EXECUTIVE COMPENSATION REGULATION: CORPORATE AMERICA, HEAL THYSELF[†]

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I. INTRODUCTION

The debate over executive compensation plans is nothing new.[1] For quite some time, executive compensation has concerned shareholders and, to some extent, the courts.[2] An early case, *Rogers v. Hill*, presents a rare example of judicial intervention into the world of executive compensation. *Rogers* involved a shareholder derivative suit brought to recover bonuses paid to the executives of American Tobacco.[3] Under the bonus plan set forth in the company bylaws, the president of American Tobacco was entitled to two and one-half percent of the corporation's net profits that exceeded $8,222,245.82.[4] In 1930, according to this calculation, the president was entitled to a bonus of over $840,000.[5] The Supreme Court decided, despite the fact that the bylaw was properly enacted, that the payments could be viewed as excessive and may have amounted to corporate

† *See Luke* 4:23 (King James) ("Physician, Heal Thyself").

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1. Throughout this Note the use of "executive compensation" refers to compensation in the form of salary, bonuses, stock options, and other forms of compensation paid to chief executive officers (CEOs) of corporations.

2. *See, e.g.*, Rogers v. Hill, 289 U.S. 582 (1933); Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941), *aff'd mem.* 32 N.Y.S.2d 131 (App. Div. 1941).

3. 289 U.S. at 584–86.

4. *Id.* at 585 n.1. This dollar amount was the estimated amount of net profits earned by the company in 1910. *Id.*

5. *Id*. at 585 n.2.

waste.[6] It ordered reinstatement of the injunction on the payments, pending further litigation to determine whether the payments did in fact constitute waste.[7]

But judicial intervention like that in *Rogers* is rare. Courts have routinely been unwilling to scrutinize compensation plans.[8] *Heller v. Boylan*, a later case brought by American Tobacco shareholders, is more typical of judicial involvement with executive compensation. In *Heller*, a New York Supreme Court judge refused to reduce bonuses paid under the same bylaw challenged in *Rogers*.[9] The judge determined that even though the payments were large and possibly excessive, they were not so high as to raise the compensation to the level of waste.[10] The court was openly troubled by what standard it would apply if it decided to cut payments to the executives.[11] In the end, the court determined that it was "ill-equipped to solve or even to grapple with [this] entangled economic problem[]."[12] The court took the view that shareholders are best suited to determine "what is reasonable compensation for [the corporation's] officers."[13]

In recent years, executive compensation has received more media attention than ever before.[14] Corporate scandals and the New York Stock Exchange's ("NYSE") disclosure of Richard Grasso's compensation have fueled the public's belief that executive compensation schemes need to be changed.[15]

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6. *Id*. at 590–92. The Court made this determination even though it expressly found "no inference of actual or constructive fraud." *Id.* at 591.

7. *Id.* at 592.

8. Compensation plans are generally considered to fall under the business judgment rule, which means that courts will not closely scrutinize the plans unless they are completely unreasonable. JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY MATERIALS AND PROBLEMS 771 (5th ed. 2003) (1982).

9. Heller v. Boylan, 29 N.Y.S.2d 653, 660 (Sup. Ct. 1941), *aff'd mem.* 32 N.Y.S.2d 131 (App. Div. 1941); *see Rogers*, 289 U.S. at 584.

10. *Heller*, 29 N.Y.S.2d at 680.

11. *Id.* at 679–80.

12. *Id.* at 680.

13. *Id.*

14. *See, e.g.*, Amy Baldwin, *Grasso Resigns Under Pressure: $140M Pay Package for Chairman of NYSE Sparked Public Furor*, BOSTON GLOBE, Sept. 18, 2003, *available at* http://www.boston.com/business/markets/articles/2003/09/18/grasso_resigns_under_pressure (last visited Jan. 21, 2004) (discussing the resignation of the New York Stock Exchange (NYSE) Chairman after his compensation package was disclosed) (on file with Arizona Law Review); Patrick McGeehan, *Executive Pay: A Special Report; Again, Money Follows the Pinstripes*, N.Y. TIMES, Apr. 6, 2003, at 1 (discussing executive compensation packages in the wake of corporate scandals).

15. The compensation packages of Enron, Tyco, and WorldCom emerged as media focal points after their respective corporate scandals. *See, e.g.*, *id.* (discussing the fact that corporate scandals have not led to a drastic change in compensation packages); *Enron Investigation: Hearing Before the Commission on Senate Finance*, Apr. 8, 2003 [hereinafter *Enron Investigation*], *available at* 2003 WL 11717254 (testimony of Pamela Olson, Assistant Secretary, Tax Policy, Department of the Treasury) (discussing "questionable executive compensation practices" of Enron.); Baldwin, *supra* note 14; Jon Chesto, *Tyco Drops a Dime; Firm Details Kozlowski's Lavish Ways*, BOSTON HERALD, Sept. 18, 2002; Kurt Eichenwald, *Enron's Many Strands: Executive Compensation: Enron Paid Huge Bonuses in '01; Experts See a Motive for Cheating*, N.Y. TIMES, Mar. 1, 2002, at A1

Commentators have debated issues such as the merits of certain compensation packages, the incentive implications of types of compensation, and the effects of government regulation.[16] And government regulation has come on the heels of this debate.[17] Such government regulations can be broken down into two categories: disclosure and tax.[18] Disclosure regulations seek transparency for shareholders,[19] while the tax regulations seek financial disincentives for excessive compensation.[20] But these regulations have not and will not curb executive compensation excesses, nor have they or will they extinguished popular sentiment that executives are vastly overpaid.[21]

But increased governmental regulation is not the answer, nor is repealing the current executive compensation regulations. Instead, the answer lies with Corporate America. This Note urges Corporate America to remedy the executive compensation on its own—to "heal thyself."[22] Parts II and III of this Note discuss the current disclosure and tax regulations of executive compensation and their shortcomings. Part IV discusses potential government regulations Congress or the SEC could implement if Congress determines that more regulation of executive compensation is necessary. Part IV also points out why increased government regulation will not help. Part V provides examples of self-regulating mechanisms that companies can and should adopt to address current concerns and to prevent further governmental regulation.

(reporting that Kenneth Lay received two bonus payments totaling $10.6 million and Jeffrey Skilling received two bonuses totaling $7.5 million, the last of each executives' checks was paid on February 5, 2001, and the company filed for bankruptcy reorganization on December 2, 2001, less than ten months after the last payment); David Glovin, *WorldCom CEO's Pay Package Raises Concerns, Judge Says*, L.A. TIMES, Dec. 11, 2002, at Business 3; Carrie Johnson & Christopher Stern, *Judge Puts Limits on WorldCom; Freeze on Documents and Executives' Pay*, WASH. POST, June 29, 2002, at E01; John Rega & Patrick Oster, *Enron's Incentives Rewarded Executives as Losses Were Hidden*, BLOOMBERG NEWS, Mar. 2, 2002; Andrew Ross Sorkin, *Tyco, After the Glitter and the Agile Math*, N.Y. TIMES, Jan. 1, 2003, at C1.

16. *See, e.g.*, Melvin Avon Eisenberg, *Contractual Freedom in Corporate Law: Articles & Comments; The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1489–94 (1989); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 20–28 (2000); Geoffrey S. Rehnert, Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1152–54 (1985).

17. 17 C.F.R. §§ 228, 229, 240, 249 (2005); 26 C.F.R. § 1.162-27. *See* Homer Kripke, *Fifty Years of Securities Regulation in Search of a Purpose*, 21 SAN DIEGO L. REV. 257, 260–68 (1984) (discussing the purposes behind SEC disclosure regulations).

18. 17 C.F.R. §§ 228, 229, 240, 249; 26 C.F.R. § 1.162-27.

19. *See* Kripke, *supra* note 17, at 261 (stating one of the purposes of the disclosure regulation is "providing useful information to assist investors in making buy, sell, and hold decisions in securities").

