How to Rein in Executive Compensation?

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Abstract: This article examines various corporate governance and compensation design issues that contribute to excessive executive compensation. It discusses numerous reform efforts to curb excessive executive pay. It provides some legal scholars’ comments on the “Say on Pay” bill and the SEC’s new compensation disclosure rules. In response to the global financial crisis, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA). In order to stimulate a recessionary economy with tax cuts and spending, Congress passed the American Recovery and Reinvestment Act of 2009 (ARRA). The ESSA created the Troubled Assets Relief Program (TARP) to purchase distressed assets from financial institutions. The ESSA stipulates executive pay restrictions at recipient institutions of TARP funds. The ARRA amended the EESSA’s executive compensation restrictions. In addition to the ESSA and the ARRA, Congress vigorously proposed various legislative measures to rein in executive pay at recipient institutions of government bailout funds, and these proposed measures are described in this article. In order to stave off further regulations/legislative measures, corporations have to engage in voluntary efforts to rein in executive pay.

INTRODUCTION

How to rein in executive compensation? This issue has been examined by various parties such as Congress, the Security Exchange Commission (SEC), academics, governance experts, businesses, and the media. Public outcry reaches a peak as recent reports indicate that despite the billions of taxpayer bailout money received by the financial institutions, the latter paid out $18.4 billion in bonuses to their employees in 2008 [1]. Amid a deepening recession, President Obama signed into effect on February 17 the American Recovery and Reinvestment Act of 2009 which aims to stimulate the economy with a combination of tax cuts and spending. To address the public outcry over hefty Wall Street pay packages, the legislation also imposes executive pay limits at 359 banks receiving government bailout money [2, 3].

As for industries that do not need government assistance, what should be done to curb excessive executive pay so as to achieve internal equity but without sacrificing external competitiveness? This paper examines the relationship between excessive executive pay and various corporate governance and equity issues. It addresses the appropriate design of executive compensation packages, followed by a discussion of the various reform efforts and legislative proposals to rein in executive pay.

VARIOUS GOVERNANCE AND INTERNAL EQUITY ISSUES

Bebchuk and Fried [4, 5] argued that high CEO compensation is due to the influence of the CEO over the nomination and pay of board directors. In a discussion on U.S. corporate governance, Michael Jensen, Jesse Isidor Straus Professor of Business Administration Emeritus at Harvard Business School, pointed out that even independent outside directors are beholden to the CEO and stay close to what the latter wants them to do [6]. Petra and Dorata [7] found that CEO performance-based compensation is less likely to be kept low by a CEO who also serves as the chairperson of the board. Further, there is an increased likelihood that CEO performance-based compensation is kept low when the board size is no more than nine members who do not serve on more than two boards. These findings are in support of some of the results from Core, Holthausen, and Larcker’s [8] study which indicates that firms with weaker governance structures offer higher compensation for CEOs, and these firms are also characterized by poor performance.

Based on the data from Fortune magazine’s 250 largest publicly traded firms, a report prepared for Representative Henry A. Waxman, Chairman of the Committee on Oversight and Government Reform, indicates that compensation consultants who provided advice about executive compensation to a minimum of 113 of Fortune 250 companies in 2006 also generated fees from other services to these firms. These compensation consultants with conflicts of interest generated 11 times more in fees from other services than from advice on executive compensation. The median CEO salary correlated positively with compensation consultant’s extent of conflict of interest. Comparing the median CEO salary of Fortune 250 firms that used conflicted consultants to that of firms that did not use conflicted consultants, it was 67% higher. As evidenced in the years between 2002 and 2006, the Fortune 250 companies that used compensation consultants with the most substantial conflicts of interest as opposed to those firms that did not use conflicted compensation consultants experienced CEO pay increase more than twice as fast [9]. This report indicates the importance of hiring...
independent compensation consultants who provide advice on executive compensation to the board, but do not provide other services to the company. If a consultant provides not only advice to the board on executive compensation, but also other services paid by the executives of the company, then how can the consultant be objective with respect to how much the executives who pay him/her for other services should be paid?

Chan [10] discussed the arguments for and against the expansion of shareholder power. Bebchuk and Fried [5] strongly advocated that shareholders be given direct access to the corporate proxy for director nominations. They considered that in order to ensure that directors focus on the interests of the shareholders, the former must be both independent of management and dependent on shareholders. However, opponents such as Bainbridge [11] and Core, Guay, and Thomas [12] argued against the expansion of shareholder power. One argument raised by Bainbridge [11] is that a corporation, as viewed by the nexus-of-contracts theory of contractarianism, is a group of people bound by a collection of contracts. Therefore, he opposed to the expansion of shareholder power for shareholders do not own the corporation in its entirety. Core et al. [12] pointed out that corporate governance may be improved with enhanced director independence through giving shareholders access to the corporate proxy for director nominations. However, onerous cost may be involved with an entirely independent board. As there is only a limited supply of qualified independent directors, an increase in the demand for the latter will heighten the cost in getting them. Chan [13] found in a study that a majority of interviewees were not in favor of providing shareholders with access to the corporate proxy for director nominations. Some interviewees raised the issue that a shareholder nominee may not be representing all shareholders, but just a special interest group. Other issues were also raised, for example, a couple of interviewees criticized that the eligibility requirements for the nominating shareholders are arbitrary.

