it is this legal principle which shapes and makes possible the current system of executive compensation.

American legal doctrine is consciously designed to prevent outside interference in most forms of substantive decisionmaking by corporate boards of directors.[39] Of foremost importance is the business judgment rule.[40] To be sure, corporate law doctrine does recognize a class of decisions so egregious that they cannot be protected by the business judgment rule, no matter how honestly the board made them. This substantive limit on the scope of the business judgment rule is referred to as the doctrine of "waste."[41] Cases delineating this doctrine hold that while directors cannot merely give away corporate assets to executive officers, once a plausible argument can be made that the payments are providing a benefit to the corporation or its shareholders, the decision to make such payments comes within the protection of the business judgment rule.[42]

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39. For justifications of deference to managerial decisionmaking in the specific context of executive compensation, see Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984); Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979); Beard v. Elster, 160 A.2d 731, 736 (Del. 1960). The most famous justification of judicial noninterference in the compensation decision is found in Heller v. Boylan, 29 N.Y.S.2d 653, 667, 680 (Sup. Ct.), aff'd, 32 N.Y.S.2d 131 (App. Div. 1941). One of the best general justifications of the business judgment rule is found in Joy v. North, 692 F.2d 880, 885–86 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

40. The rule has been enunciated in various, somewhat contradictory ways. See Robert C. Clark, Corporate Law 123–25 (1986). Essentially, however, it is a doctrine that insulates a very large category of corporate decisions from legal attack, decisions defined, typically, as those taken by directors "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Moreover, the rule generally embodies a *presumption* that directorial actions have been taken in good faith, so there is a burden on the attacking party to prove bad faith, fraud or self-dealing. See id. at 812, cited in Clark, supra, at 123–24. See generally Charles M. Yablon, On the Allocation of Burdens of Proof in Corporate Law: An Essay on Fairness and Fuzzy Sets, 13 Cardozo L. Rev. 497, 497 (1991) ("The legal rules governing liability of corporate officers and directors for breach of fiduciary duty . . . operate . . . by describing the effect of undertaking certain types of transactions on the allocation of the burden of proof in a subsequent lawsuit.").

41. Interestingly enough, most of the important Delaware decisions on the doctrine of waste involved challenges to the payment of executive compensation, particularly stock options. See, e.g., *Michelson*, 407 A.2d at 224 (stock option plan); *Beard*, 160 A.2d at 736–37 (stock option plan). For an argument that these cases actually changed the meaning of "waste" from a standard of egregiousness or unconscionability to a standard of "no consideration whatsoever," see infra notes 106–107.

42. This is a somewhat controversial version of the concept of waste as it appears in *Beard* and *Michelson*. For a defense of this view, see Yablon, supra note 40, at 516–17; infra note 105.

Accordingly, a director who honestly believes that increasing the CEO's compensation is needed to reward him adequately for his future services or to motivate him appropriately to maximize value for shareholders is protected by the business judgment rule.[43] But what if the director is not very sophisticated in financial matters (as Crystal tells us many compensation committee members are not) or has simply not had the time or inclination to inform himself as to the pros and cons of the compensation scheme? Here the law comes to the rescue by expressly stating that directors may fulfill their duty to make an informed decision by relying on the reports of expert corporate advisors.[44]

Imagine then that you are corporate counsel, fully versed in this area of law. The CEO asks you whether there would be any "problems" if the board were to vote him a compensation package raising his pay by, say, 50%. Knowing the answer he wants and expects (and knowing who is going to be signing your next paycheck from the company), your immediate response is: "I don't see any problem, as long as we are careful to follow the correct procedures." Having thus asserted your legal competence, you proceed to explain that the compensation decision must be made by directors who have no conflict of interest. This immediately excludes any directors who are also officers of the company (since their own salaries may be affected in various ways by the CEO) as well as close personal relatives of the CEO. It should not be difficult, however, to find two or three outside directors who, while well disposed to the CEO personally and, as present or retired executives, not opposed in principle to large increases, nonetheless do not stand to benefit in any personal pecuniary way from authorizing an increase in the CEO's salary. These individuals, lacking any potential taint of "conflict of interest," will become the compensation committee. Under standard corporate law principles, such committees can be delegated the full power of the board of directors to take most actions,

43. The rules on executive compensation now incorporated in American Law Institute, Principles of Corporate Governance § 5.03 (Proposed Final Draft 1992) [hereinafter ALI, Principles of Corporate Governance], make this point explicitly. Section 5.03 states that a compensation arrangement satisfies the director's or officer's "duty of fair dealing" if it is (1) "fair," (2) authorized by disinterested directors, (3) ratified by disinterested directors, or (4) ratified by shareholders and does not constitute waste. Note that under this standard, approval or ratification of a compensation decision by a committee of "disinterested" directors would completely insulate the decision from judicial review, even if it does not satisfy the "waste" standard.

The comments to this section recognize that it subjects compensation decisions to "less intense scrutiny" than other "self-interested transactions," but justifies this because, among other reasons, "institutionalized procedures for disinterested decision-making that are now practiced by large public corporations make it less likely that corporations will be disadvantaged by unfair compensation arrangements with senior executives." Id. § 5.03 cmt. c.

44. See Del. Code Ann. tit. 8, § 141(e) (1991); N.Y. Bus. Corp. Law § 717(a)(2) (McKinney 1992); ALI, Principles of Corporate Governance, supra note 43, §§ 4.02, 4.03.

including determining the CEO's future compensation.[45]

Having assured that the directors making the decision will not be subject to charges of conflict of interest or bad faith, how will you insure that their decision is a fully informed one? You will get an expert to come and advise them, preferably an expert armed with lots of charts and comparative data that the committee can peruse and that you can keep on file to show exactly how "informed" the compensation committee's decision really was. On whose expert opinion will you advise the directors to rely in making their decision?—obviously, that of the compensation consultant.

Finally, how will you protect the committee from charges of waste, from charges that its members are simply giving away assets of the company to the CEO and receiving nothing of value in return? You will make very sure that the compensation consultant enunciates *arguments* justifying the proposed compensation in terms of the added benefits it will bring to the company by, for example, increased motivation and retention of key executives. It is not necessary that the arguments be overwhelming or indisputahle, or that lesser forms of compensation be shown to be inadequate. It is enough if the arguments might reasonably be accepted by a director voting for the proposed compensation package. As we have seen, supplying such arguments is the compensation consultant's basic stock in trade.

Thus, the factors previously described as responsible for the recent upward spiral of executive compensation—the greater use of compensation consultants, the free availability of information on compensation levels, the indeterminacy of arguments justifying extra compensation, and the amenability of compensation committees to such arguments[46]—are all, in some sense, the products of a legal regime that deliberately insulates directorial decisions from legal challenge on substantive grounds and seeks only to insure that directors are well-informed and unbiased in making such decisions. Whether such rules are appropriate in the area of executive compensation and whether they can and should be changed, are the subjects of the next section of this essay.

II. The Possibilities for Change

Crystal's book represents a powerful indictment of the present system, and it is one that is echoed by politicians, institutional investors, and the shareholder advocacy groups that have become such an important part of the corporate governance debate in recent years. Deciding what kind of change is appropriate and desirable, however, is a far more difficult proposition. Solutions abound, ranging from an absolute cap on executive salaries, to various proposals for increased disclosure

45. See, e.g., Del. Code Ann. tit. 8, § 141(c) (1991).
46. See supra notes 28–38 and accompanying text.

of compensation levels, to changes in the function of outside directors and compensation committees.

What follows is an analysis of some current proposals for regulating and restraining executive compensation. My preferred approach is one that employs a stricter standard of judicial review to create a more credible litigation threat, a threat which, in turn, may give corporate counsel reasons to restrain managerial excess.

A. *Income Caps and Compulsory Incentives: The Self-Effectuating Solutions*

The simplest and perhaps most effective response to executive overcompensation would be to prohibit it. There have been a number of proposals designed to achieve this end by defining some particular level of compensation for executives that either may not be exceeded or that, if exceeded, results in a penalty for either the executive or the corporation.[47] Such a proposal was pending before Congress this year in the form of a tax bill that would have capped the corporate income tax deduction for executives' compensation at $1,000,000.[48]

Another form of income cap that has found favor with various management gurus is a limit on compensation based on the ratio between executives' and workers' salaries. Thus, Peter Drucker has argued that as a general rule, a CEO's compensation should be between fifteen and twenty times that of the lowest-paid worker.[49] A bill was introduced in Congress to limit deductibility of incomes on the basis of this principle,[50] and it has been adopted by at least one publicly traded American company.[51]

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47. The ultimate tax disincentive Crystal mentions was imposed in Denmark in the 1960s, under which any executive making more than $53,000 was taxed on the excess at a marginal rate of 105% (p. 26).