20. 26 C.F.R. § 1.162-27.

21. Loewenstein, *supra* note 16, at 4 ("Many articles and books simply assume that [CEOs are overpaid], in part because the data regarding CEO pay seems so compelling.").

22. *Luke* 4:23 (King James).

II. FEDERAL REGULATION OF EXECUTIVE COMPENSATION

A. Disclosure Regulation: An Attempt at Transparency

A complete understanding of the current regulatory scheme and the need for corporate action in the area of executive compensation requires, at a minimum, a cursory discussion of the purposes behind the disclosure regulations. The disclosure regulations were meant to address the paucity of executive compensation information in the marketplace.[23] The underlying belief is that the private market functions more efficiently when all parties involved have all the relevant information.[24] In particular, the disclosure regulations protect investors from corporate fraud[25] by requiring the disclosure of information that allows shareholders to detect fraud.[26] Furthermore, the disclosure regulations promote knowledgeable decision-making by establishing standards that make the information accessible and easy to understand.[27] With this in mind, the discussion now turns to the current regulatory scheme.

Section 402 of Regulation S-K[28] specifically governs disclosure of executive compensation packages. Section 402 lists all the required executive compensation disclosures that corporations must file under the Securities Act of 1933,[29] the Securities Exchange Act of 1934,[30] and Energy Policy and Conservation Act of 1975.[31] Section 402 "requires *clear, concise and understandable* disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers . . . and directors."[32] The

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23. Kripke, *supra* note 17, at 261; Patrick J. Straka, *Executive Compensation Disclosure: The SEC's Attempt to Facilitate Market Forces*, 72 NEB. L. REV. 804, 805 (1993) ("SEC maintains that the goals of the rules are to 'assure that shareholders are well informed and that all the facts regarding the compensation that the shareholders are paying are out in the open, and to foster better accountability of the board of directors to the shareholders.'").

24. Kripke, *supra* note 17, at 261. Imperfect information is a commonly known cause of "market failure." There is a basic economic assumption that people will act in a way that serves their best interest, however, if they do not have enough information to know what is in their best interest the market will fail to reach a competitive equilibrium. *See generally* ROBERT A. COLLINGE & RONALD M. AYERS, ECONOMICS BY DESIGN PRINCIPLES AND ISSUES 11–12 (2d ed. 2000).

25. Kripke, *supra* note 17, at 261.

26. *Id.* at 262 (arguing that disclosure regulation is really an "aid to the enforcement of antifraud laws").

27. Straka, *supra* note 23, at 804–05 (discussing a statement made by the SEC Chairman to the effect that current executive compensation disclosure was "impenetrable, legalistic narrative").

28. 17 C.F.R. § 229.402 (2005). Though Section 402 is not the only regulation relating to compensation disclosure it is illustrative of other such regulations. *See* 17 C.F.R. §§ 228, 229 (providing disclosure regulation).

29. Securities Act of 1933, 15 U.S.C.A. § 77a (West 2005).

30. Securities Exchange Act of 1934, 15 U.S.C.A. § 78a (West 2005).

31. Energy Policy and Conservation Act of 1975, 42 U.S.C.A. § 6362 (West 2005).

32. 17 C.F.R. § 229.402(a)(2) (emphasis added).

regulation specifically states that all disclosures should be in a form the shareholders can understand.[33] This correlates with the 1933 Act's stated purpose of providing the shareholders with information they can use when deciding how to vote their shares.[34]

Section 402 provides that compensation awarded to the CEO must be disclosed "regardless of compensation level."[35] The company must also disclose the compensation packages for the four most highly compensated executive officers, other than the CEO,[36] unless the total of salary and bonuses paid to a particular executive is at or below $100,000.[37] These requirements apply to any arrangement under which cash, stock, stock options, or other compensation may be received.[38] This provides shareholders with complete compensation information, allowing them to make informed decisions on executive compensation plans.[39]

In an attempt to make information presented to shareholders and the public more accessible, Section 402 requires certain information be provided in table format.[40] One such table is the "Summary Compensation Table,"[41] which includes annual compensation amounts, such as salary and bonuses, and long-term compensation, such as restricted stock awards and long-term incentive plans.[42] The other required tables provide information about stock option grants,[43] information on long-term incentive pay,[44] and pension benefits.[45]

The information presented in these tables improves the ease with which shareholders and the general public can examine the executive compensation plans

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33. *Id.* Specifically the regulation requires information to be provided in forms, making it more accessible to interested parties. *See infra* notes 40–46.

34. *See* Kripke, *supra* note 17, at 261 (noting that one purpose of the disclosure regulation was to provide useful information to investors).

35. 17 C.F.R. § 229.402(a)(3)(i).

36. *Id.* § 229.402(a)(3)(ii).

37. *Id.* § 229.402, Instruction 1 to Item 402(a)(3). This seems to reflect a judgment by the regulators that $100,000 is not an amount most investors would worry about, which may be a questionable assumption in my mind.

38. 17 C.F.R. § 229.402(a)(7)(ii). Under the regulation the plan can include any "plan, contract, authorization or arrangement, whether or not set forth in any formal documents." *Id.*

39. *See* Straka, *supra* note 23, at 805 (stating that the purpose of disclosure regulations is to provide shareholders with the facts about executive compensation plans). The inclusion of stock options is extremely important because if stock options went unreported, some executives would appear to make less money than they were actually making. *See* AFL-CIO Executive PayWatch Database, *at* http://www.aflcio.org/corporate america/paywatch/ceou/database.cfm (2004) (last visited Feb. 26, 2005) [hereinafter AFL-CIO Executive Pay Watch Database]. Without the reporting of stock options, the CEO of Cisco Systems would only appear to have made one dollar in 2003, while he actually made almost $34.8 million after exercising some of his stock option grants. *Id.*

40. 17 C.F.R. § 229.402(b)–(f), (i)(3)(i).

41. *Id.* § 229.402(b).

42. *Id.*

43. *Id.* § 29.402(c), (d), (i)(3).

44. *Id.* § 229.402(e).

45. *Id.* § 229.402(f).

of public corporations.[46] However, this information is only important if the stockholder plays an active role in the company.[47] For example, the disclosure requirements provide a shareholder with much of the material information needed to influence corporate compensation decisions through internal corporate procedures, such as proxy solicitation.[48] However, most shareholders will not be this active and do not pay much attention to these tables.[49]

B. Tax Regulation: An Attempt to Limit Deductibility

Regulating executive compensation through the Internal Revenue Code was another governmental attempt to address exorbitant executive salaries.[50] Prior to the adoption of the current regulation, the amount that a company could deduct as a business expense for executive compensation was the same as it was for all employees: the company could only deduct "reasonable" pay for services rendered.[51] This arguably meant that excessive executive compensation was impermissible under the old tax rule as well.[52] However, under the "reasonableness" test of the old tax rule, the courts applied a fact-intensive analysis to determine the "reasonableness" of the challenged compensation, which often did not result in a finding of unreasonableness.[53] The courts looked to factors such as the financial condition of the employer, services performed, how comparable companies compensated their CEOs, and how much control the executive had over the company.[54] In an attempt to create a clear limit on the amount of compensation that the government could subsidize, Congress, as part of a 1993 budget bill, passed a tax regulation limiting the amount of executive

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46. *Id.* § 229.402. Although the regulation requires that corporations place the pertinent information in tables that are more accessible to the lay investor, the lay investor may still need professional help to analyze the meaning of the numbers; but with these requirements, at least the information is available.

47. *See* BAUMAN ET AL., *supra* note 8, at 477–80 (citing an excerpt from ROBERT CHARLES CLARK, CORPORATE LAW 389–94 (1986) (discussing collective action problems such as rational apathy and free-rider problems that lead to shareholder inaction when presented with corporate proxy or disclosure material)).

48. *See supra* notes 40–46 and accompanying text (relating to the tables required by the disclosure regulation and the materials in those tables).