Turning to the issue of internal pay equity, the current ratio of CEO to average worker pay is 400:1 as reported in *The Economist* [14]. Further, Wade, O’Reilly and Pollock [15] found that CEO overpayment (underpayment) was associated with overpayment (underpayment) of subordinates. CEO power was positively related to subordinate compensation. CEO power was denoted with the chairman of the board position that the CEO occupied. The authors conducted their study based on five-year data from over 120 firms. They examined the data from the top five management levels of each firm. Level 1 consists of just the CEO, and Level 2 consists of the chief financial officer, the chief operating officer, the president and division president. Level 3 consists of executives with titles such as executive vice presidents, and Level 4 consists of vice presidents. Level 5 includes general managers of divisions. Their findings indicate that the CEO overpayment and underpayment effects cascaded asymmetrically down the levels, and these cascades reduced in magnitude the further they went down the organizational levels. Higher turnover was associated with internal and external underpayment inequity. Internal underpayment inequity denotes underpayment compared to the CEO’s pay, and external underpayment inequity denotes underpayment compared to the average wage paid by other organizations for the position [15].

Gnyawali, Offstein, and Lau [16] discussed the economic and behavioral perspectives with respect to the CEO pay gap and the effects of the latter on the competitive behavior of a firm. They defined the CEO pay gap to be the difference between the compensation of the CEO and the average compensation of the remaining top management team (TMT) members. Based on the tournament theory argument [17], they described the economic perspective to denote that the TMT members are inspired and motivated by the tournament prize as represented by the enormous pay and position of the CEO, and they will work hard for the firm in order to compete for the prize. As for the behavioral perspective, a huge CEO pay gap may be detrimental to group cooperation and behavioral integration due to unhealthy competition among the TMT members. These authors studied the relationship between the CEO pay gap and three competitive behavior dimensions: competitive activity, competitive complexity, and competitive magnitude. Competitive activity refers to the volume of competitive actions undertaken by the firm, and competitive complexity refers to the firm’s variety of competitive activities. Competitive magnitude refers to the significance of the firm’s competitive actions. Based on data from the U.S. pharmaceutical firms, they found that CEO pay gap was significantly related in a positive direction to two competitive behavior dimensions: competitive activity and competitive complexity; however, it was not significantly related to competitive magnitude. They commented that CEO pay gap may in the short run induce the volume and variety of less significant competitive activities due to tournament-like competition among the TMT members. However, the tournament-like behaviors may be detrimental to group functioning, and this could, in turn, negatively affect the competitive viability of the firm in the long term. Based on their findings, these authors commented that a large CEO pay gap from an economic perspective may help directors and important stakeholders to incentivize executives to a high level of performance.

**COMPENSATION DESIGN**

RiskMetrics Group (RMG) is an undisputable leader in risk management, governance services, and financial research and analysis. In 2007, it acquired Institutional Shareholder Services (ISS), the leading corporate governance advisor. RMG went public in 2008 [18]. RMG produces numerous research publications on executive compensation and corporate governance, and they can be obtained online from its website (http://www.riskmetrics.com). Some of these research works are referenced in this article.

Firms often engage in peer group benchmarking in designing executive compensation. However, Cheng and Wu [19] of RMG cautioned that biased benchmarking may contribute to the escalation of executive pay over time. Based on the 2006 proxy statements of 373 and 235 of the S&P 500 and S&P Mid-Cap 400 firms, respectively, Faulkender and Yang [20] attempted to explain CEO pay after controlling for CEO characteristics, size, and firm performance. They found that the compensation peer group’s median pay dominates that of each of the following proxies for the CEO labor market: peers with the same 2-digit SIC code as the firm;
peers within a certain size limit in the firm’s same 2-digit industry; peers chosen to be in the performance peer group; and the firm’s CEO pay in the previous year. They also identified that the statistically significant factor that explains compensation peer group composition is the CEO compensation level at the potential peer firms after controlling for size, industry and performance. It seems that firms select potential peers with higher levels of CEO compensation to be in the benchmarking group in order to justify a higher level of CEO pay. This selection bias is more prominent in firms with attributes such as the CEO also serves as the chairperson of the board; older directors who serve on multiple boards; and the compensation consultant is Towers Perrin. These attributes point to weak corporate governance in these firms. Lower selection bias is found in firms with institutional shareholders holding substantial shares, newly hired CEOs, and greater number of shareholder proposals on curbing excessive executive compensation.

Cheng and Wu [19] of RMG reported that under the revised executive compensation disclosure rules of the SEC, data from companies with filings available as of the end of 2007 indicate that around 28% of the S&P 500 companies used a benchmarking peer group of 10 to 15 companies, and approximately 24% used a benchmarking peer group consisting of 15 to 20 companies. They reported that around 32% of the S&P 1,500 companies used a benchmarking peer group consisting of 10 to 15 companies, and around 25% used a benchmarking group of 15 to 20 companies. They noted that while the distribution by peer group size of the S&P 500 companies was similar to that of S&P 1,500 companies, the average peer group size was slightly larger among S&P 500 companies than among S&P 1,500 companies. They cautioned that when peer group size is too small, statistical analysis of peer benchmarking may not produce significant results. On the other hand, when peer group size is too large, the cost and difficulty have to be considered.