48. Bill Clinton has endorsed a plan to eliminate corporate tax deductions for "excessive executive pay." Kevin G. Salwen, Clinton Backs Executive Pay Set By Holders, Wall St. J., October 9, 1992, at C1. He would apparently support the $1 million cap contained in H.R. 4287, 102d Cong., 2d Sess. (1992). This proposal would have applied to all forms of remuneration except fringe benefits. See Report of Finance Committee, reprinted in Tax Analysts, Tax Notes Today, Mar. 9, 1992, available in LEXIS, TAXANA Library, TNT File. A version of the bill containing the cap on income deductibility was subsequently passed by Congress and vetoed by President Bush. The limit on deductibility of executive compensation then reappeared in the House version of a bill, H.R. 5260, 102d Cong., 2d Sess. (1992), extending emergency unemployment benefits, but this provision was dropped from the final bill. See New Law Will Impose 20 Percent Withholding Tax on Pension Distributions, P.R. Newswire, July 21, 1992, available in LEXIS, Nexis Library, Wires File.

49. See Peter F. Drucker, Is Executive Pay Excessive?, Wall St. J., May 23, 1977, at 20.

50. See Bevis Longstreth, CEO Pay: Don't Let the Government Decide, Wash. Post, Mar. 17, 1992, at A17 (describing Rep. Martin Sabo's (D. Minn.) bill, which would deny corporate deductions for executive compensation in excess of 25 times the compensation of a company's lowest-salaried employee).

51. The company, Herman Miller, Inc., a mid-sized office furniture manufacturer, caps the CEO's salary at 20 times average workers' pay. The system was developed by

On the other side are those who argue that the problem is too little incentive on the part of contemporary executives. They argue for mandated "pay-for-performance" compensation that would eliminate the dangers of option swaps that remove any real downside risk for executives, performance targets that are set too low, or other features of supposedly motivational compensation that do not, in fact, provide the CEO with sufficient incentive to motivate him to top performance.[52] Even Professor Crystal advocates legislating an optimal way to distribute stock options.[53]

Are these solutions advisable, or even on the right track? They share little in common except the assumption that there is a single correct, or at least generally preferable, way of computing and distributing executive compensation. It is precisely this shared assumption—that one can specify, in general, the forms and amounts of compensation

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Dr. Carl Frost, a management consultant, in light of Drucker's suggestion. See Nelson-Horchler, supra note 26, at 28, 35.

W. Edwards Deming would abolish all pay-for-performance and motivational forms of compensation, limiting all employees to a straight salary plus profit sharing. He points out that among the legendary hard-working Japanese executives, the CEO earns a straight salary that varies little from year to year. Again, there have been only very limited attempts to use such a system in American corporations. See Linden & Contavespi, supra note 31, at 210; see also Edward Neilan, Salary Differences Can Ruin Firm's 'Wa,' Wash. Times, Mar. 29, 1992, at A15 (top Japanese executives typically get a fixed salary and an annual bonus equal to several months' salary; stock option plans are unheard of). Many highly regarded Japanese firms are said to pay their CEOs no more than five times the pay of the lowest worker.

52. Many of these commentators have a pet compensation device that they would either mandate or favor through various legal means. One frequent suggestion is that executives should be required to *purchase*, not merely be given in restricted form, a certain amount of the company's stock. For example, Dr. Ira T. Kay, another management consultant, suggests that companies *sell* "jumbo stock option grants" to their executives. Because they are sold rather than given, such options would carry real downside risk, but would be larger and therefore have greater upside than the typical executive stock option. See Lyons, supra note 14, at 22. CSX Corp is offering its top 140 executives the right to purchase corporate stock, but is offering them an interest-bearing loan for 95% of the purchase price. See Linden & Contavespi, supra note 31, at 209.

Some observers, however, consider stock price to be a poor indicator of managerial performance. Thus, they seek to use some other method, such as average stock price over time, or return on investment, or earnings per share. For an excellent (if slightly outdated) discussion of the pros and cons of various measures of executive achievement, see Vagts, supra note 9, at 240–43. For a more recent argument, see Gregg A. Jarrell, Take the Long View on Executive Pay, Wall St. J., Aug. 28, 1992, at A10.

53. He wants companies to give their executives options that (1) have a strike price no lower than the average of the last two years' market price, which is then increased to reflect the rate of return on a ten-year government bond; (2) cannot be exercised or swapped for ten years; and (3) at the end of ten years, have a payout determined by averaging the company's market price for the last two years (pp. 249–51). Crystal thinks enough of this particular proposal to argue that Congress should tax compensation paid under it at 50% of the executive's marginal rate. He proposes to compensate for the income loss by *increasing* the tax on all other forms of executive compensation (p. 251).

that would be preferable for all CEOs at all public companies—that is most questionable about this style of regulation of executive compensation.

There are both negative and positive reasons for resisting such procrustean solutions to executive compensation. The negative argument is that none of these proposed solutions is very convincing as the single right and true way to compensate executives. The very fact that some experts, like Drucker, seek a flat income cap, while others, like Crystal, push for a strongly incentivized form of compensation, ought to signal that there is not much consensus as to the right compensation method in all cases.

Indeed, it is hard to imagine how there could be such agreement given the very different kinds of businesses, corporate structures, and CEOs who would all be affected by such a blanket rule. Is it reasonable to assume that a CEO who is the founder of a high-tech firm that has just gone public should be compensated in the same manner as the CEO of a business in a mature industry fighting for market share against foreign competitors with lower labor costs? Or that either firm should pay the same type or amount of compensation as a troubled company that has just brought in a new CEO to try to stave off bankruptcy?

It is not difficult to find CEOs whose compensation far exceeds that allowable under any of the proposed income caps. Indeed, executives have been hired by parent companies to run subsidiaries for multimillion dollar pay packages.[54] The Sony Corporation's contracts with Peter Guber and Jon Peters are perhaps the most celebrated examples,[55] but one can certainly find others in which, one could well argue, something very much like arms-length bargaining has resulted in executives' being paid (usually through incentive payments) far more than the proposed income caps.[56] If public corporations are willing to pay these sums, why enact an arbitrary rule that prevents them from successfully bidding for the services of these high-powered individuals?[57]

54. Crystal notes that heads of subsidiaries may be members of the senior management team and may be very highly compensated. However, they prefer not to be known as "key policy-making members" in order to avoid the compensation disclosure required by the SEC (pp. 236–37). Jensen and Murphy describe the president of a subsidiary who is compensated at a percentage of the subsidiary's earnings, and does not want to be an executive of the publicly traded parent because he would have to disclose his compensation. See Jensen & Murphy, supra note 9, at 145.

55. In addition to the $60 million they made selling their production company to Sony, Guber and Peters each received $2.75 million in base pay and 8% of the profits of Sony Entertainment. Peters has already been pushed out of his executive position, but Guber will get a $50 million bonus if he stays five years. See In Hollywood, a Nouveau Royalty Made by Mergers, N.Y. Times, Mar. 1, 1992, § 3, at 5.

56. To induce Barry Diller to stay at 20th Century Fox after Rupert Murdoch's News Corporation had taken it over, Murdoch reportedly offered him a 5% interest in the company's profits, a deal worth over $50 million. See id.

57. One can with hindsight point to many instances of bad judgment on the part of

Those who argue that *all* compensation should be highly incentivized face even more difficult problems. First and foremost is the difficulty of determining what if any impact any executive, even a CEO, has on overall corporate performance. Any compensation linked strictly to stock performance is going to overcompensate those running companies in industries whose success may be due to extraneous factors and penalize those in industries in a downward cycle. We have all seen various real estate tycoons who were "geniuses" in a period of generally rising real estate prices. Should CEOs of publicly held real estate companies claim similar compensation in times of rising prices? Should CEOs of oil companies be penalized if world-wide oil prices fall?[58]

These considerations suggest that perhaps the baseline for incentive compensation should be something other than straight stock performance—perhaps a comparison of performance with similar companies. Once the company is able to pick a baseline, however, a whole new set of difficulties emerge. Not only is there the danger that the company, with the likely help of the compensation consultant, will pick a group of companies that do not look too hard to beat, but what does one do if the stock of one or more of the companies rises or falls due to a tender offer, bankruptcy, or other firm-specific event? Obviously, midterm adjustments of the baseline must also be contemplated.