49. *See* BAUMAN ET AL., *supra* note 8, at 477–80; *see also infra* notes 109–25 and accompanying text.

50. *See* Mark A. Salky, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?*, 49 U. MIAMI L. REV. 795, 812–13 (1995).

51. 26 U.S.C.A. § 162(a)(1) (West 2005). The requirement for reasonableness was the only limit on compensation for tax deduction before the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312. Salky, *supra* note 50, at 814. *See generally* E.L. Kellett, Annotation, *Reasonableness of Compensation Paid to Officers or Employees, so as to Warrant Deduction Thereof in Computing Employer's Income Tax*, 10 A.L.R.3d 125 (1966).

52. Salky, *supra* note 50, at 814 (noting that there is some literature arguing this point).

53. *Id.* at 814–15.

54. Salky, *supra* note 50, at 814–15.

compensation a corporation could deduct.[55] Under Section 162(m), the maximum amount a publicly held corporation can deduct for a "covered employee" in a taxable year is one million dollars.[56] The regulation's major purpose was to create an incentive for corporations not to pay their top executives excessive salaries.[57]

However, the regulation itself has significant exceptions that defeat the purpose of the rule.[58] For example, the deductibility limit does not include any compensation earned for attaining certain performance goals.[59] There are conditions on this exemption: the company's compensation committee—consisting solely of outside directors—must set the performance goal;[60] all material information about the compensation, including the performance goal, must be disclosed to the shareholders; a majority of the shareholders must approve the plan before payment of the compensation;[61] and the compensation committee must "certif[y] that the performance goals and any other material terms were in fact satisfied."[62] The grant of stock options can squarely fall within this exemption, if all the proper steps are followed.[63] Therefore, a large portion of an executive's compensation is exempt from the million dollar cap and, as such, is tax deductible. In addition, the current regulation exempts payments deferred until retirement from the deductibility limit.[64]

The result of these exemptions is that companies can easily maneuver around the million dollar cap.[65] These loopholes largely render the regulation toothless.

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55. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13210, 107 Stat. 312, 469–71 (codified as 26 U.S.C.A. § 162(m)).

56. 26 U.S.C.A. § 162(m)(1); *see also id.* § 162(m)(2)–(4) (defining the terms "publicly held corporation," "covered employee," and "applicable employee remuneration"); 26 C.F.R. § 1.162-27(b) (2005).

57. *See* H.R. REP. NO. 103-11, at 646 (1993) (noting the reason for changing from the reasonableness test to a one million dollar deductibility cap was to reduce excessive executive compensation).

58. *See, e.g.*, Ryan Miske, Book Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1684–94 (2004) (discussing regulation 162(m)'s cap on executive compensation and the lack of "bite" due to the performance-based pay exemption); Salky, *supra* note 50, at 817.

59. 26 U.S.C.A. § 162(m)(4)(C).

60. *Id.* § 162(m)(4)(C)(i). An "outside director" is someone who is not a current employee of the corporation, is not a former employee receiving compensation for prior services during the taxable year, has not been an officer of the corporation, and does not receive compensation other than for services as a director. 26 C.F.R. § 1.162-27(e)(3)(i)(A)–(D).

61. 26 U.S.C.A. § 162(m)(4)(C)(ii).

62. *Id.* § 162(m)(4)(C)(iii).

63. *See* Miske, *supra* note 58, at 1685.

64. 26 U.S.C.A. § 162(m)(4)(E); Miske, *supra* note 58, at 1692.

65. *See* Salky, *supra* note 50, at 817 (suggesting that "well-advised compensation committees can get around [the one million dollar deductible limit]").

III. EFFECT OF THE FEDERAL REGULATIONS

A. Executive Compensation in the Shadow of Regulation

The federal disclosure and tax regulations have been unable to reduce executive compensation packages.[66] One statistic often cited to criticize the excesses of executive compensation packages is the disparity between CEO compensation and the compensation of a rank-and-file worker in the same company.[67] In 1980, before the most recent amendments to the disclosure and tax regulations, the major executives at a company earned approximately forty-five times the amount that a non-managerial worker earned at the same company.[68] By 1995, executive compensation was 160 times more than the amount of the ordinary worker.[69] Just five years later, in 2000, CEOs at large companies earned 458 times the amount earned by the rank-and-file employees.[70] This vast disparity has fueled public frustration.[71]

The sheer monetary amounts of some executives' compensation plans are staggering. For example, the CEO of Abercrombie & Fitch Co., Michael Jeffries, received a compensation package in 2002 totaling over sixty-six million dollars.[72] In 2003, the CEO of Cisco Systems, John Chambers, received a compensation package worth over fifty-eight million dollars,[73] while S.J. Palmisano, CEO of IBM, received a compensation package amounting to just over twenty million dollars.[74] These examples are lavish, but they are not out of the ordinary.[75] The numbers indicate a decrease in compensation from 2001 to 2002, but for some this decrease is not enough.[76]

B. Effects of Disclosure Regulation on Executive Compensation

It is difficult to determine with any degree of certainty what effect one variable can have on a given outcome without controlling for all other variables.

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66. AFL-CIO Executive PayWatch Database, *supra* note 39.

67. *See* Editorial, *Americans Still Furious About Corporate Scandals*, USA TODAY, Jan. 13, 2004, at 15A (reporting on an interview with William McDonough, Chairman of the Public Company Accounting Oversight Board conducted by the *USA Today* Editorial Board) [hereinafter *Americans Still Furious*]; *see also* Paul Krugman, Editorial, *Enemies of Reform*, N.Y. TIMES, May 21, 2002, at A21.

68. Krugman, *supra* note 67.

69. *Id.* This statistic covers compensation *after* the amendments were made to the disclosure and tax regulations. *Id.*

70. *Id.*

71. *See Americans Still Furious*, *supra* note 67.

72. AFL-CIO Executive PayWatch Database, *supra* note 39.

73. *Id.* This compensation package was composed of a one dollar salary, with the balance of the compensation accounted for by stock options. *Id.*

74. *Id.*

75. McGeehan, *supra* note 14. A survey of two hundred large companies showed that the 2002 average for total compensation packages was $10.83 million. *Id.*

76. *Id.* The total compensation for CEOs has gone down twenty percent. *Id.* However, the secretary-treasurer of the AFL-CIO states, "[w]e think that C.E.O. pay still continues to be totally out of line with company performance." *Id.*

However, when looking at disclosure and its effect on executive compensation, there are studies and real-world examples from which to make inferences.[77]

Even though the NYSE is not a company controlled by SEC disclosure rules,[78] the resignation of Richard Grasso is a relevant real-world example of the effect disclosure can have.[79] The NYSE announced in late August 2003 that Grasso, then CEO, had agreed to a new contract running through 2007.[80] The announcement also disclosed the details of the executive compensation package, stating that Grasso would receive the same salary and bonuses as he received under his 1999 to 2005 contract.[81] The news of a $140 million distribution to Grasso from his deferred compensation plan shocked observers.[82] Within a week a public furor was heard loud and clear. Leaders of large pension funds, traders on the floor of the NYSE, a former CEO of the NYSE, and Senator Joseph Lieberman all called for Grasso's resignation.[83] Within a month, Grasso resigned his position after failing to get a vote of confidence from his board of directors.[84] Grasso's resignation suggests that disclosure of executive compensation packages *can* lead to change. Had Grasso's compensation package not been disclosed, he would probably still chair the NYSE.[85] It is not clear yet whether this controversy will lead to a decrease in the new chairman's compensation package, but the temporary replacement for Grasso receives only a nominal salary of one dollar.[86] Perhaps the outrage over Grasso's salary will remain in the minds of those who determine compensation for future NYSE executives.[87]

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77. *See* Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, at 504–20 (1998); Michael E. Ragsdale, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 561–65 (1993); *see also* Baldwin, *supra* note 14 (discussing the resignation of Richard Grasso after the disclosure of his compensation package); Matthew Cox, *New York's Hevesi Says NYSE's Grasso Should Resign*, BLOOMBERG NEWS, Sept. 16, 2003.