They further examined the size of companies in a benchmarking group. Depending on a company’s industry, strategy and business environment, one of the following: revenue, assets, or market value may be used as a proxy for company size. To prevent the ratcheting up of executive compensation, it is important to have consistent, objective and quantitative criteria to determine the size of companies selected for the benchmarking group. As a safeguard, the peer group should not include too many larger or smaller companies in order to prevent biases in the peer group benchmarking process. They also cautioned that when a company’s ranking in size is smaller relative to peer companies in the benchmarking group, this may ratchet up executive compensation since the increase in executive pay corresponds with the increase in company size. As it is common practice that companies set the target percentile at or higher than the median of a peer group’s executive pay for their CEO’s pay, this further ratchets up executive compensation [19].

In determining peer companies’ industry, one of a few industry classification schemes such as the Standard Industrial Classification (SIC) system should be selected. Companies should develop consistent and appropriate criteria in the selection of peer companies’ industry. As a safeguard, peer companies should be selected from similar or relevant industries. It is important to examine the pay-setting process of a peer company to be sure that it is sound and sustainable. A peer company’s compensation committee should be independent. If peer companies’ executive pay is unsustainable due to a questionable pay-setting process, this may escalate executive compensation. It is important to select peer companies with a range of performance from low to high. If only peer companies with high performance were selected to be in the benchmarking group, then this would ratchet up executive compensation for executives get higher pay at peer companies with high performance [19].

The peer benchmarking process includes the executive pay components being benchmarked and the target percentile, that is, the intended level of the executive pay component expressed as the percentile of amounts paid at peer companies to similar executives through the peer benchmarking process. The target percentile should be adjusted upward or downward if the company’s ranking in size deviates significantly from the 50th percentile. For example, if a company’s size is smaller than all the peer companies in the benchmarking group, the median company in the group is dissimilar to the company. Therefore, setting the target percentile of executive compensation at the median with respect to peer companies’ executive pay is unreasonable [19].

**Equity Compensation Plans**

Brockway and Seaton [21] of RMG reported that although stock options are still the most prevalently used equity-based awards, performance-based awards are gaining more common usage. The equity-based incentive plans use performance criteria such as total shareholder return (appreciation in stock price together with reinvested dividends) and/or financial performance metrics such as return on equity (ROE), return on assets (ROA), return on invested capital (ROIC), cash flow return on investment (cash flow ROI), and economic value-added (EVA). They mentioned that although seldom practiced, all these ratios (ROE, ROA, ROIC, and cash flow ROI) when measured relative to industry norms are more meaningful. However, Equilar [22], the market leader for benchmarking executive and director compensation, noted that due to the current market volatility, more companies are using relative performance measures. To alleviate the concerns that the latter may result in large payouts to executives even with negative company results, many performance plans stipulate that awards are given only with the achievement of at least the threshold performance requirements.

Brockway and Seaton [21] also discussed the pros and cons of these financial performance metrics. For example, ROA examines the company’s efficiency in managing its assets, but this measure does not examine the company’s financial decisions. Financial metrics such as ROE, ROA, and ROIC focus on returns in terms of net income, and the drawback is that the latter is affected by various special one-time charges with extraordinary gains or losses as one example. Therefore, managerial performance may be better evaluated based on the returns in terms of cash flow as opposed to unadjusted net income, for the company’s stock value is theoretically based on the company’s expected cash flows. More and more companies are now using economic
value-added (EVA) as a financial metric, for it takes into consideration the “cost of capital (or the weighted average cost of the company’s combined debt and the theoretical return that shareholders require from an investment in the company)” (p. 18) [21]. The use of these financial ratios has the major drawback that executives can try to increase their compensation by manipulating the timing of expenses, revenues, and so on in order to meet the near-term targets.

In addition to quantitative measures, qualitative measures of strategic objectives such as product development and customer satisfaction should also be included in an equity-based compensation program. In other words, the latter should include measures of both financial and strategic objectives [21].

**Cash Compensation**

The components of cash compensation are salary, bonus, and non-equity incentive compensation [23]. Equilar [22] indicates that executive pay cuts have been rising since June of 2008. This may be due to public pressure, employee layoffs, and the need for cash conservation. The cut in CEO pay amounts to 20% at FedEx, 25% at Motorola, and 33% at Western Digital. Non-equity incentive compensation denotes short- and long-term performance-based cash awards given in addition to both salary and bonus. Under the SEC’s new disclosure rules, non-equity compensation differs from bonus awards in that the latter are discretionary [23].

**Perquisites**

As perquisites do not link to performance, but their visibility is enhanced under the new compensation disclosure rules, some companies try to curtail them amidst the public outcry against excessive executive compensation. Fortune Brands, Intel, Lockheed Martin and Sunoco are recent examples of companies that have cut back various executive perquisites. According to Equilar, 16.1% of Fortune 100 companies reported their intent to remove various perquisites in 2006 or by the beginning of 2007 [24]. Currently, the economy is in a recession with massive layoffs and business failures. Therefore, it is not a good justification to say that perquisites can help to hire the best, for there are so many talented people desperate to be employed in this bad economic situation.