Moreover, setting the goals to be achieved through incentive compensation can also involve difficulties. Crystal's suggestion (p. 249) that stock price appreciation should at least exceed the risk-free rate of return over a ten-year period seems reasonable. [59] But what happens if five years have passed and the price of the stock is stagnant? At that point the CEO, to realize any value on his option, would have to earn substantially more than *twice* the risk-free rate of return. Will such a CEO be tempted to put the corporate funds into high-risk investments?

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corporations that have paid enormous amounts to actors, sports figures, or corporate executives, even when the payments were the result of arms-length bargaining. Moreover, there are undoubtedly agency problems and other defects with the processes by which many of these salaries are negotiated. Nonetheless, we generally consider the corporate decisions to pay Arnold Schwarzenegger, Bobby Bonilla, or Jon Guber large amounts of money to provide their services to the corporation as rational, if risky, investments designed to create profitable returns. Few would argue that the law should discourage, on the basis of some objective notion of value or for any other reason, such agreements between private contracting parties.

By the same token, the decision to offer an executive a strongly incentivized pay package may well be a rational business strategy designed to maximize profits for the corporation, even if it results in the successful executive's reaping huge amounts of compensation. Again, there seems no reason for the law to prohibit such contracts generally, unless one concludes that the opportunities for corruption of the process are very great and cannot otherwise be avoided.

58. See Vagts, supra note 9, at 243 (discussing pros and cons of incentives based on securities price).

59. See supra note 53 and accompanying text.

Or will he simply give up trying to meet the incentive goals and spend more time over the next five years on the golf course? Again, some kind of midterm adjustment seems necessary, whether to readjust the compensation or fire the CEO. In either event, however, one should notice that Crystal's preferred ten-year perspective for managerial decisionmaking has been substantially truncated.

Ideally there is a positive benefit in allowing different companies to use a variety of compensation techniques. Not only does this allow for the tailoring of the compensation to the different problems, goals, and time frames that various corporations may have, but it also creates possibilities for experimentation,[60] for trying different and innovative compensation methods, and for studying whether companies that use motivational compensation have better or worse results than those that pay straight salaries and bonuses. Such studies might help develop a consensus as to what forms of compensation are most effective in maximizing managerial effort. What is clear is that no such consensus now exists.

There is, it seems to me, only one good argument for rigid across-the-board limits or mandatory rules governing the forms and amounts of executive compensation. One might conclude, after looking at the way various good ideas like stock options and incentive plans have been abused in practice, that no matter how preferable individually tailored compensation schemes might be in theory, the process for setting compensation is so susceptible to corruption and difficult to police that it is better to limit the board's choice of compensation devices severely. Before embracing such a solution, however, one should at least consider the alternatives.

B. *A Louder Voice for the Owners: The Shareholder Solutions*

Another substantial body of opinion in the compensation area seeks the solution, or at least a siguificant amelioration of the problem, in more informed and active shareholder oversight of the process by which compensation decisions are made. There has been a siguificant increase in recent years, in the activity of institutional shareholders and of groups that seek to advise and represent them. Among their major targets have been CEOs who, it is claimed, have overcompensated themselves while posting poor or mediocre performances for the shareholders. Such institutional investors do appear to have had an impact, at least with respect to certain individual companies.[61]

60. The ALI justifies the limited scrutiny of § 5.03 in part because it leaves the corporation free to "award liberal or novel forms of compensation to attract or retain valued executives." ALI, Principles of Corporate Governance, supra note 43, § 5.03 cmt. e.

61. The case most frequently cited is that of ITT Corp. The compensation of its Chairman, Rand Araskog, was almost doubled between 1989 and 1990, although in that same year the company's profits rose less than 4% and its stock fell 18%. The California

The goals of the institutional investors, as stated by groups that claim to speak for them, are relatively modest. They would continue to allow directors wide latitude in setting executive compensation,[62] and they would seek only marginal legal changes designed to allow directors to function more independently[63] and to provide shareholders with clearer and more complete disclosure involving executive compensation.[64]

None of these proposals seems likely to do any serious harm. No one can argue much with a rule that keeps the company's investment banker off the compensation committee or that requires the company to disclose precisely the method and level of CEO compensation.[65] The question is really whether such changes will do any good. After all, many compensation committees already consist only of independent outside directors, and, in many cases, information about CEO compensation is not all that difficult for investors to find.[66]

Public Employees' Retirement System (CalPERS), perhaps the institutional investor most active in corporate governance issues, refused to vote its million shares in favor of reelection of directors at the 1990 annual meeting. The following year, Araskog's pay was reduced by about a third (to $7.6 million) and ITT announced a new stock option plan for its top executives that contained substantially more stringent performance criteria. Other companies that have arguably responded to institutional investor pressure include Fairchild, General Dynamics, and UAL Inc. See Lyons, supra note 14, at 4–6; Christina Toh-Pantin, Shareholders Take on High-Paid Executives, The Reuter Bus. Rep., Apr. 1, 1992, available in LEXIS, Nexis Library, Business File.

62. A survey by Georgeson & Co. published in December 1991 reported that 66% of institutional investors supported the role of independent compensation committees in setting pay levels. See Georgeson & Co., Survey of Institutional Investors on Executive Compensation 4 (1991). But Bill Clinton, in response to a questionnaire from United Shareholders Association, stated that he would "permit shareholders to determine the compensation of top executives." See Salwen, supra note 48, at C1.

63. They would exclude all directors who have, or are agents of entities which have, advisory, financial, or customer relationships with the company. It is also frequently suggested that the independent compensation committee be permitted to hire its own independent counsel and compensation consultants (pp. 242–44).

64. Such disclosure proposals include (1) listing the pay of each individual officer receiving above a certain compensation level; (2) providing clearer information about, and a statement as to the value of, stock options and other forms of motivational compensation; and (3) disclosing the compensation committee's criteria and formula used to determine compensation levels. These goals are taken from the agenda listed in the Institutional Shareholder Services Report. See Lyons, supra note 14, at 7. Many of these goals would be achieved by passage of the "Corporate Pay Responsibility Act" introduced by Carl Levin (D-Mich.) in the Senate, S. 1198, 102d Cong., 1st Sess. (1991) and by John Bryant (D-Tex.) in the House, H.R. 2522, 102d Cong., 1st Sess. (1991).

65. Jensen & Murphy, supra note 9, at 144–45, suggest such an argument, but it is premised on the assumption, which they admit is hard to demonstrate empirically, that boards would adopt more strongly motivational compensation if they did not fear the adverse publicity.

66. Not only do the current SEC rules mandate considerable disclosure on this area in the proxy statement, see Schedule 14A, 17 C.F.R. § 240.14a-101, item 8 (1992); Regulation S-K, 17 C.F.R. § 229.402 (1992), but the business press devotes substantial space and effort to reporting on executive compensation. Perhaps the most well-known

The basic fact is that, although there has been increased activism in the area of shareholder compensation from some investors, notably public pension funds, it has had little effect on general levels of executive compensation, which have continued to increase even as the economy moved into recession. Is there reason to believe this situation is likely to change?

The answer of most academic commentators has been a qualified "no." Some believe that there are unlikely to be significant changes in the level of monitoring and control of corporate decisionmaking without major legal and structural changes in the current system.[67] Others argne that the problems of effective shareholder action with respect to most corporate matters are likely to be insurmountable.[68]

A general debate about shareholder activism is beyond the scope

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report is the annual Forbes survey of executive compensation. See, e.g., Corporate America's Most Powerful People: What 800 Companies Paid Their Bosses, Forbes, May 25, 1992, at 182.

This is not to deny that CEOs can, and often do, hide the precise details of their compensation from the shareholders through a variety of techniques. Perhaps the most prevalent method is failure to disclose information about risk factors that make it difficult to evaluate the present value of future payments like options. Nonetheless, the point is that even under today's disclosure standards, the most egregious offenders in the compensation area, the ones most likely to arouse shareholder action, are generally known, even if all the details are unclear. It seems doubtful that greater detail alone will significantly change the level of shareholder response.

67. See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811, 813–14 (1992) [hereinafter Agents Watching Agents]; Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 608 (1990) [hereinafter Shareholder Passivity]; Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.–Oct. 1989, at 61, 65–66; cf. Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 59–61 (1991) (argning that legal constraints in the United States on ownership of large blocks of stock by financial institutions have prevented effective oversight of corporate activity, and contrasting the more effective monitoring mechanism available under the permissive German and Japanese systems).