78. *See Taking Stock of Dick Grasso*, ECONOMIST, Sept. 20, 2003, at 13 (noting that the NYSE is a private firm that is not usually subject to rules imposed on public firms).

79. *See* Baldwin, *supra* note 14.

80. Press Release, N.Y. Stock Exchange, *NYSE Announces New Contract for Dick Grasso Through May 2007* (Aug. 27, 2003), http://www.nyse.com/Frameset.html?displayPage=/press/1061982038732.htmll (stating Mr. Grasso would receive approximately $140 million, most of which came from payouts from deferred compensation) (last visited Feb. 20, 2005) (on file with Arizona Law Review).

81. *Id.*

82. *Id.*

83. Baldwin, *supra* note 14.

84. Thor Valdmanis, *NYSE faces Thursday without Richard Grasso*, USA TODAY, Sept. 17, 2003.

85. At this point this is pure speculation, but prior to the disclosure of the compensation package there had been no call for Mr. Grasso to resign, there was no suggestion of wrongdoing by Mr. Grasso, and he had done a lot to make the NYSE the leading securities market. *See* Baldwin, *supra* note 14.

86. Christine Seib, *Ex-Chief of Citigroup to Stand in as Head of NYSE*, TIMES (London), Sept. 22, 2003.

87. Patrick McGeehan, *Disclosing Pay of Executives Often Leads to Raises*, N.Y. TIMES, Oct. 11, 2003, at C1 (discussing a statement by Charles Elson, a professor at

While the Grasso situation reveals the potential effects disclosure can have on corporate governance, some scholars believe that disclosure actually leads to higher compensation.[88] For example, Professor Edward Iacobucci believes that disclosure leads to a greater emphasis on pay-for-performance compensation packages, and the greater emphasis on performance measures produces an increase in executive compensation.[89] Professor Iacobucci accounts for the increase in a couple of ways.

First, if a firm switches from a system without performance incentives to a pay-for-performance system, the increase in executive compensation is required by the executives to offset the increased risk they face.[90] If the risks do not materialize, then the executives receive larger compensation packages than they would under a set-salary compensation plan.[91] Once managers' compensation is tied to performance, they have an incentive to direct their energy toward increasing their performance-based pay.[92]

Second, disclosure may lead to a market effect that increases the pay of executives.[93] From an executive's perspective, if other executives earn more, that executive may have an incentive to bargain harder for an increase in compensation.[94] The executive's desire to bargain harder may come from envy, or it may simply come from a desire to be paid an amount that more adequately represents the executive's ability.[95] The latter and less cynical of the two propositions is illustrated by comparing two firms that are competing in the same market.[96] If an outsider considers two similar firms whose executives are paid differently, the outsider will likely assume that the higher paid executive has greater ability.[97] Executives that feel their compensation does not reflect their abilities have an incentive to put forth increased effort to raise their compensation.[98]

However, simply because disclosure may lead to higher executive compensation does not mean that it is undesirable.[99] Mandatory disclosure decreases the costs to shareholders of obtaining information on executive compensation packages.[100] This decrease in cost may lead to a reduction in the

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the University of Delaware's school of business and economics, that he would be surprised if this did not lead to lower pay for future NYSE Chairpersons).

88. *See, e.g.*, Iacobucci, *supra* note 77, at 503; McGeehan, *supra* note 87.

89. *See* Iacobucci, *supra* note 77, at 503–05.

90. *Id.* at 505–06 (explaining that greater rewards are required under risky ventures because generally, executives, like most people, are risk averse).

91. *Id.*

92. *Id.* at 505.

93. *Id.* at 510–17.

94. *Id.* at 513.

95. *Id.* at 513–17.

96. *Id.* at 515–16.

97. *Id.* at 516.

98. *Id.*

99. *Id.* at 517–18.

100. *Id.* at 497–98.

amount of shareholders who free ride or who, as a result of rational apathy, did not otherwise receive the information before.[101]

According to Professor Iacobucci, disclosure regulations have also led, at least in part, to an increase of institutional investors in the capital markets.[102] The presence of institutional investors changes corporate governance and benefits individual investors.[103] The benefits to investors include the fact that institutional investors are often more sophisticated, they typically hold larger blocks of shares and thus wield more power or control over corporate affairs, there is less concern about rational apathy because of the greater return that the institutional investor will realize, and institutional investors may be able to deter mismanagement in other companies.[104] Because mandatory disclosure rules lower the cost of obtaining information needed to affect management decisions, the disclosure regulations are considered crucial in keeping institutional investors active in the capital markets.[105]

While all of Professor Iacobucci's arguments are logical at the theoretical level, the effect of disclosure in practice is much less certain. Despite the fact that institutional investors are more prevalent now than in the past, the continued presence of individual investors means the continuation of many of the same problems.[106] So long as there are individual investors there will be collective action problems; and thus it is important to understand how these problems affect whether the disclosure regulations will change corporate governance.[107]

First, it is not clear that the disclosure regulations alleviate rational apathy, at least with respect to individual shareholders.[108] If a shareholder is rationally apathetic when considering an issue concerning executive compensation, then the details required by the disclosure regulations will not benefit that shareholder because the shareholder will not take the time to become informed. However, as mentioned above, the disclosure regulations reduce the costs to shareholders of becoming adequately informed to make decisions.[109] Thus, if a shareholder has a large enough share in the company, the costs of becoming informed on an investment decision may be less than the benefits of becoming informed.[110] In that situation, the rational apathy problem does not exist. In essence, the effect the mandatory disclosure regulations have on corporate governance will depend on the level of investment in the company.

101. *Id.*
102. *Id.*
103. *Id.* at 498.
104. *Id.* at 498–99.
105. *Id.* at 499.
106. *See* BAUMAN ET AL., *supra* note 8, at 477–80.
107. *See supra* notes 47–50 and accompanying text.
108. *See* BAUMAN ET AL., *supra* note 8, at 477. Rational apathy exists when the costs of taking the time to become informed about some issue are greater than the benefits. *Id.*; Straka, *supra* note 23, at 835 (discussing the fact that small shareholders' costs will still outweigh the benefits of making an informed decision).
109. Straka, *supra* note 23, at 835.
110. *See id.*

In addition to rational apathy, collective action also poses a free-rider problem.[111] Free riders rely on others to take the time to become informed about the issue and then "free ride" on those efforts.[112] They do not pay any of the costs associated with becoming informed, but they nonetheless reap all of the benefits.[113] The free rider problem rears its ugly head when each shareholder decides to let others pay the costs of becoming informed.[114] The net effect is that no one becomes informed, and consequently, change does not occur.[115] The rational apathy and free-rider problems make sense when dealing with many individual small investors, but the question remains whether the presence of institutional investors changes the dynamic.

As previously mentioned, institutional investors often hold large blocks of shares in a number of companies.[116] Therefore, they have more of an incentive to maximize their benefits through changes in corporate governance.[117] If the institutional investor owns enough stock in a company, the investor will be able to control many of the corporate decisions, either through voting its shares or by electing a friendly board of directors.[118] But despite these monetary incentives, not every institutional investor becomes active in the corporate governance process.[119] Rather, some institutional investors decide to refrain from becoming too active for a number of reasons: institutional investors have little incentive to coordinate, most institutional investors prefer liquidity, and many are not willing to increase costs by becoming active in corporate governance.[120] Even though some institutional investors will not be active participants in corporate governance, overall, they are more sophisticated and do spend the time necessary to become informed about the companies in which they invest.[121]

As the preceding discussion demonstrates, it is difficult to determine with specificity what effect disclosure regulation has on executive compensation. It may bring about change, as it did in the Grasso situation.[122] Or it may lead to higher levels of executive compensation as Professor Iacobucci suggests.[123] But even if he is correct, these higher levels of compensation and increased disclosure may still have the positive effect of bringing the executive's incentives closer to those of the shareholders.[124] Despite the uncertainty about this effect, the consensus is that disclosure regulations are beneficial to the extent they make information about

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111. *See* BAUMAN ET AL., *supra* note 8, at 479. The free rider problem considers a situation where costs of obtaining information may be less than the benefits of becoming informed; however, a shareholder will still not incur the costs. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *See* Iacobucci, *supra* note 77, at 498.