**Deferred Compensation**

Deferred compensation plans, qualified and nonqualified, allow employees to defer to a later date on a voluntary basis the receipt of taxable income. Qualified plans offer favorable tax deductions and meet the requirements of both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). Qualified plans, for example, the 401(k) plans, have dollar limits on employee contributions. Therefore, nonqualified plans, without the limits on dollar contributions, are offered to highly paid employees. Nonqualified plans are used as an aid to recruit and retain executives, and companies may make a matching contribution. Participants’ contributions are not taxed until they are paid out. Clark Consulting’s 2007 Executive Benefits survey indicates that a nonqualified deferred compensation program was offered by 95% of Fortune 1000 companies, and that the most common types of deferred compensation included salary and bonus. Corporate matching contributions came from 56% of the companies, and as a proportion of employee contributions, they amounted to 4 to 20 percent. Companies may provide interest on executives’ deferred compensation that is above the market rate. Again, similar to perquisites, nonqualified deferred compensation plans serve as a recruitment and retention tool which is not tied to executive performance [24]. The question that arises is in a recession with financial losses and massive layoffs, are companies’ matching contributions to nonqualified deferred plans justifiable? In other words, should companies’ matching contributions to these plans be eliminated?

**Supplemental Executive Retirement Plan**

A supplemental executive retirement plan (SERP) is a nonqualified pension plan that provides retirement benefits in excess of those allowed under tax-qualified pension plans. The company makes most, if not all, of the contributions to a SERP. As a defined benefit plan, a certain amount of benefits is paid to participants. As a defined contribution plan, the benefits are based on the company’s and maybe the executive’s contributions together with earnings over a period of time. There are two types of SERPS: restoration plans and enhanced SERPS. As a qualified pension plan is subject to compensation limits under tax rules, restoration plans seek to restore benefits to highly paid executives that are curtailed under a company’s qualified pension plan. In 2008, the tax code limits the compensation to $230,000.

As an example, with a company’s defined contribution SERP plan that provides 10% of pay, an executive who earns more than $230,000 will only get 10% of $230,000, which is the compensation limit set by the tax code. As a result, the executive will get $23,000. For an executive who earns $500,000 a year, the company’s 10% yearly contribution to a qualified pension plan should give the executive $50,000. In order to provide the executive the remaining $27,000, the company sets up a restoration plan [24].

As of 2008, the tax code limits the benefit to $185,000 that can be paid under a qualified pension plan. Therefore, with a defined benefit plan, a company that pays an annual pension in the amount of, for example, 45% of a participant’s final average salary of $500,000 will result in $225,000 in annual benefit. As the qualified plan limits the benefit that can be paid to $185,000, a restoration plan can be designed to parcel out the remaining $40,000 [24].

Enhanced SERPs are used to provide top executives with enhanced retirement income beyond the benefits provided by a restoration plan. As an example, a company has an enhanced SERP which provides 60% of the final average pay that includes both salary and bonus. To carry on with the previous example, the executive with the $500,000 final average salary may earn $1.2 million as the final average pay which consists of both salary and bonus. Therefore, 60% of $1.2 million will amount to $720,000 in pension benefit. As the qualified pension plan limits the annual benefit that can be paid out to $185,000, the remaining $535,000 will be distributed under an enhanced SERP. Similar to deferred compensation plans, SERPs are not linked to performance, but they are used for the purposes of recruitment and retention [24]. Again, in a recession with financial losses, massive
layoffs, and decreasing value of equities, employees and shareholders all suffer. Should highly paid executives be protected with enhanced SERPs?

**Severance Pay and Golden Parachutes**

When a company has no change in control and an executive leaves, severance payments come into play. With a company’s change in control due to a merger or acquisition, and an executive loses his/her position or major changes are involved with the latter, golden parachutes or change-in-control (CIC) payments are made [25]. There has been huge public outcry over excessive severance and golden parachute payments. Bob Nardelli’s severance pay package serves as a notorious example of excessive executive pay. When Nardelli left his CEO position at Home Depot, he was given a $210 million severance package. Home Depot’s poor performance under Nardelli’s reign sparked investors’ outrage. Deane [25] of Institutional Shareholder Services (ISS), a wholly-owned subsidiary of RMG, noted the best practices in severance agreements in the following. Severance payments should not be provided for failed performance. There must be a rational severance formula. For example, severance multiples of salary and bonus should be 1X, 2X, or 3X. Bonus should denote the target bonus for the year in which termination occurs, or the preceding few years’ average bonus. Long-term incentive awards should not be included in the severance formula.

Deane [25] of ISS pointed out that the best practices in golden parachute payments involve two conditions: a major change in the ownership structure of the firm, and the associated employment termination or a major change in the nature of the job. To restrict parachute payments to executives, the Tax Reform Act of 1984 created Sections 280G and 4999 of the Internal Revenue Code. Section 280G does not allow a company tax deduction for any excess parachute payment, and Section 4999 imposes on the recipient of any excess parachute payment a nondeductible excise tax of 20 percent. Under Section 280G, the amount in excess of the base amount allowed constitutes an excess parachute payment. The base amount of parachute payments equals to the average W-2 income of the executive for the five-year period prior to the year in which a change in control occurs. If parachute payments were greater than or equal to three times the base amount, all payments over one times the base amount would be subject to excise tax penalties. The Tax Reform Act has created unintended consequences. Instead of cutting back on parachute payments, a great number of companies cover the excise taxes with additional payments. Further, these companies also pay for the income taxes on the excise-tax gross-up payments [25].