68. See John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1317–28 (1991); Jeffrey N. Gordon, Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law, 60 U. Cin. L. Rev. 347, 347–65 (1991); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445, 453–63 (1991).

Those commentators inclined to be pessimistic point to non-legal obstacles to shareholder monitoring like the free rider problems involved in collective action, see Coffee, supra, at 1339–40 & n.234 (problems of investors in agreeing on effective corporate policies); Gordon, supra, at 373–74; Rock, supra, at 453–63, 474 (differential trading styles among investors), and the agency cost problems involved with institutional shareholders themselves. As Professor Black puts it, "The [problem] with institutional investor oversight, broadly speaking, is that . . . the institutions are themselves managed, by money managers who need . . . watching and appropriate incentives." Black, Agents Watching Agents, supra note 67, at 815; see also Rock, supra, at 469–78 (describing "the outlines of the institutional investor agency problem").

of this essay. What is worth noting, however, is that executive compensation is a particularly difficult issue to control through shareholder monitoring.[69]

There are three factors that make shareholder monitoring of compensation decisions particularly difficult: (1) most compensation issues are company-specific and require case-by-case analysis; (2) the benefits of a successful challenge are questionable and difficult to value, and there is substantial downside risk to any challenge; and (3) agents of institutional investors are likely to be reluctant to take such actions. Conversely, corporate executives have very strong incentives to resist effective shareholder oversight.

It is generally agreed that shareholder monitoring is better suited to process or structural issues common to many companies than to company-specific issues, which are more costly and difficult for outsiders to evaluate.[70] Most compensation decisions are about whether a particular CEO should be given a particular form and amount of compensation.[71] That decision involves all the complex firm-specific variables described in the earlier sections of this essay.[72]

69. It is true that shareholders now do not have the power to approve or disapprove most forms of compensation decisions directly, the major exceptions being stock option plans and employee stock purchase plans, which, to obtain favorable tax treatment, must he submitted to a shareholder vote under Internal Revenue Code §§ 422(b)(I) and 423(b)(2), respectively. See 26 U.S.C. §§ 422(b)(I), 423(b)(2) (1988). However, large shareholders always have the power to contact the directors *informally* to express disapproval of any decision, including a compensation decision. The indirect threat is that directors who fail to follow such informal advice may face a proxy contest.

70. See Black, Agents Watching Agents, supra note 67, at 834; Black, Shareholder Passivity, supra note 67, at 580–81. Black notes that institutional investors are more likely to monitor for corporate actions that are generally considered harmful to shareholder welfare (like certain defensive tactics against takeovers) than corporate actions whose benefit or harm to the shareholders depends on many company-specific factors (like a CEO pay raise). An institutional investor can achieve economies of scale in monitoring by looking for, and opposing, the same defensive tactics in many companies. It is accordingly more expensive and difficult to monitor for company-specific issues. Black does note, however, that there is no clear demarcation between general and company-specific issues. Black, Agents Watching Agents, supra note 67, at 835.

71. While there may be some issues that can be elevated to the level of general principles, like mandating independent directors on the compensation committee or vetoing options with a strike price below market, compensation issued in accordance with such general guidelines can still be excessive or otherwise inappropriate.

72. See supra notes 64–65 and accompanying text. Interestingly, the Institutional Shareholders Services Proxy Voting Manual, (2d ed. 1991), seeks to develop as many general rules as possible for option plans. For example, Institutional Shareholders Services ("ISS") recommends disapproval of any option plan involving a "mature company" that would involve dilution by greater than 5% of the fully diluted outstanding shares, see id. at 331, and any plan for top management with an exercise price less than 100% of fair market value, see id. at 334. Nonetheless, the fundamental recommendation of ISS is that each long-term incentive plan be examined on a "case-by-case basis." Id. at 323.

Moreover, the benefits an institutional investor can obtain from a successful compensation challenge are small and uncertain. The only clear financial benefit is the amount by which compensation is reduced. This is likely to have a negligible impact on the value of the investor's shares. Of potentially greater value, but far more difficult to measure, are the indirect benefits to the company of obtaining a more highly motivated CEO or of reducing employee resentment over unfair CEO compensation. Weighed against these speculative benefits, however, is the very significant downside risk that a compensation challenge will engender ill will toward the shareholder from the management group.[73]

Finally, the agency problems of the institutional investor must be considered. Financial institutions are also run by corporate executives who may be receiving, or be interested in receiving, compensation at levels or in forms not very different from those that are under attack from the various shareholder groups. Such executives are unlikely to mount or join challenges to executive compensation plans because they may feel, after careful consideration (much like outside directors), that the compensation being offered to their fellow executives is perfectly appropriate. In this context, it is worth noting that most of the challenges to executive compensation have come from pension funds run by *public* officials.[74]

In contrast incumbent corporate management, and the CEO in particular, have uniquely powerful incentives to avoid effective shareholder monitoring of their compensation.[75] Each dollar successfully

73. Consider the detriment to investors under the following scenarios: (1) the investor successfully obtains a change in compensation, but top management now views the investor as an enemy, is less receptive to informal advice on other matters, and takes steps to protect itself against possible future challenges to its control; (2) the investor fails to obtain a change in compensation and is still viewed as an enemy by top management with the deleterious effects noted above; or (3) the investor fails to obtain a change in compensation and, to maintain credibility, is obliged to engage in a proxy contest it does not want (obviously, if the investor had wanted a proxy fight, it would have pursued that avenue in the first place).

74. Indeed, most of the challenges seem to have come from either CalPERS or the New York City Employees Retirement Fund. See, e.g., Michael Quint, Reebok Is Criticized About Pay, N.Y. Times, Mar. 20, 1992, at D3 (Elizabeth Holtzman, New York City Comptroller, criticizes compensation of Reebok CEO and seeks committee of independent directors to determine compensation).

Other problems faced by the agents of institutional investors involve their own time horizons and fear of personal vilification. Changes in executive compensation, particularly those designed to increase executive motivation, will have little immediate impact on stock prices or corporate performance. Even "activist" investors are likely to look for situations in which changes in management or in major corporate policies (e.g. divestment) will probably have bigger and more immediate payoffs. Moreover, investors who challenge compensation too vigorously may worry about their own reputation in the business community and about the negative impact it could have on their future job prospects.

75. Perhaps the most vivid illustration of the dangers of incurring the wrath of such

saved for the corporation involves a dollar of personal loss for the executive.[76]

Considered from this rather abstract perspective, then, shareholder monitoring, even if enhanced by some new disclosure rules and even if the SEC gives shareholders increased rights to vote on proposals relating to compensation policy, appears a very doubtful solution to the problem of executive compensation.

One thing this perspective fails to consider, however, is the very strong political and social concern about wealth disparities in this country and about job loss due to the failure of American businesses to compete effectively in many industries against their foreign counterparts. Both these concerns have undoubtedly had some impact on pension fund managers, particularly those who are public officials, as well as on Congress and the SEC.[77] The more cynical might point out, however,

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corporate executives is Graef Crystal's own recent job history. For the last three years he produced articles for Fortune magazine about the 200 highest compensated executives. Crystal has described how his critical analyses of the pay packages of a number of CEOs, but most particularly of Steven Ross and Nicholas J. Nicholas, the CEOs of Time Warner, which publishes Fortune, led to difficulties in getting his fourth article published by the magazine and ultimately led to his resignation. He subsequently began to write for Financial World, where he produced articles that attacked specific CEO pay packages in much the way he does in his book. These criticisms engendered threatening letters or rebuttals from a variety of CEOs and their lawyers. He was fired from Financial World in February, 1992. See Graef Crystal, On the Lam from Overpaid CEOs, N.Y. Observer, Apr. 6, 1992, at 1.

Managers can also make monitoring difficult by setting their agendas in ways that split the shareholder group, obfuscate the true value of the compensation, or make the scheme particularly complex. They can make cosmetic but unimportant changes in response to criticism, or they can simply ignore the criticism.

76. It cannot be argued that CEOs might welcome "pay for performance" or other incentivizing schemes that might increase their long-term payments. As we have seen, CEOs have nothing against incentive payments; they just do not like tbem to be particularly risky. For shareholder monitoring to be effective, it must either reduce the amounts or increase the risks of the compensation the CEO receives, compared with the compensation scheme that would exist absent such monitoring. Such effective monitoring necessarily involves a diminution in compensation to a risk-averse CEO.