117. *Id.*

118. *See* BAUMAN ET AL., *supra* note 8, at 489.

119. *Id.*

120. *Id.* at 489–91.

121. *See* Iacobucci, *supra* note 77, at 598.

122. *See supra* notes 78–87 and accompanying text.

123. *See supra* notes 88–98 and accompanying text.

124. *See* Iacobucci, *supra* note 77, at 497–503.

executive compensation available to shareholders ho desire and utilize that information.[125]

C. Effects of Tax Regulation on Executive Compensation (or Lack Thereof)

The one million dollar deductibility limit has had little effect, if any, on curbing executive compensation totals.[126] There are numerous explanations why the cap on deductibility has not been successful.[127] First, companies can simply decide to pay executives a salary of more than a million dollars and not take the deduction on the excess.[128] Second, there are many exemptions to Section 162(m) of the tax code,[129] the performance-based compensation exemption being the most utilized.[130] After subtracting for the exceptions, Section 162(m)'s deductibility limit applies only to salaries and guaranteed bonuses.[131]

In addition to these short-comings, empirical evidence questions the effectiveness of Section 162(m) in limiting executive compensation.[132] In the first year after Section 162(m) took effect, executive pay rose at a rate twenty-nine percent faster than in the previous fourteen years.[133] Executive pay increased more than 9.1% from 1994 to 1995, which is more than two percent greater than the average annual increase in executive pay during the previous fourteen years.[134]

Another problem noted with the tax code's million dollar limit is the lack of flexibility it gives the IRS to challenge certain executive compensation packages.[135] Prior to the specific dollar limit on deductibility, the IRS was free to challenge any compensation package it considered unreasonable.[136] By creating the specific deductibility limit, Congress has implicitly stated that any amount of executive compensation under one million dollars is reasonable,[137] when in fact, the reasonableness of a compensation plan depends on the circumstances.[138]

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125. *See, e.g.*, *id.* at 517–19.

126. *See* Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 86–94 (1998).

127. *Id.* at 87–89.

128. *Id.* at 88. It is not clear how many companies actually do this, but it is at least an option.

129. 26 U.S.C.A. § 162(m) (West 2005); *see also* Stabile, *supra* note 126, at 88; *supra* notes 58–64 and accompanying text.

130. *See* Stabile, *supra* note 126, at 88 (going so far as to say the performance-based pay exception to § 162(m) renders the limit on deductibility meaningless); *see also* Benjamin Alarie, *Executive Compensation and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s*, 61 U. TORONTO FAC. L. REV. 39, 66 (2003).

131. *See* Stabile, *supra* note 126, at 88–89.

132. *Id.* at 89–94.

133. *Id.* at 89.

134. *Id.*

135. *Id.* at 96–98.

136. 26 U.S.C.A. § 162(a)(1) (West 2005).

137. Stabile, *supra* note 126, at 96–97.

138. *Id.*

It must be noted that allowing a performance-based compensation exemption is not necessarily a negative.[139] Performance-based compensation can bring the executive's incentives in line with those of the shareholders, mainly because the executive often becomes a shareholder through stock options.[140] These incentives may lead to gains for the corporation that may not have been attained without tying the manager's fortunes to the fortunes of the corporation.[141]

Whether Section 162(m) is a complete failure or a moderate success depends upon what Congress intended.[142] If Congress intended the million dollar deductibility cap to reduce excessive executive compensation, then the regulation has failed.[143] Based on the regulation-created bias toward performance-based compensation, the regulation helped dramatically increase total compensation during the strong stock market in the late 1990s.[144] If Congress intended Section 162(m) to increase tax revenue, it failed[145] as well because companies conformed to the million dollar cap by using the performance-based exemption and did not pay additional taxes.[146] But if Congress intended the regulation to increase pay-for-performance compensation, then Section 162(m) accomplished its goal.[147]

D. Executive Compensation in the News

If the recent corporate scandals had not occurred, the Sarbanes-Oxley Act ("Sarbanes-Oxley") would still be a glimmer in Congress's eye, corporate action would not be under a microscope, and this call for self-regulation would be unnecessary. However, the scandals did occur, and corporations need to understand the mistakes that those corporations made in order to effectively self-regulate and avoid increased governmental regulation of executive compensation.

Enron, WorldCom, and Tyco are just a few corporations that have received recent media attention because of their executive compensation practices.[148] Although these companies likely represent exceptional examples of executive compensation problems, they are still important to consider because the problems occurred under the current regulatory system.[149] These examples are also important because they could point the way for future legislation.[150]

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139. Alarie, *supra* note 130, at 66.
140. *See* Iacobucci, *supra* note 77, at 517–18.
141. *See id.*
142. *See* Alarie, *supra* note 130, at 68–69.
143. *See id.*; Stabile, *supra* note 126, at 89.
144. *See* Alarie, *supra* note 130, at 68.
145. *Id.* at 67.
146. *Id.* at 67–68.
147. *Id.* at 68.
148. *See, e.g.*, Eichenwald, *supra* note 15; Rega & Oster, *supra* note 15; Sorkin, *supra* note 15; *see also* Johnson & Stern, *supra* note 15.
149. 17 C.F.R. § 229.402 (2005), and 26 U.S.C.A. § 162(m) (West 2005), were both amended to essentially their present state in the 1990s, almost a decade before any of the recent corporate scandals.
150. After the Enron debacle, Congress held hearings on what can be done to regulate executive compensation to prevent further problems from occurring. *See Enron Investigation*, *supra* note 15; *CEO Compensation in the Post-Enron Era: Hearing Before*

The collapse of Enron in December of 2001 raised many questions concerning accounting practices, retirement plans, and executive compensation packages.[151] This Note will only address the latter of these three issues.[152] According to the Report of the Joint Committee on Taxation ("Report"), Enron's philosophy was to pay for performance.[153] The compensation packages for many executives included base pay, bonuses, and long-term incentive payments.[154] In 2000, the total compensation for the 200 highest paid employees amounted to $1.4 billion, of which $1.2 billion was comprised of stock options.[155] The stock compensation practice by Enron was not found to violate any applicable regulation, but the Report noted that using stock options may only increase executives' incentives to maximize short-term returns.[156] The Report also mentioned that Enron's Compensation Committee acted as a rubber stamp for executive compensation agreements, rather than as the intended independent check on executive compensation.[157]

Another problem the Report noted is the large number of executives who chose deferred compensation.[158] Between 1998 and 2001, Enron executives deferred more than $150 million in compensation, fifty-three million of which was paid out in accelerated distributions in the weeks preceding bankruptcy.[159] Deferred compensation plans permitted Enron executives to defer income tax obligations while maintaining some control over these payments.[160] These plans also prevented the company from deducting deferred payments until the payments were actually made to the executive.[161]

Enron also employed a practice of providing executives with loans containing forgiveness clauses, and loans without forgiveness clauses that were nonetheless forgiven later by the corporation.[162] The Report stated that Kenneth Lay alone accounted for over $106 million in corporate loans, ninety-four million

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Comm. on Senate Commerce, Sci., and Transp., May 20, 2003 [hereinafter *CEO Compensation*] (statement of Brian Hall, Associate Professor, Harvard Business School), 2003 WL 21187230; *CEO Compensation*, *supra* (statement of Damon A. Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organization), 2003 WL 11718232.

151. The Joint Commission on Taxation released a three-volume report on Enron and these issues. *See generally Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, Feb. 2003 [hereinafter *Report*], *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html (last visited Feb. 26, 2005) (on file with Arizona Law Review).