Based on an analysis of S&P 500 companies’ proxy statements as of July 1, 2008, Papadopoulos [26] of RMG concluded that excessive parachute payments were attributed to excise tax gross-ups. For companies that reported gross-up payments, the latter constituted as a proportion of total change-in-control (CIC) payments around 18 percent or $13.9 million. Excise tax gross-ups could be greater than $100 million in extreme cases. With excise tax gross-ups, companies’ CIC payments were, on average, 65% higher than companies’ CIC payments without the excise tax gross-ups. The percentage of companies with excise tax gross-ups was higher among those with weak governance practices such as the CEO also holding the chairman position and a poor record on compensation issues. Due to shareholder pressure, a number of companies eliminated the excise tax gross-up provisions from their severance plans. Under the Emergency Economic Stabilization Act of 2008 (EESA), the participating financial institutions in the government bailout program are prohibited from providing their senior executives with golden parachutes.

In order to curb the excessive parachute payments, excise tax gross-ups should be eliminated. It would not be a surprising development if the prohibition against the provision of golden parachutes to senior executives of bailout institutions in the financial industry were extended to corporate America.

**DISCUSSION**

Reform efforts to rein in executive compensation have been undertaken by various parties such as the U.S. President, Congress, the SEC, the Treasury Department, the exchanges, pension funds, institutional investors, shareholder activists, and businesses. The most recently enacted laws include the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (ARRA). Examples of other notable reform efforts include the Sarbanes-Oxley Act (SOX) of 2002; the SEC approved New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) rules requiring independent directors to be on the compensation committee; the SEC’s new rules for executive and director compensation disclosure adopted on July 26, 2006; the “Say on Pay” or “Shareholder Vote on Executive Compensation Act” which was approved on April 20, 2007 by the House of Representatives; the SEC’s proposal to expand investors’ power; and the Aspen Principles developed by the Council of Institutional Investors and the Business Roundtable [10]. Further, there is ongoing debate with respect to the expansion of shareholder power [27, 28]. Parties such as the institutional investors, pension funds, unions, and shareholder activists favor shareholder access to proxy materials for director election. On November 28, 2007, the SEC voted 3 to 1 to restrict shareholder access to company proxies [29]. In April of 2009, Mary Schapiro, Chairman of the SEC, suggested two options to expand shareholder power. One option would be to give direct access to certain shareholders so that their nominees would be on the proxies. The other option would involve changes to the bylaws of the company so that shareholders could put their nominees on the ballots. The U.S. Chamber of Commerce challenges the SEC’s power to grant shareholders access to the proxy, for state laws govern director elections and shareholder rights. The federal powers of the SEC are restricted to proxy disclosure rules [30].

With SOX’s limited clawback provision, the CEO and the CFO have to repay bonuses and profits to the company as a consequence of the restatements of fraudulent financial reports. The SEC’s 2006 new rules for executive and director compensation disclosure attempt to inform the public the companies’ executive compensation policies and practices, and the decision-making process for stock option grants. So far, the “Say on Pay” bill which aims to give a nonbinding vote to shareholders on executive compensation has not been
enacted into law. The Aspen Principles are guidelines to steer companies’ focus on long-term performance instead of on short-term results. Companies are required to stop providing quarterly earnings guidance to analysts and to abstain from making remarks on the latter’s earnings estimates [10]. Some of these reform efforts are examined further in the following.

**Say on Pay and the New Compensation Disclosure Rules**

The “Say on Pay” bill was approved in April of 2007 by the House of Representatives. However, a companion bill introduced by then Senator Barack Obama was read twice and referred to the Committee on Banking, Housing, and Urban Affairs. With the current Obama presidency, a “Say on Pay” bill which gives shareholders a nonbinding vote on executive compensation may be enacted into law this year. Bainbridge [31] criticized that the “Say on Pay” proposal involves shifting decision-making authority from the board to the shareholders. He argued that the foundation of U.S. corporate law is director primacy. The latter denotes that the board of directors is vested with discretionary authority to make binding corporate decisions. Other critics claim that the Say on Pay vote has no teeth for it is not legally binding. Yet, it puts pressure on board members to make justifiable pay decisions based on performance. If the compensation committee members ignored shareholders’ advisory vote on executive pay, shareholder activists could undertake vote no campaigns to remove them [10, 32].

Gopalan [32] argued that the “Say on Pay” bill and the new SEC compensation disclosure rules express the social consensus against excessive executive compensation unlinked to performance. For CEOs and board directors to modify their behavior that invites disapproval and to take action that curbs excessive executive pay, they have to internalize the norm against greed which underlies the “Say on Pay” bill and the new SEC compensation disclosure rules. Socialization can help CEOs and directors to internalize the norm against pay without performance, and it can be done through engagement with large institutional shareholders, adherence to best practices in setting CEO pay, and suppression of conflicting norms such as “greed is good” (p. 242) [32].

He noted that there must be decentralized enforcement of the norm underpinning the “Say on Pay” bill and the new SEC compensation disclosure rules. Institutional shareholders should withhold votes from compensation committee directors who approved excessive compensation packages that were not linked to performance. If institutional shareholders failed to sanction the board, then shareholders should sanction the institutional shareholders for failing to take action against excessive pay. The application of social sanctions ensures that CEOs and board directors internalize the norm that pay has to be geared to performance as expressed by the “Say on Pay” bill and the new SEC compensation rules [32].