77. The SEC has recently announced certain changes in Rule 14a-8, 17 C.F.R.§ 240.14a-8 (1992), which will enable shareholders to vote on a wider range of proposals relating to executive compensation. In a number of recent no-action letters, the SEC has changed its prior position that shareholder proposals relating to executive compensation of senior management were matters relating to tbe ordinary business of the company and did not have to be disclosed to shareholders under Rule 14a-8. See Chrysler Corporation, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,103, at 79,217 (Feb. 13, 1992); Grumman Corporation, SEC No-Action Letter, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,105, at 79,219–20 (Feb. 13, 1991); International Business Machines Corporation, SEC No-Action Letter, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,106, at 79,223 (Feb. 13, 1992).

In June 1992, the SEC also proposed new rules regarding disclosure of executive compensation matters. See SEC: Proposed Rules on Executive Compensation Disclosure, Exchange Act Release No. 33-6940 [1991-1992 Transfer Binder] Fed. Sec.

that by tinkering with the disclosure rules or the shareholder proposal rules of 14a-8, promulgated under the Securities and Exchange Act, Congress and the SEC can give the appearance of reforming the process when, in fact, given the real constraints on effective shareholder oversight, particularly in the executive compensation area, these changes are likely to have little if any impact.

One possible note of hope in this rather bleak picture is the emergence of corporate gadfly groups as a significant factor in public debates on corporate law issues.[78] While they often portray themselves, and undoubtedly think of themselves, as representing the "shareholders," institutional or otherwise, in fact the gadfly groups have very different incentives and motivations than the investors they seek to represent. Unlike investors, they have no financial stake in particular companies. They have no need to maintain cordial relations with management, and they have strong incentives to challenge present governance practices, including executive compensation, as loudly and publicly as possible. Indeed, Professor Crystal's current role, now that he has given up his compensation consulting, is to consult for various gadfly groups, and his book is clearly a part of their program to increase public and shareholder awareness and outrage over these issues.

The major problem with the gadfly groups is their lack of an independent source of power. Their influence is dependent on their prodding some other group to action, whether group that be institutional shareholders, Congress, or the SEC. There is, of course, a mechanism in our society that might enable such groups directly to raise issues of CEO overcompensation before governmental officials with the expertise to understand them and the power to prevent or redress such

L. Rep. (CCH) (July 2, 1992). The basic thrust of these proposals is to provide much more information about the compensation being paid to top management, particularly long-term incentive compensation. The proposals would require disclosure of comparative data on shareholder returns, as well as clearer and more detailed information about compensation. They would also require disclosure of a signed report by the compensation committee setting forth the basis for its compensation proposals. A version of these rnles was adopted by the SEC on October 15, 1992. See Kevin G. Salwen, SEC to Allow Investors More Room to Talk, Oct. 15, 1992, Wall St. J., at C1.

78. By "corporate gadflies," I mean those shareholder advocacy groups who claim to represent the shareholder interest generally and do not themselves hold substantial stock positions in any companies. Two of the most prominent examples are Institutional Shareholder Services, Inc., and United Shareholders Association. The leaders of these groups seek to increase public awareness of issues like executive compensation. Such groups do not refrain from public denunciation of specific instances of managerial misconduct or from public appearances to discuss these issues. See, e.g., Transcripts of Episodes of *Nightline*, CNN's *Crossfire*, and Adam Smith's *Money World*, which covered the topic of CEO salaries, P.R. Newswire, July 1991 available in LEXIS, Nexis Library, Wire File (appearances by Nell Minow, Institutional Shareholder Services; Robert Monks, Institutional Shareholder Partners; Ralph Whitworth, United Shareholders Association). Such organizations have some similarities to the consumer advocacy groups that arose in the 1970s, but unlike consumer groups, have thus far not sought to use litigation to achieve their objectives.

actions. The mechanism is a lawsuit. Its potential efficacy in reducing executive overcompensation is examined in the following section.

C. *Counsels of Restraint: The Litigation Solutions*

As a general matter, corporate lawyers hate litigation. It is expensive, time-consuming and risky. Whenever a lawsuit is filed challenging a corporate transaction, it is always a bit of a rebuke to the corporate lawyers who provided the legal advice for that transaction. It means that some other lawyers have examined the deal and believe it can be successfully attacked. If the lawsuit succeeds, it can damage the careers of the lawyers who originally advised the company to proceed with the transaction.

Corporate lawyers, in and out of academia, also tend to view litigation as a questionable means of effectuating social policy.[79] No doubt it

79. Indeed, the failure of corporate law to regulate executive compensation decisions in a substantive way represents a conscious decision by state court judges developed over an extended period of time. The case law suggests two primary justifications for this failure to regulate. The first is a claim about the competence of courts, the second an ideological claim about the inappropriateness of governmental agencies' setting the compensation levels of private individuals.

The classic statement of judicial incompetence to determine executive compensation appears in Heller v. Boylan, 29 N.Y.S.2d 653, 679–80 (Sup. Ct.), aff'd without opinion, 32 N.Y.S.2d 131 (App. Div. 1941), a standard in corporate law casebooks. Such claims of judicial incompetence, particularly when made by judges themselves, always raise a suspicion of disingenuousness. Courts, after all, routinely value human lives, not to mention lost body parts and reputational damage. How can these judges really claim not to know how to assess a corporate executive's compensation?

Moreover, determinations of whether executive compensation is reasonable or excessive are being made frequently by courts themselves. This fact is underappreciated because the determinations are generally made not in derivative suits by disgruntled shareholders, but in tax cases brought by the Internal Revenue Service, under I.R.C. § 162 (West Supp. 1992), against the officers of closely held corporations for deducting more than a "reasonable allowance" for salaries against gross income. See Clark, supra note 40, at 199–200; Vagts, supra note 9, at 257–61. Another federal statute that has engendered such litigation is section 36(b) of the Investment Company Act of 1940 (ICA), 15 U.S.C.A. § 80a-35(b) (West 1988 & Supp. 1992), under which management fees paid to mutual fund advisors have been attacked for failing to account for changing economic conditions. See, e.g., In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.) (dismissing such action where the minority shareholder had not first made a demand on the directors of the funds), cert. denied, 414 U.S. 857 (1973).

Reading the cases, however, it seems clear that something deeper than concerns about competence is involved in the judicial reluctance to become involved in setting executive compensation levels. A substantial part of it is what we might call the ideology of capitalism—the idea, enunciated by libertarian philosophers from Locke to Richard Epstein, that there is a basic human entitlement to the property an individual obtains through her own actions (without stealing or defrauding others) and that government actions which take away such property are morally suspect.

Corporate lawyers since at least Berle and Means have recognized that there is something less than total privacy in the relationships among directors, officers, and shareholders of the "public" corporation. The notion that executive compensation is would be a waste of judicial resources to have the courts determine the appropriateness of each pay raise or compensation package every corporate CEO receives. Moreover, the people who generally bring such lawsuits, the shareholder plaintiffs' bar, are widely regarded as rather poor monitors of managerial wrongdoing. These attorneys are suspected of bringing weak lawsuits for their settlement value and of being too willing to settle meritorious cases too quickly or for too little, so long as they are assured of an appropriate fee. Finally, litigation is viewed as introducing greater uncertainty and risk into a system that ought to function on the basis of clear and predictable legal rules.[80]

While there is some validity to these concerns, they seem to misconstrue the fundamental relationship between legal rules and corporate behavior. Most legal regulation of corporate behavior does not take place in court, but in lawyers' offices, as corporate lawyers counsel their clients as to what they must do to avoid legal "problems" in connection with the actions they want to take.[81] We have already seen that the standard legal advice in connection with executive compensation—that is, delegate the decision to disinterested outside directors, obtain a lot of information, and rely on experts—is a product of the deferential and process-based rules that currently apply to such decisions.[82]

Imagine for a moment that the standard applied by the state courts to compensation decisions was not that of avoiding "waste," but perhaps something akin to a proportionality test—a requirement, for example, that compensation be "reasonable in relation to the corporate benefits expected." The importance of such a change would not be primarily in its effect on the results of litigated cases, but in the impact it could have on *ex ante* discussions between CEOs and corporate counsel. Imagine a CEO consulting his counsel as to whether there would be any "legal difficulties" if the compensation committee voted him a 50% compensation increase. Counsel must now consider whether such an increase can be defended as "reasonable," not merely before a predisposed committee of board members, but in an adversarial proceeding before an unknown judge. She will want to consider how pros-

property obtained by individuals through voluntary contractual relationships is questionable, even on basic libertarian assumptions. After all, those agreeing to pay the compensation, the outside directors, are not exchanging their own property but that of the shareholders for the executives' services. The extent to which the shareholders can be said to have consented to the deal is highly problematic. Accordingly, even if one holds to rather strict libertarian precepts, greater regulation of the executive compensation process is not precluded on ideological grounds.