152. For a more in-depth discussion of the accounting practices and retirement plans, see *id.*

153. *Id.* at 41.

154. *Id.* at 36.

155. *Id.*

156. *Id.* at 41.

157. *Id.*

158. *Id.* at 40.

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.* at 41–42.

of which he paid back with Enron stock, which in a short time became virtually worthless.[163] It is quite likely that these loans, and this repayment scheme, provided the impetus behind the provisions in Sarbanes-Oxley Act prohibiting such executive loans.[164]

The Report made specific findings about the effect of the tax code's Section 162(m) deduction limit on executive compensation at Enron.[165] Unsurprisingly, the Report stated that the million dollar deduction limit on executive compensation did not have a major effect on Enron's compensation arrangements.[166] Although most of the compensation paid to the executives qualified for the performance-based exemption,[167] approximately eleven percent of the amount paid did not.[168] The fact that Enron chose to pay salaries that exceeded the million dollar deduction limit indicates that the limit did not affect Enron's decision about how much to provide in salary. The Report concluded, that Section 162(m) did not curb executive compensation.[169] In fact, the Report even recommended repealing the million dollar limit and addressing compensation concerns through other laws.[170] Whether the Report signals future regulatory changes for executive compensation is yet to be seen.[171]

WorldCom is another case of a company ravaged by an accounting scandal that ended in bankruptcy.[172] Payments to WorldCom's executives, particularly to former CEO Bernard Ebbers, raised red flags.[173] WorldCom was paying Ebbers $1.5 million a year in an annual pension and gave Ebbers a $408 million loan.[174] According to Richard Breeden, a court-appointed monitor for WorldCom during its bankruptcy proceedings, the Compensation Committee approved the payments to Ebbers after Ebbers allowed the head of the Committee to use a company airplane.[175] All this occurred despite the disclosure and tax regulations.

Tyco also faced criticism for its executive compensation packages. New York prosecutors charged Tyco's former CEO, Dennis Kozlowski, with looting the

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163. *Id.* at 42.
164. *See infra* notes 183–95.
165. *Report*, *supra* note 151, at 42–43.
166. *Id.* at 42.
167. *Id.*
168. *Id.*
169. *Id.* at 42–43.
170. *Id.*
171. The Report was released in February 2003.
172. *See* Christopher Stern, *WorldCom to Put Curbs on CEO's Pay, Influence; Some Profits Targeted for Dividends*, WASH. POST, Aug. 26, 2003.
173. *See* Don Stancavish, *WorldCom to Get Report on Rescinding Ebbers's Pay*, BLOOMBERG NEWS, Sept. 10, 2002.
174. *Id.*
175. *Id.* This suggests that Ebbers controlled the Compensation Committee, a committee intended to be completely independent from the corporation's executives. 26 U.S.C.A. § 162(m)(4)(C)(i) (West 2005) (requiring that a wholly independent compensation committee approve any performance-based compensation before it can be excluded from the one million dollar deduction limit).

company and its shareholders.[176] Prosecutors alleged that Kozlowski improperly used programs the corporation established for loans to executives to make unauthorized loans to himself.[177] Despite the fact that the Tyco situation may have involved fraud, it is important to note that Tyco had board-approved mechanisms in place that granted the questionable loans to executives.[178] These board-approved mechanisms were used to give bonuses and loans, which were later forgiven, to as many as forty Tyco executives.[179] There is testimony that most of the bonuses paid to executives were deferred through pension plans,[180] meaning that they did not need to be reported to investors, so the disclosure requirements would not have revealed these benefits.

The executive compensation problems at Enron, WorldCom, Tyco, and other companies not mentioned in this Note have already produced increased governmental regulation of corporations.[181] In addition to Sarbanes-Oxley, if the recommendations from the Enron Report are followed, there will likely be more governmental regulation.[182] It is important for corporations to understand how Sarbanes-Oxley changed the executive compensation landscape, and to understand what further regulations the government may enact so that corporations can address these concerns through self-regulation.

IV. SARBANES-OXLEY AND POSSIBLE FUTURE CHANGES TO EXECUTIVE COMPENSATION REGULATION

A. The Sarbanes-Oxley Act of 2002: The Death Knell for Executive Loans

Sarbanes-Oxley is a congressional response to the multiple corporate scandals that plagued the first few years of the twenty-first century.[183] The majority of Sarbanes-Oxley is not dedicated to executive compensation issues, but it does address corporate loans to executives. As discussed above, Enron,

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176. *See* Chesto, *supra* note 15; Johnson & Stern, *supra* note 15; Sorkin, *supra* note 15.

177. Chesto, *supra* note 15; Johnson & Stern, *supra* note 15; Sorkin, *supra* note 15.

178. Chesto, *supra* note 15; Johnson & Stern, *supra* note 15; Sorkin, *supra* note 15.

179. Chesto, *supra* note 15; Johnson & Stern, *supra* note 15; Sorkin, *supra* note 15. *But see Mistrial Declared in Tyco Fraud Case; Other Developments*, FACTS ON FILE WORLD NEWS DIGEST, April 8, 2004, 242C1 (discussing testimony by former board members that alleged the board did not approve many of the bonuses or loans that were considered problematic) [hereinafter *Mistrial Declared*].

180. *Mistrial Declared*, *supra* note 179.

181. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

182. *Id.*; *see Report*, *supra* note 151. Recommendations are interspersed throughout the Report.

183. Sean A. Power, Comment, *Sarbanes-Oxley Ends Corporate Lending to Insiders: Some Interpretive Issues for Executive Compensation Surrounding the Section 402 Loan Prohibition*, 71 UMKC L. REV. 911, 912 (2003).

WorldCom, and Tyco allowed executives to obtain loans from the corporation.[184] These three companies were not alone in allowing this practice; there is a long history of insider loans.[185] At one time, it was the general practice to provide favorable loans to executives as a basic component of a good executive compensation package.[186] But despite the long history of insider loans, Congress decided to stop it.[187]

Section 402 of Sarbanes-Oxley makes it unlawful for a corporation to make a loan, either directly or indirectly, to any of its directors or officers,[188] unless the corporation is in the business of granting loans to the public and certain other conditions are met.[189] The legislative history suggests that the rule's purpose is to protect investors by eliminating loans that could otherwise be hidden.[190]

But there is fear that Section 402's prohibition will end practices that simply aid in a company's administration.[191] For example, one of these practices is the cashless stock option exercise, allowing an employee who owns stock options to exercise those options without having the up-front cash to do so.[192] Instead, a broker, or the corporation, initially puts up the funds for the option and receives reimbursement once the deal has closed.[193] This process usually takes a total of three days.[194] Under Section 402, this process could arguably be considered a loan for the three-day period preceding the deal closing.[195] This shortcoming of Sarbanes-Oxley is a perfect example of the challenges the government faces when it attempts to regulate corporate internal affairs. Oftentimes, the regulations hinder administration more than they remedy the problem.

B. Proposals for Further Government Regulation of Executive Compensation

On the grand scheme of governmental regulations of executive compensation, we currently rest somewhere between the extremes of having the government cap compensation packages[196] and allowing the free market to set the

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184. *Id.* at 911–12 (noting that loans to insiders have been standard practice for years).

185. *Id.*

186. *Id.*

187. *See id.* at 913–15.

188. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 787 (2002) (codified as amended at 15 U.S.C. § 78m(k)).

189. *Id.* The conditions to be met are: the loan must be made in the ordinary course of the consumer credit business of the corporation, it must be the type of loan that is generally available to the public, and it is made on market terms, or at least no better terms than those offered to the general public. *Id.*

190. Power, *supra* note 183, at 919.

191. *Id.* at 937.

192. *Id.* at 924–30.