Gopalan [33] argued that instead of depending solely on regulations to rein in excessive executive pay, social sanctions such as shaming can be used to reinforce the social norm against exorbitant executive compensation. He pointed out that shaming involves negative publicity of CEO and board directors’ improper actions in order to deliberately tarnish the reputation of these individuals. He considered that for shaming activity to be successful, both the external element denoting outsiders’ activities (e.g., shunning, ostracism, dirty looks, and so forth) to instill shame, and the internal element denoting the feelings of shame are necessary. With greater disclosure of executive compensation, and if the latter were excessive, shareholders would be outraged against the CEOs and the board directors who approved the compensation packages. Shareholders’ objection to excessive executive pay would exert pressure on the board to rein in executive pay. Thus, social sanctions enforce the social norm of linking pay to performance, and the internalization of this norm helps CEOs and board directors to serve shareholders’ interests.

Donahue [34] criticized that the new executive compensation disclosure rules fail to result in complete disclosure due to the following:

1. No information pertaining to compensation consultants’ conflicts of interest is provided. For example, he described the situation between North Fork Bancorporation (“North Fork”) and Mercer Human Resources Consulting. The latter was hired to provide advice on executive compensation. Mercer recommended $288 million as a golden parachute to North Fork’s top three executives. This golden parachute package was noted for an uncommon practice which involved the inclusion of an estimated $44 million in tax gross-up on the CEO’s restricted stock. According to an analysis performed by a pay expert, the tax gross-up to the CEO could go as high as $11 million. As Mercer performed other human resource services to North Fork at the time that executive compensation advice was provided to the latter, this represented the potential for conflicts of interest. In 2002 and 2003, Mercer garnered almost $1 million for actuary services to a retirement plan at North Fork.

2. The SEC does not require the disclosure of target performance levels on the part of companies if such disclosure would be competitively harmful to these companies. The key issue in the area of executive compensation is pay should be tied to performance. However, the new rules on disclosure do not require companies to disclose whether performance targets have been attained or to disclose the specified level of pay that corresponds to a specified level of target performance. Therefore, shareholders will be ignorant of the rationale or justification for the executives’ pay and how the executives are paid. Without the information pertaining to performance targets, shareholders will not be able to judge whether or not the compensation committees have approved of pay packages that are tied to performance. Shareholders will be kept in the dark as to the performance levels that must be attained in order to get the corresponding performance awards.

3. The understatement of total compensation for only earnings at above-market interest rates on deferred compensation have to be disclosed and perquisites not exceeding $10,000 do not have to be disclosed. Firms can break the perks down into less than $10,000 increments in order to qualify for the exemption. For example, a firm does not have to disclose the allocation of $9,000 to each of the following: basket ball tickets, football tickets, and theater tickets. Regardless of the amount of money
involved, all perquisites should be disclosed so as to find out whether they are necessary or just simply wasteful spending such as daily flowers for the offices.

Donahue [34] proposed that the SEC should require the disclosure of compensation consultants’ services to the companies, the nature of each type of service and the charge for each service. Such disclosure helps shareholders to determine the nature of the relationship between the compensation consultants and management, and whether the former are independent of the latter. He also proposed that companies should be required to disclose the target performance levels after the measurement of the performance tied to the award so as to mitigate any competitive harm. Thus, the SEC should mandate companies to disclose after the conclusion of the performance period the target performance, the actual performance, the performance measure, the success or failure of performance target attainment, and the amount awarded for the achievement of the target performance. This disclosure after the performance period has been concluded alleviates competitive concerns on the part of the companies and helps shareholders to gain access to information pertaining to the linkage between pay and performance. The SEC should mandate the disclosure of all deferred compensation earnings. Also, it should require companies to present earnings that were paid at an above-market interest rate in a footnote. The SEC should mandate the disclosure of all perquisites by eliminating the $10,000 threshold for perquisites disclosure. Thus, shareholders will be able to find out the types of perquisites offered and the amount incurred for each type of perquisites. They will then be able to determine whether the perquisites are justifiable or wasteful.

Martin [35] lamented that although the revised compensation rules provide shareholders with enhanced executive compensation disclosure, shareholders are not able to effect changes in compensation decisions. She illustrated with the Walt Disney case whereby an excessive compensation package led to a shareholders’ derivative lawsuit against Walt Disney. Both the Delaware Supreme Court and the Court of Chancery ruled in favor of the defendants. The Delaware Supreme Court reemphasized that it would not undertake a review of the compensation package substantively, but it would only examine the decision-making procedure undertaken by the board to make compensation deliberations. Although the Delaware Supreme Court pointed out that Disney’s compensation board failed to exercise best practices in making the challenged compensation decision, but without the presence of gross negligence, Disney board members were not found to be liable for errors in due care.

Directors’ decisions are protected by the business judgment rule which requires the exercise of the duty of care in order to make informed decisions. Decisions are considered to be informed with the absence of gross negligence. With respect to the business judgment rule, courts examine, in most cases, only process due care, and not substantive due care in decision making. Therefore, as long as the decision-making process is devoid of gross negligence, even if the compensation package were excessive, there would not be a substantive review of the compensation decision. Thus, shareholders cannot win where there is no violation of procedural due care in decision making pertaining to executive compensation. Shareholders have only limited remedies for excessive executive compensation under existing state laws. Even if a compensation board acted in good faith and exercised procedural duty of care, excessive compensation packages could still result [35].