80. See Yablon, supra note 3, at 78–79.

81. See, e.g., Ronald J. Gilson & Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 Bus. Law. 247, 249 n.9 (1989) ("Arguably the interpretations of case law by experienced takeover lawyers are among the most important sources of takeover law."); Yablon, supra note 3, at 79–80.

82. See supra notes 39–45 and accompanying text.

perous a year the company has had, as well as what types, amounts, and forms of compensation have been the subject of litigation (and of adverse judgments) in recent years. If the proposal seems out of line with what courts have previously approved (or even in a dangerous gray area) the lawyer has a strong incentive to advise the CEO that perhaps he would be on stronger legal ground by lowering the increase, or making more of it contingent on improved corporate performance. In other words, the possibility of litigation and the consequent uncertainty of result at least create an incentive for restraint by CEOs seeking substantially above-average compensation.[83] It serves to some degree to counteract the ratcheting effect of salaries.[84]

Would corporate action really be affected by such a subtle change in the legal standard? There are good reasons for believing it would. The corporate bar is extraordinarily sensitive to legal change, particularly any change in the attitudes of the Delaware courts, let alone the legal rules these courts apply.[85] Consider the enormous reaction of the corporate bar and corporate boards to the Delaware Supreme Court's

83. Of course, such compensation arguments will still retain a substantial level of indeterminacy. Arguments over which companies are comparable and what measures of performance to compare will undoubtedly remain. In a judicial proceeding, however, these arguments will take place in an adversarial setting before a neutral decisionmaker. Corporate counsel, in evaluating whether a pay increase can be justified, will seek to determine whether the comparisons used and other bases for the increase can be defended in such an adversarial proceeding. Accordingly, counsel would have an incentive to evaluate the arguments of the compensation consultant critically, to determine whether they can prevail in a judicial proceeding. At the present time, in contrast, counsel need only determine that some such arguments have in fact been made to the board.

84. It is worth noting that two of the academic lawyers who have thought the most about this issue have both endorsed litigation as at least an option of last resort. Professor Vagts states that "courts need to understand that while judgments on the excessiveness of compensation are not easy to make, they are usually not impossible." Vagts, supra note 9, at 276. He notes that "[i]f the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocketbooks and egos as much as the executives demand." Id.

Professor Vagts' modest call for greater judicial activism, issued nine years ago, has of course not been heeded. Rather, as the previous discussion has shown, the problem of executive compensation has grown far worse in the last decade. See supra notes 6–17 and accompanying text. This essay differs from Professor Vagts' recommendation in that it calls for a substantive change in the law of executive compensation, advocates a legal standard that will create incentives for corporate lawyers to restrain pay increases, and looks to corporate gadfly groups to bring the necessary test cases.

Dean Clark also argues for a credible litigation threat. He would give successful derivative plaintiffs a straight 10% bounty based on the amount of the excessive compensation. Clark would limit the role of the courts, however, to enforcing a strict process-oriented rule, and would preserve the rule of total deference to compensation decisions made by a compensation committee composed entirely of disinterested directors. See Clark, supra note 40, at 219.

85. In this context, it is worth noting that by at least some historical accounts, the relative reduction in corporate executive compensation levels that took place in the late

decision in *Smith v. Van Gorkom*,[86] a case that arguably did not change the legal formulation of the director's duty of care in Delaware at all, but merely held that a particular decision by a particular board did not meet the traditional standard.[87] That decision was credited with causing "consternation" in the corporate world and causing the "bottom to fall out" of the director's and officer's insurance market.[88] Even though the problem has been ameliorated by giving companies power to add "exculpatory" provisions removing duty of care liability for their directors,[89] the case is still credited with having "fundamentally transformed" boardroom practices.[90]

Consider also *Unocal Corp. v. Mesa Petroleum Co.*,[91] in which the Delaware Supreme Court upheld a board's decision to utilize certain defensive tactics, but did so under a formulation of the business judgment rule somewhat less deferential to directors than the traditional formulation. That case has been called "the basis for all analysis of defensive actions" by a prominent Delaware attorney,[92] and its meaning, permutations, and significance have been probed extensively by corporate law scholars.[93]

Given these circumstances, it seems plausible that even one or two Delaware cases which announced that executive compensation decisions would be judged by a "proportionality" standard—the reasonableness of the compensation weighed against the benefits likely to be conferred by the CEO—and that perhaps invalidated a compensation

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1930s was caused in part by the (rather inconclusive) shareholder litigation of that period. See Vagts, supra note 9, at 246, 253–55.

86. 488 A.2d 858 (Del. 1985).

87. The *Van Gorkom* court's formulation of the legal standard for the director's duty of care as one of "gross negligence" and as requiring an "informed" decision, see id. at 872–73, was not significantly different from the formulation in many earlier cases. See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Gimbel v. Signal Cos., 316 A.2d 599, 610–11 (Del. Ch.), aff'd per curiam, 316 A.2d 619 (Del. 1974); Mitchell v. Highland-Western Glass, 167 A. 831, 833 (Del. Ch. 1933).

Of course, I am heing somewhat disingenuous when I say that *Van Gorkom* did not involve a change in the law. The change was the court's willingness to descrihe as "gross negligence" directorial conduct that most corporate lawyers had assumed would be protected under the business judgment rule. This exemplifies, however, my broader point that corporate lawyers are highly sensitive to shifts in attitude or emphasis by Delaware courts.

88. John R. MacKay II & John D. Hogoboom, Protecting Directors and Officers, N.J. L.J., Nov. 21, 1991, at 6 (Supp.).

89. Del. Code Ann. tit. 8, § 102(b)(7) (1974).

90. Gandolfo V. DiBlasi & Norman Feit, Directors' Duty Will Often Vary Based on Individual Situations, Nat'l L.J., May 28, 1990, at 20.

91. 493 A.2d 946 (Del. 1985).

92. Audrey Duff, 1979–1989 Ten Years of Upheaval: The Ten Biggest Deals, Am. Law., Mar. 1989, at 44 (statement of A. Gilchrist Sparks III).

93. See, e.g., Gilson & Kraakman, supra note 81, at 266–74 (analyzing the proportionality test for judicial review of management's efforts to defend against hostile takeovers).

package which the court found to be unreasonable under such a standard, would certainly get the attention of the corporate bar and corporate boards. Learned speculation as to exactly what features made a compensation package unacceptable would occupy both the academic and practice-oriented legal periodicals.

Fear of "signing off" on a compensation package that later was disapproved would certainly give corporate lawyers and directors reason to exert some restraint, but a successful lawsuit would not create the fear of ruinous damage claims against corporate directors that *Van Gorkom* did. The remedy in such a lawsuit would probably involve nothing more than invalidation of some of the executive's stock or options or restitution of some money to the corporation.[94] By the same token, such a change in the judicial standard of review would not prevent experimentation and diversity as to different forms of compensation, although in time certain "safe harbors" of compensation might develop.

The litigation option would be far from a panacea, of course. CEOs would retain powerful incentives to pay themselves in accordance with their own views of their value to the firm, and corporate counsel would still have powerful incentives to help them achieve it. As noted, the damages in most cases would be small, no more than a few million dollars, and would probably involve restitution by the CEO or invalidation of some form of stock-related compensation. Nonetheless, the prospect of such a lawsuit undoubtedly would be viewed with concern by some CEOs and corporate counsel.

Some would seek to deal with the problem by making the pay increase more clearly contingent on improved performance. Others would exercise restraint. Others would undoubtedly ignore the litigation threat and do whatever they could to maximize their compensation. The most that can be said about the effect of the litigation solution is that it would not have the negative effects of the procrustean solutions[95] and, since it would operate in tandem with and in addition to the impact of institutional shareholders, it would have some greater impact than that of the institutional shareholders alone.[96]

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94. While directors might be held liable for approving such invalid compensation, the damages to the corporation could almost invariably be recovered from the CEO, the individual who actually received the illegal payment. See ALI, Principles of Corporate Governance, supra note 43, § 5.03(a)(2) cmt. h.