193. *Id.*

194. *Id.*

195. *Id.*

196. *See* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 242 (Rev. ed. 1992). However, even individuals who believe most strongly that executives are over-compensated understand that this type of regulation would not be plausible. *Id.* (pointing out that "price controls cause misallocation of resources").

price.[197] But the demand for executive compensation reform may push us toward more governmental regulation.[198]

Many possible government regulations have been offered in response to the executive compensation problem. One modest proposal for change simply suggests that shareholders vote every year on the whole executive compensation package, including base salary, bonuses, and any performance pay.[199] Professor Mark Loewenstein concludes that this proposal is simply a logical extension of shareholders' rights under current SEC rules, which allow shareholders to submit non-binding proposals concerning executive compensation to be included in proxy materials.[200] Shareholder ratification is not required under the current rules, but the proposal would mandate ratification of the entire compensation package rather than just the performance-based portion that Section 162(m) of the tax regulation requires.[201]

While this modest proposal provides shareholders with a new outlet to exercise their power to influence corporate governance, it is not clear whether it goes far enough to alleviate executive compensation problems. It also fails to address the problem of rational apathy, and it does not ensure lower compensation or fewer stock options.

Another proposed regulation is in the area of computing executive compensation. The corporate practice of granting more stock options to executives may create incentives skewed toward short-term wealth maximization rather than long-term corporate well-being.[202] These concerns have led to further recommendations for new methods to compute executive compensation.[203] According to Professor Brian Hall and Damon Silvers, the excess and abuse problems of stock options have arisen because of the favorable tax implications of granting options as opposed to simply giving stock to executives.[204] There is a general feeling among boards, according to Professor Hall, that options are much cheaper to grant than other forms of equity compensation.[205] Boards consider stock

197. *Id.* (discussing that even Mikhail S. Gorbachev, the former leader of the Soviet Union, was willing to attest that there is no substitute for a free market).

198. *Id.* at 23.

199. Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 221–23 (1996).

200. *Id.* at 221–22 ("The idea of shareholder ratification is a modest and logical step from current SEC policy regarding shareholder voting on executive compensation. Under current SEC interpretations of Rule 14a-8 of the SEC's proxy rules, shareholders who otherwise meet the eligibility requirements under the rules for submitting proposals for inclusion in the proxy materials may submit nonbinding proposals regarding executive compensation.").

201. *Id.* at 222.

202. *See CEO Compensation*, *supra* note 150 (statement of Mr. Damon A. Silvers Associate General Counsel, American Federation of Labor and Congress of Industrial Organization).

203. *See id.* (statements of Mr. Damon A. Silvers Associate General Counsel, American Federation of Labor and Congress of Industrial Organization and Brian Hall, Associate Professor, Harvard Business School).

204. *See id.*

205. *Id.* (statement of Brian Hall, Associate Professor, Harvard Business School).

options inexpensive because under the current rules, standard options do not have to be listed as an expense on the income statement, there is no cash expense when options are granted, and valuation is very complex and tends to result in options being undervalued.[206] However, Professor Hall notes that the true economic cost of stock options to shareholders is much higher than boards perceive.[207]

To alleviate this problem, Professor Hall suggests requiring corporations to account appropriately for all compensation expenses, including stock options, on corporate accounting statements.[208] Requiring corporations to include a charge for options granted on their accounting statements would force boards to more closely evaluate the amount of compensation granted through options.[209] According to Professor Hall, option reporting would help solve the current distortion of compensation decisions toward option grants.[210] Corporate boards have generally been reluctant to consider other forms of equity pay because they can grant options without having to include those options on the corporation's accounting statements.[211] If corporations are required to include option grants on accounting statements, executive compensation plans might suffer from less distortion, ultimately resulting in compensation that is not considered as excessive.[212]

Another option that legislators have available is to directly regulate the exercise of stock options. Representative Barney Frank introduced a bill that proposed to regulate the exercise of executive stock options.[213] The proposed bill would require the five most highly compensated executives or directors of a company to remit profits from the exercise of a stock option if within one year the value of the stock went down a "material amount."[214] This bill attempted to deal with the incentive to inflate stock price before the exercise of stock options.[215] While this bill would have definitely altered executive actions, it appears as though this bill die in committee.[216]

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206. *Id.*

207. *Id.* (stating "the dramatic increase in the use of options has led to an upward bias in CEO pay since many boards perceive options to be much cheaper than their true economic cost to shareholders").

208. *Id.* Both chambers of Congress have seen proposals to require companies to expense out stock options granted to executive officers. *See* S. 1890, 108th Cong. (2004); H.R. 3574, 108th Cong. (2004). The House bill, at the time of the writing of this Note, has been referred from the House to the Senate and is currently in the Senate Commission on Banking, Housing, and Urban Affairs. Bill Tracking Report HR 3574 (2005).

209. *See CEO Compensation*, *supra* note 150 (statement of Brian Hall, Associate Professor, Harvard Business School).

210. *Id.*

211. *Id.*

212. *Id.*

213. H.R. 4208, 108th Cong. (2004).

214. H.R. 4208 § 3(2).

215. H.R. 4208 § 2(1).

216. *See* 2004 Bill Tracking H.R. 4208 (2004) (showing that this bill was referred to committee on the day it was proposed and there has been no action since that date), *available at* http://thomas.loc.gov/.

Another proposal for governmental reform relates more closely to the shareholder's role in corporate governance. Damon Silvers, Associate General Counsel for the AFL-CIO, recommends what he terms "democratization of corporate board elections."[217] His plan entails including long-term investors' slate of board candidates with management board candidates on the corporation's proxy for annual elections to the board of directors.[218] The purpose of the proposal is to give long-term investors, typically institutional investors, a louder voice.[219] This proposal may produce greater communication between the board and investors, with the added benefit of greater board independence.[220]

Other suggestions for reform relate specifically to the use of the tax code to regulate executive compensation. As discussed in Section II.C, Section 162(m) of the tax code sets a deductibility limit for executive compensation, excluding performance pay, at one million dollars.[221] One reform suggestion is to simply do away with the section completely.[222] Repealing Section 162(m) would effectively resurrect the reasonableness standard for consideration of permissible compensation deductions.[223] This would allow the IRS more flexibility in challenging any compensation that it considers excessive, and it would also provide the courts with more flexibility in determining whether a particular compensation package is reasonable under the given circumstances.[224]

One last executive compensation reform proposal suggests using the tax code to lessen the disparity in pay between CEOs and rank-and-file workers.[225] This proposal would grant a deduction for executive compensation only to the extent that it was not more than twenty-five times the amount of compensation received by the lowest paid full-time worker in the corporation.[226] This proposal directly attacks the noted disparity between executive compensation and compensation of rank-and-file workers.[227] Instead of simply putting a cap on deductibility, this reform measure would allow greater deductions for executive compensation if the average worker is paid more. While this proposal sounds equitable, it is not difficult to envision potential problems, such as, misallocation of resources, inflated worker salary, overall economic inflation, and complaints by executives that they are not earning what they are worth.

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217. *CEO Compensation*, *supra* note 150 (statement of Damon A. Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organization).

218. *Id.*

219. *Id.*

220. *Id.*

221. *See supra* notes 50–65 and accompanying text.

222. *See Report*, *supra* note 151, at 43.

223. *See* 26 U.S.C.A. § 162(a)(1) (West 2005).

224. *See* Stabile, *supra* note 126, at 96–97.

225. *Id.* at 99.

226. *Id.* (discussing a proposal by Representative Sabo to make this law).

227. *See supra* note 67–71 and accompanying text (discussing the widening difference between executive pay and the pay of rank-and-file workers).

V. HEALING THYSELF: MEASURES CORPORATE AMERICA CAN IMPLEMENT BEFORE CONGRESS ACTS

A. Why Self-Regulation Is the Better Answer

With all of the options that government regulators have available, Corporate America should recognize that it needs to act to heal itself. Self regulation is better than government interference for several reasons.