The Emergency Economic Stabilization Act of 2008 (EESA)

The Emergency Economic Stabilization Act of 2008 (EESA) was enacted in response to the global financial crisis. It created the Troubled Assets Relief Program (TARP) to purchase distressed assets from financial institutions. The participating financial institutions are subject to the following restrictions on executive pay:

1. They cannot offer incentives that could induce the Senior Executive Officers (SEO) to take “unnecessary and excessive risk” in their endeavors. The SEOs of a public company denote the five executive officers who are required to disclose their compensation under the Securities Exchange Act of 1934. These individuals include the CEO, the CFO, and three other executive officers who are the highest compensated. The SEOs of a private company refer to the top five highest-paid executives comparable to a public company’s executives who are required to disclose their compensation.
2. Any bonus or incentive payment offered to a SEO must be subject to clawback provisions so that the institution can recover the payment if made on the basis of materially inaccurate financial statements or other criteria.
3. No golden parachute payments to SEOs.
4. SEOs’ deductible compensation is capped at $500,000 [36].

The American Recovery and Reinvestment Act of 2009 (ARRA)

In order to stimulate a recessionary economy with tax cuts and spending, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA) on February 17. The ARRA amended the EESA’s executive compensation restrictions. Depending upon the amount of TARP funds provided by the Treasury Department to the participating financial institutions (i.e., the TARP recipients), executive compensation restrictions are extended to additional employees beyond the SEOs under the ARRA. For example, one of the ARRA’s executive compensation restrictions involves a bonus prohibition which would apply to more employees if the TARP recipient received more TARP funds. TARP recipients are prohibited from paying any bonus other than a long-term restricted stock award that does not amount to greater than a third of an employee’s yearly pay. Further, the restricted stock award can be redeemed only with the repayment of the government bailout money. The bonus prohibition applies to the SEOs and at least the next 20 employees with the highest pay at each of the TARP recipients receiving $500 million or more in government bailout money. As for the TARP recipient getting $250 million to less than $500 million in federal aid, the bonus prohibition applies to the SEOs and at least the next 10 employees with the highest pay [3].

Under the ARRA, some of the remaining amendments to the EESA’s executive compensation restrictions include the
following. The clawback requirement of the EESA is extended to the TARP recipient’s next 20 highest-paid employees. Also, the ARRA’s expanded clawback policy provides recovery of retention awards in addition to bonus and other incentive compensation paid on the basis of materially inaccurate financial statements or other criteria. Differing from the EESA, the ARRA defines the term “golden parachute” to be any payment to a departing executive for any reason except for payments for accrued benefits and services rendered. The ARRA extends the prohibition on golden parachute payments to the next five most highly-paid employees beyond the SEOs. TARP recipients are required to offer their shareholders a “say on pay” vote, which is a nonbinding vote on executive compensation at shareholder meetings. The ARRA has an executive compensation provision which requires the U.S. Department of the Treasury to review retroactively bonuses and other compensation paid before ARRA’s enactment to the SEOs and the 20 most highly-paid employees of TARP recipients. The Secretary of the Treasury must seek reimbursement to the federal government if these payments were improper [3].

Further Regulations and Legislative Measures

Martin [35] proposed that as there is a gap between enhanced executive compensation disclosure and limited remedies under existing state laws for shareholders’ litigated claims of excessive executive pay, there must be further federal regulations, state regulations, and efforts on the part of the self-regulated organizations (SROs) such as the NYSE and the NASDAQ to rein in executive pay. Traditionally, corporate governance is a matter of state law. The states can enhance regulation of executive compensation with increased court review and statutory measures. If courts were to conduct a merit review of executive compensation decisions, lawsuits pertaining to excessive executive pay would have a better rate of success [35]. Bainbridge [11] argued that if a board’s decision were to be reviewed by the court and/or shareholders, then the decision-making power would be shifted from the board to the court/shareholders. The discretionary decision-making authority of the board would be undermined in order to bring about board accountability.

State statutes could be amended in order to give shareholders more power over compensation issues. For example, an amendment that stipulates shareholder approval of executive compensation could be mandated. State law could be amended so as to increase shareholder engagement in the director nomination and election process. Corporate bylaws addressing the issue of executive compensation could also be passed [35]. In addition to efforts on the part of the states, the SROs such as the NYSE and NASDAQ could impose more stringent requirements by amending the listing rules so as to provide greater corporate accountability in the area of executive compensation. The SROs could curb CEO power by imposing requirements on members such as separating the board chairman and CEO roles; enhancing compensation consultants’ independence; and curtailing executive involvement in the compensation decision-making process [35].

At the federal level, as noted earlier, Mary Schapiro, Chairman of the SEC, suggested in April of 2009 to grant certain shareholders direct access to the proxy or to change the corporate bylaws so that shareholders could put on the ballots their nominees. On the legislative front, Senator Charles Schumer indicated that he would introduce legislation to ratify the power of the SEC to provide proxy access to shareholders. This planned legislation would also provide a non-binding vote to shareholders with respect to executive compensation [30]. Some of the most recent measures proposed by Congress to rein in executive pay include the Compensation Fairness Act of 2008 (S. 3675), the AIG bonus tax bill (H.R. 1586), the Compensation Fairness Act of 2009 (S. 651), and the Grayson-Himes Pay for Performance Act of 2009 (H.R. 1664) which are described in the following.