95. See supra notes 47–60 and accompanying text.

96. Indeed, the interaction of the potential for litigation with the increased activity of institutional shareholders is likely to enhance the impact of both. One of the reasons management and counsel might fear a lawsuit, even for relatively low damages, is that it focuses the attention of institutions on the allegedly high pay and poor performance of that company's executives. This would particularly be so if, as suggested infra notes 111–113 and accompanying text, such suits are most likely to be brought by gadfly groups claiming to represent institutional shareholders.

By the same token, institutional shareholders, who as noted previously, see supra

What are the downsides of litigation? Most frequently cited are excessive costs, both in time and money, the dangers of frivolous lawsuits, and the uncertainty created by litigation. Overlitigation and frivolous litigation, however, occur primarily when liability is weak or uncertain but potential damages are clear and substantial. Imagine, for example, a management that has instituted defensive tactics which successfully ward off a tender offer for the company (which has 5,000,000 shares outstanding) at $100 per share. After the offer is defeated, the stock drops to $50 and stays there. A plaintiffs' lawyer knows that if the lawsuit is successful, she is looking at a possible $250 million recovery and, assuming a modest 25% fee award, a potential fee of $62.5 million. Even if she thinks the case is weak on liability (say, only a 10% chance of success), she still has a strong incentive (approximately $6.25 million worth)[97] to continue prosecuting the claim. Moreover, looking at things from the defendants' side, if they too believe there is a 10% chance of a $250 million recovery, they have an incentive to offer up to $25 million to settle the case. Plaintiffs' lawyer, knowing this, has yet a further incentive to keep litigating the claim until she gets such a settlement.

Executive compensation litigation, in contrast, is likely to involve rather uncertain and fairly low damages. Assume that a CEO, whose company had flat earnings and a drop in stock price last year, convinces the board to double his pay from $2 million to $4 million. This looks like a pretty strong case on liability, but only involves a maximum damage award of $2,000,000. A plaintiff's lawyer, moreover, considering all the exigencies and difficulties of litigating derivative cases and the fact that a judge might decide the CEO was entitled to some increase, could well decide there was a 50% chance of obtaining a $500,000 fee. Thus, even this rather strong case represents a value to her of less than $250,000.[98] Moreover, she knows that the CEO and board, facing an embarrassing but not ruinous lawsuit, may well be inclined to litigate rather than settle. She is likely to spend her time and resources pursuing weaker claims with potentially bigger payoffs.[99]

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notes 61–74 and accompanying text, might be reluctant to challenge management directly for paying itself too much, could assume an ostensibly helpful role. They could express fears to management that the proposed pay package could create what they would term "litigation problems" and suggest a reduction in pay or increase in the risk factor for that reason.

97. This is based on computing the certainty equivalent of a 10% chance of obtaining $62.5 million (.10 x $62.5 = $6.25). For simplicity's sake, this computation ignores risk aversion and discounting to present value, both of which would tend to reduce the value of the claim to the plaintiff's attorney, but would still leave plenty of incentive.

98. Here, the time value of money and risk aversion may have a real impact.

99. Despite all the controversy in recent years over executive compensation, and the large numbers of plaintiffs' firms specializing in shareholder litigation, there seems to have been only one lawsuit brought in the last few years challenging an executive's compensation. That action, brought in Delaware in 1990, attacked the compensation

With respect to increased litigation uncertainty, it has already been suggested that such increased uncertainty is not invariably a problem. In the area of executive compensation, increased litigation risk may have the salutary effect of giving corporate counsel greater incentive to restrain executive overcompensation.[100]

The basic problems with using litigation to curb excess compensation are not, therefore, increased costs or uncertainty. Rather, they are the following: (1) whether Delaware and other influential state courts will be willing to change the substantive corporate law of executive compensation in the manner suggested here, and (2) whether anyone is willing to initiate the lawsuits that might result in such changes in the substantive law. Those questions are considered below.[101]

Delaware law does not now encompass the kind of objective "proportionality" standard I have suggested for reviewing executive compensation.[102] Yet, surprisingly, there is language in the cases that does come rather close. At least three opinions of the Delaware Supreme Court expressly state, in ruling on the validity of options granted to executives, that "there must be a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted."[103] It appears that in the 1950s the Delaware courts did evaluate compensation plans through an objective analysis of their terms, and one option plan was actually invalidated on this basis.[104] Even when disinterested director or shareholder ratification had oc-

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paid by Fairchild Corporation to its CEO. The litigation was quickly settled on terms that cut the CEO's salary and options and froze future increases. See Fairchild Corp., 1991 Annual Report 33–34 (1992).

100. See supra notes 85–94 and accompanying text; see also Yablon, supra note 3, at 62–71.

101. See infra note 109 and accompanying text.

102. For these purposes, I am excluding the tax cases, which do utilize such a standard.

103. Beard v. Elster, 160 A.2d 731, 737 (Del. 1960); accord Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984) (citing *Beard*); Olson Bros. Inc. v. Englehart, 245 A.2d 166, 168 (Del. 1968) (same); see also Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 664–66 (Del.), on reh'g, 91 A.2d 57, 59 (Del. 1952) (there must be consideration for the granting of an option); Kerbs v. California E. Airways, 90 A.2d 652, 657–58 (Del. 1952) ("There must be a reasonable relationship between the services rendered by the employee and the value of the option granted.").

104. In *Kerbs*, 90 A.2d at 656, the court struck down a stock option plan that it found provided no benefit to the corporation. The court noted that the "reasonable relationship" test was potentially applicable to both a stock option plan and profit sharing plan for top executives. However, it did not have to decide that issue with respect to the option plan because the court determined that the option terms were "not reasonably calculated to insure that the defendant will receive the contemplated benefits." Id. The court noted that the options did not require the executive to continue employment with the company. Id. at 657.

It should also be noted that within a few months after these options were granted, the company's stock price had doubled from $1 per share (the exercise price) to over $2. See id. at 655 n.1. Thus, this deal may also have run afoul of the notorious Delaware "smell" test. See Dennis Block et al., The Business Judgment Rule, *in* Twentieth curred, compensation could still be invalidated under an objective standard, although invalidation required a finding that the payment at issue was "unconscionable" or "shockingly large."[105]

In the 1960 case of *Beard v. Elster*, however, there was a significant change in the Delaware approach. In *Beard*, disinterested director approval alone was sufficient to establish the validity of the compensation plan. The court's only role was to inquire as to the board's subjective good faith in approving the transaction.[106] Compensation cases decided since 1960 have followed the subjective approach of *Beard*,[107] and the ALI Principles of Corporate Governance embody a similar

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Annual Institute on Securities Regulation 173, 180–81 (C. Nathan et al. eds., 1989) (discussing the "smell test" in Delaware).

The plaintiff also sought to challenge the profit-sharing plan under the "reasonable relationship" standard. The Court construed that standard, however, in a shareholder ratification context, as requiring a showing of "spoliation or waste of corporate assets" or payments that are not merely unreasonable, but "shockingly large." *Kerbs*, 90 A.2d at 658.

105. See *Gottlieb*, 90 A.2d at 664–66; *Kerbs*, 90 A.2d at 658. In *Gottlieb*, the Delaware Supreme Court reversed a grant of summary judgment, holding that the directors' good faith belief that a compensation plan provided benefits was insufficient. It held that "evidentiary fortification of the fairness and reasonableness of the plan" was required, and that such plans would be invalidated if the amounts paid were "unconscionable." *Gottlieb*, 90 A.2d at 665.

On reargument, the court in *Gottlieb* sought to clarify the effect of shareholder ratification. It stated that a compensation scheme would be invalid, even if ratified, if it could be shown that "*no reasonable businessman*, fully informed as to the respective values, and acting in good faith, *could be expected to consider the bargain attractive to the corporation*." Gottlieb v. Heyden Chemical Corp., 91 A.2d 57, 59 (Del. 1952) (emphasis added).

106. The court in *Beard*, 160 A.2d at 737, while ostensibly reaffirming the rule of *Kerbs* and *Gottlieb*, actually overturned the rule set forth in those cases. The *Beard* court stated that *Gottlieb* would have been decided differently if the *Gottlieb* board had been disinterested. See id. The first *Gottlieb* opinion, however, says just the opposite, noting that even compensation approved by "honest directors" might not be "legally sound." 90 A.2d at 663–64.