First, self-regulation is preferable because it offers increased flexibility.[228] Corporations need to be able to respond quickly to changed circumstances. Self-regulation provides companies with the necessary flexibility, while governmental regulations take time to amend and change. Self-regulation allows companies to maneuver around this one-size-fits-all approach to rulemaking by allowing each company to custom-tailor a plan to rein in executive compensation while accounting for its individual business needs. Governmental regulations are general rules that apply to everyone, not taking into account that every company has a different structure.

Second, self-regulation can achieve a broader purpose by focusing on the underlying problems at the single-company level. A significant amount of legislation is created to deal with very specific problems[229]—an approach we can call "regulation by fire extinguisher"—rather than dealing with the larger problems. This type of legislation tends only to focus on minor flare-ups at the periphery.

Third, self-regulation creates an incentive for compliance.[230] A company that creates its own regulation plan will view that plan as reasonable, whereas it is more likely to view a governmental regulation as unreasonable.[231] From a therapeutic jurisprudential perspective this makes sense.[232] Professor David Wexler, one of the founders of the therapeutic jurisprudence school of thought, discusses this phenomenon in a different realm.[233] In an article concerning criminal law, Professor Wexler explains that having the client assist in creating a

228. Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 182 (1995). Though this Note discusses industry regulation under the watchful eye of a governmental administrative agency, it does offer a good explanation of why self-regulation is preferred in other context.

229. Sarbanes-Oxley, while important, is this type of legislation. It was developed to respond to the Enron, WorldCom, and Tyco problems. It has done a lot in the way of regulating certain areas, but as far as executive compensation is concerned it has not done much to alleviate any problems noted above.

230. Michael, *supra* note 228, at 182.

231. *Id.*

232. Therapeutic Jurisprudence is a school of legal/psychological thought that looks at the effect of the law on the participants in the legal process, with an eye towards where the law can act as a therapeutic agent. For more information visit www.therapeuticjurisprudence.org.

233. David B. Wexler, *Some Reflections on Therapeutic Jurisprudence and the Practice of Criminal Law*, 38 CRIM. L. BULL. 205 (2002).

rehabilitation plan helps the client to become committed to the plan.[234] The same should be true for companies that self-regulate. The company executives will become invested in the plan—just as the criminal client buys into the rehabilitation plan—because they were integral in its creation.

Allowing for flexibility, avoiding one-size-fits all regulation, and creating an atmosphere where executives become invested in improving their corporate affairs are all reasons why Corporate America should have an opportunity to self-regulate. Legislators need to understand that every company is unique and one rule will not work for all companies. If companies are given time to remedy their own internal affairs they will meet the challenge.

B. Self-Regulation Solutions

There are several solutions to current executive compensation problems that should serve as a starting point for dialogue within Corporate America. Companies can begin self-regulating by requiring boards of directors to determine the true costs of stock options to shareholders. In essence, this would be similar to requiring companies to expense out options grants, but they would not actually mark them as an expense on their financial records. This would make a compensation board reconsider the compensation packages they are offering and possibly move away from high cost stock options to lower cost compensation choices.[235]

Companies can also address the executive compensation problems by enhancing the performance measures used to determine compensation.[236] To avoid the perverse incentive that stock options present, i.e., inflating the stock price before exercising stock options, companies should tie compensation to more than simply stock price.[237] Rather than emphasizing short-term gains, as with stock options, the company should grant rewards consistent with a long-term vision for the company's success.[238] Measures of long-term vision could include maintaining a predetermined debt/equity ratio,[239] maintaining a healthy level of investment, or avoiding warranty costs related to the failure of the company's product. Alternatively, the company could require that any stock purchased by an executive must be held for a period of years before it could be sold.[240]

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234. *Id.* at 207.

235. *See supra* notes 208–12 and accompanying text.

236. Interview with Suzanne Cummins, Senior Lecturer, Eller College of Management at the University of Arizona, in Tucson, Ariz. (Sept. 24, 2004) [hereinafter Cummins Interview].

237. *Id.*

238. *Id.*; Mary M.K. Fleming, *A Closer Look at Executive Compensation*, NAT'L PUB. ACCT., Nov. 1, 1997, at 17.

239. Cummins Interview, *supra* note 236. The purpose of this provision is to make sure the company is taking advantage of debt leverage, but not to a point that would lead to insolvency. *Id.*

240. *Id.* This would tie the executive's fortunes to that of the company's, but should be able to cut down on the incentive to over inflate the stock price because the executive will not be able to sell before the market corrects for the over inflation.

If the above option is unattractive, corporations could use an objective measure of performance that takes into account a variety of performance factors.[241] This multi-ratio formula could take into account the stock price, but it could also include other measures of performance that would eliminate the incentive to artificially boost stock price.[242] The ideal multi-factor formula would include short-term and long-term performance measures that would ensure that an executive is taking into account both the present and the future interests of the shareholders.[243] The multi-factor performance measure could be a function of stock price, cash flows, investment (long-term and short-term), cost of goods, warranty costs, company cutbacks, positions added, net profits, some customer satisfaction measure, or other appropriate measures that do not have perverse incentives.[244] Ultimately, this multi-factor performance measure probably will not decrease total executive compensation, but it will decrease any incentive that executives may have to artificially inflate stock price, or worse, cook the books.[245]

Ryan Miske proposes another solution that corporations could implement without governmental regulation.[246] Miske postulates that a truly independent compensation committee engaged in "arm's length bargaining with managers when setting executive compensation" would solve the current executive compensation problems.[247] Although Miske calls for state regulation to implement his suggestion,[248] government regulation is unnecessary. Corporate boards should recognize that it is in the shareholder's best interest to have a committee, made up of independent directors, determine the executive compensation packages through arm's length bargaining. Government regulations imposing such dealings are unnecessary if companies can implement them on their own. The end result would be the same as Miske touts, i.e., more reasonable executive compensation packages.[249]

If companies begin with these three small steps—requiring the board of directors to value the stock options, enhancing the performance measures, and requiring an independent compensation committee—they will be on the right path

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241. *Id.*; *see also* Fleming, *supra* note 238 (suggesting that all compensation plans need to take into account return on investment, quality control, market share, new products, and productivity).

242. Cummins Interview, *supra* note 236.

243. *Id.*

244. *Id.*

245. *Id.*

246. Miske, *supra* note 58, at 1693–95.

247. *Id.* at 1693. A true arms length bargaining process between the executives and the compensation boards would likely have remedied some of the problems at Enron, WorldCom, and Tyco. *See supra* notes 150–82 and accompanying text. It must be noted that many different sources call for the same reform as Mr. Miske. *See, e.g.*, CRYSTAL, *supra* note 196, at 242–44 (recommending that the compensation committee have an independent compensation consultant, which the author suggest should lead to arm's length bargaining); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 981–83 (1993) (arguing that outside directors need to have equity ownership in the corporation so they have a pecuniary interest in bargaining over compensation).

248. Miske, *supra* note 58, at 1694.

249. *Id.* at 1693–95.

to correcting executive compensation abuses. The recommendations of this Note are just the tip of the iceberg. The resources that corporations have available will allow them to explore other options to improve accountability between the executives and the shareholders. Each corporation has a responsibility to assure its shareholders that its executive compensation packages are appropriate to the company's situation. Furthermore, corporations must take affirmative steps to show Congress and the nation that they are addressing excessive compensation. The country must see that government regulations are unnecessary. After these steps are taken, Corporate America can begin to regain the trust of the nation.[250]

VI. CONCLUSION

The Government's attempts to regulate executive compensation, thus far, have not been effective in dealing with executive compensation. The disclosure and tax regulations have not prevented excessive executive compensation or the recent corporate scandals. However, Congress's inability to control executive compensation does not mean that it will stop trying. Congress appears ready to act if the situation is not remedied. However, governmental regulation of executive compensation is not the answer. If companies begin with three small steps—requiring the board of directors to value the stock options, enhancing the performance measures, and requiring an independent compensation committee—they will be on the right path to correcting executive compensation abuses.

250. This may be an overly utopian view of Corporate America, but I believe that there truly are corporations that are seeking to restore America's faith in the corporate world.