On October 1, 2008, Senator John Kerry introduced the Compensation Fairness Act of 2008 (S. 3675) to amend Section 162(m) of the Internal Revenue Code (IRC). Currently, 162(m) caps compensation that is deductible to $1 million annually for the top five most highly paid executives, and commissions and performance-based pay are not included in the limitation. Senator Kerry’s proposed measure would revoke for all companies, and not just TARP recipients, the exemption for bonuses and performance-based pay. In January of 2009, Treasury Secretary Tim Geithner pledged that Treasury and the Internal Revenue Service (IRS) would examine Senator Kerry’s proposed measure to amend IRC 162(m) [37].

On March 15, 2009, American International Group (AIG) paid out $165 million in bonuses to employees of its Financial Products unit. As AIG had received over $170 billion in government bailout funds, there was great public outrage over its bonus payouts [38]. In response to the latter, the AIG bonus tax bill (H.R. 1586) was passed by the U.S. House of Representatives on March 19, 2009. With this proposed legislation, employees with annual family income greater than $250,000 at institutions obtaining a minimum of $5 billion from the government bailout funds would be subject to a surtax of 90% on bonuses received. The bonus tax would be retroactive to January 1, 2009 [39].

The financial industry reacted negatively to this bill. Due to executive pay restrictions, numerous banks would not want to participate in the federal bailout programs. Also, hedge funds and private equity firms would not want to partner with the government to buy banks’ toxic assets in fear of impending legislation that curbs executive pay. As Treasury Secretary Timothy Geithner’s financial rescue plan depends on private capital, regulators were concerned that the bill would undermine the government’s bailout efforts to stabilize the financial system [39]. The bill stalled for the White House and the Democratic leadership retreated from it [40]. Democratic Majority Leader Steny Hoyer said that since a majority of the AIG executives were returning the bonus payments, the approved bonus tax bill might no longer be necessary [41].

On March 19, 2009, the Senate Finance Committee introduced the Compensation Fairness Act of 2009 (S. 651) which applies to TARP institutions in which the government holds an equity interest. It limits executive compensation at
TARP institutions and recovers payments made out of TARP funds to executives at recipient institutions. The legislative proposal would levy a 35% nondeductible excise tax on retention and non-retention bonuses. Both the employer and employee are subject to the excise tax. In total, a 70% excise tax with employer and employee each paying half would be imposed on most bonuses. The full amount of the retention bonus is subject to the excise tax, but with respect to the non-retention bonus, only the amount in excess of $50,000 is subject to the tax. The proposed legislation would exempt institutions that have received TARP funds and other federal aid in the amount of $100 million or less. It would also cap nonqualified deferred compensation to $1 million within a 12-month period [42].

On April 1, 2009, the U.S. House of Representatives passed the Grayson-Himes Pay for Performance Act of 2009 (H.R. 1664). This bill prohibits recipient institutions of direct capital investments under TARP or the Housing and Economic Recovery Act from paying their employees compensation that is “unreasonable or excessive.” Further, they are prohibited from paying employees bonus or other supplemental payment that is not tied to performance. The Treasury Secretary must define “unreasonable or excessive” compensation and establish performance standards for bonus payments under the bill. These prohibitions only apply while government bailout funds are not repaid. However, the Grayson-Himes Pay for Performance Act of 2009 applies ARRA’s bonus prohibitions to all employment contracts. In other words, it repeals ARRA’s current provision that exempts from bonus prohibitions employment contracts made prior to February 11, 2009 [43].

CONCLUSION

To stave off regulations and legislation, companies should actively engage in voluntary efforts to address the issue of excessive executive compensation. In 2007, Lublin [44] reported that an increasing number of boards had reduced or done away with completely unjustifiable deferred compensation, perquisites, severance pay and supplemental pension plans due to the SEC’s new executive compensation disclosure rules and shareholders’ ammunition in terms of election challenges and lawsuits. Equilar [22], a leading information services firm with respect to executive compensation, noted rising executive salary cutbacks and clawback adoption rates among the 2009 executive compensation trends. However, based on the data from 309 companies in the Standard & Poor’s 500, the Associated Press found from its analysis of these companies’ regulatory filings that the median value of their perquisites increased in 2008 by almost 7%. Also, perquisites as a percentage of total compensation increased from 1.95% to 2.25% in 2008 [45].

Although most of the recently proposed legislative measures that attempt to restrict executive pay apply to recipient institutions of bailout funds from the government, Congress may extend executive pay restrictions to corporate America. It would be prudent for all businesses to take a proactive stance and engage in voluntary efforts to curb excessive executive pay. As a suggestion, firms of similar size in each industry may attempt to develop a justifiable CEO to average worker pay ratio based on factors such as experience, education, budget responsibility, profit-and-loss accountability, number of subordinates supervised, value of managed assets, contribution to product/project success, innovative ideas, community contribution, and so on. This is an effort to reduce the pay gap between the CEO and the average worker so as to attain internal equity [10]. Similar-sized firms in each industry should also come up with a pay range for each of the top management positions to ensure external pay equity. Pay components that are not tied to performance should be substantially reduced or eliminated on the part of all firms. Excise tax gross-up payments on golden parachutes should also be eliminated.

REFERENCES