The heart of the *Beard* opinion is a subtle rewriting of the legal standard set forth in *Gottlieb*. The second *Gottlieb* opinion stated that a compensation payment would be invalid if "no reasonable businessman" would consider it an attractive bargain to the corporation. 91 A.2d at 59. In *Beard*, however, the mere existence of disinterested director approval places the transaction in the gray area where reasonable businessmen might differ, and therefore renders it valid. 160 A.2d at 738–39. The standard has changed from consideration of what the hypothetical "reasonable businessman" might say about the transaction, to a finding that some (presumptively) reasonable businessmen (i.e., the disinterested directors) have found the compensation to be a good deal for the company.

107. See Pogostin v. Rice, 480 A.2d 619, 622–26 (Del. 1984); Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979). *Michelson* holds that to state a claim for waste, plaintiff must allege not merely inadequate consideration (not even an unconscionable or shockingly bad deal will suffice) but that no consideration at all was received. See 407 A.2d at 223–24. *Pogostin* cites a similar standard, while also noting that "the benefit received under incentive plans is not susceptible of valuation." 480 A.2d at 626 (citing Lieberman v. Becker, 155 A.2d 596, 600 (Del. 1959)).

approach.[108]

Outside the compensation context, the Delaware courts in recent years have begun to recognize that the business judgment rule need not require absolute deference to managerial decisionmaking. They have been willing to endorse intermediate positions that give substantial weight to disinterested board action, but retain a siguificant oversight role for the courts. *Unocal* is the most obvious example of this change in judicial attitude, but there have been others.[109]

What caused this change? Consider the following comments by two corporate law scholars on the origins of the *Unocal* standard:

> Experienced takeover lawyers passed *Cheff*'s implicit message on to their clients: If target managers, in good faith and after reasonable investigation, could locate a policy conflict with a would-be acquirer, any defensive response would be protected under the business judgment rule.
>
> As *Cheff*'s implications became clearly visible, however, they attracted hostile notice from other corners. An outpouring of academic commentary called for constraints on defensive tactics, and it even appeared possible that Congress might act to displace state law—and especially Delaware law—that was considered unduly favorable to target management . . . . Thus, there was a historical basis for predicting that political pressure might eventually prompt the Delaware courts to tighten the lax standard of review implicit in *Cheff*'s policy conflict/primary purpose test.[110]

This description of the pre-*Unocal* landscape is strikingly reminiscent of the current situation concerning executive compensation. Experienced corporate lawyers have fignred out that the business judgment rule protects almost any compensation decision made by a disinterested committee of the board. Once again, academic and shareholder groups are raising questions about the current rules, and the issue has become a political hot potato, prompting action by Congress and the SEC. In short, the political and economic climates seem ripe for a change in the law, and the Delaware courts, which are not unaware

108. See supra note 43.

109. See discussions of *Unocal*, supra notes 91–93 and accompanying text; see also Revlon v. McAndrews & Forbes Holdings, 506 A.2d 173, 179–85 (Del. 1986) (holding that auction-ending "lockup" agreement taken at shareholders' expense violated fiduciary duty). The duty imposed on incumbent management in that case radically abrogates traditional business judgment rule principles. Another intermediate position, perhaps more analogous to the standard advocated here, is the "independent discretion" courts must exercise under Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981), in reviewing dismissals of derivative suits by disinterested directors. Finally, there is the awkward case of Smith v. Van Gorkom, 488 A.2d 858, 873–88 (Del. 1985), which also seems to have involved a lessening in the deference shown to managerial decisionmaking by the Delaware courts, although the change was more attitudinal than doctrinal.

110. Gilson & Kraakman, supra note 81, at 249–50 (footnotes omitted).

of such political and economic considerations, might well provide that change.

Moreover, the major takeover cases of the last decade have created many doctrinal openings for changes and modifications in the law. Rather than a single business judgment rule, it may be more appropriate to speak of a range of deference to managerial decisionmaking, set according to a sliding scale of "fairness." The proportionality requirement of *Unocal* provides a clear analogue for the adoption of an intermediate standard in the compensation context, one that would require some objective judicial review of the relationship between the compensation paid and the benefit received.[111]

If such a change in the law is to occur, however, somebody has to be willing to bring at least a few lawsuits challenging the most outrageous instances of overcompensation. I have already shown that the plaintiff's shareholder bar is an ineffective monitor, since these cases are unlikely to involve large fees.[112] Institutional shareholders might be willing to sue in an effort to oust current management, but are unlikely to do so just to reduce managerial compensation.

The shareholder interest groups or corporate gadflies, however, do have a generalized interest in seeing the law move in the direction of more restraint on executive compensation. Moreover, they have the expertise and the resources to isolate the most egregious examples of overcompensation and to present them effectively to a court.[113] That the gadfly groups have thus far sought to affect corporate behavior pri-

111. In seeking to justify its enhanced judicial scrutiny of defensive tactics, the *Unocal* court cited "the omnipresent specter that a board may be acting primarily in its own interests." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). Surely, the same omnipresent specter exists with compensation decisions, and can similarly justify enhanced judicial scrutiny of such decisions. Moreover, in good common law fashion, a Delaware court that adopted such a standard could accurately portray its ruling as a return, of sorts, to the "unreasonableness" or "unconscionability" standard that can be found in certain Delaware cases from the 1950s.

112. See supra text accompanying notes 79–80.

113. Such gadfly groups can easily satisfy the legal standing requirements for bringing such suits. In almost all jurisdictions, shareholder derivative actions may be filed on behalf of the corporation by anyone who was a shareholder at the time of the alleged wrongdoing. See, e.g., Revised Model Business Corp. Act, § 7.41 (1991); ALI, Principles of Corporate Governance, supra note 43, § 7.02(a).

Gadfly groups would probably proceed in one of two ways: (1) they could act as legal counsel on a contingent fee basis for disgruntled shareholders of the company, much the way ordinary plaintiffs' firms now do in bringing derivative suits; or (2) they could directly purchase a few shares of stock in companies whose CEOs have been overpaid in prior years, urge the boards to limit pay increases this year, and bring suit against the boards of those companies, if any, that still approve egregious overpayments.

While plaintiffs will still confront the usual litigation facing all such derivative suits (e.g., demand requirements, special litigation committees, etc.), their status as crusaders for improved corporate governance is likely to give them greater credibility with the courts than is usually enjoyed by plaintiffs' counsel.

marily through lobbying, publicity, and shareholder voting seems to me to reflect the general anti-litigation bias found in the corporate world.

While derivative litigation by gadfly groups would undoubtedly provoke some challenges under standard Delaware doctrine, a suit by such a group, obviously brought for more than just settlement value, would, I think, have enhanced credibility with the Delaware courts. Moreover, such groups can draw on considerable business and legal expertise in pursuing such litigation, including the talents of Professor Crystal himself. In his book, Professor Crystal tells many stories of executives who have given themselves huge pay increases while corporate performance has been average or below-average. It would be nice for him to have an opportunity to tell those stories to a judge.

Conclusion

Ultimately, the question of how to compensate executives to maximize their productivity and value to the firm is a question for management science, not for law. A role for law arises when the top executives of public corporations, acting without effective oversight or restraint, are able to abuse the decisionmaking mechanisms of the public corporation to give themselves unconscionable amounts of compensation unrelated to risk or performance. Professor Crystal's book makes a powerful case that such abuses are rampant in corporate America, and accordingly, his book also makes a powerful case for legal change.

Determining what kind of legal change is desirable, however, is a much more difficult question. Even those who decry current compensation practices cannot agree on what should replace them. Should incomes over $1 million be subject to a cap on deductibility, as in the bill vetoed last summer by President Bush, or should the tax code be used to promote greater use of real performance incentives, as Crystal urges? Are institutional investors ready to exert their power and influence to curb compensation abuses, as the shareholder advocacy groups maintain? Do they need only SEC rules providing additional disclosure regarding compensation and a chance to talk freely among themselves without violating the proxy rules, or, as some academic commentators suggest, has the potential impact of the institutional investor been overstated?

In this essay I have viewed each of these proposed solutions with some skepticism, yet I am not ready to dismiss any of them out of hand. I have suggested, however, that those shareholder advocates who seek to change the executive compensation process should also consider enlisting the aid of the courts. If the background legal rules against which the compensation decision takes place can be changed, corporate lawyers might find it prudent to advise the board of potential litigation risk, perhaps even to counsel restraint in this area. Such changes would not be a solution to the problem of executive overcompensation. They would, however, be an improvement.