Fair Pay for Chief Executive Officers

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I. Income Disparity in America

Given the choice, it is better to be the company’s CEO than its average worker.¹ A whole lot better! With the burdens of leadership come not only manicured fingers, monogrammed shirts, and a big office, but also a significant compensation package, one that clearly separates the CEO from his workforce and the public at large.

In 1970, the average CEO at an S&P 500 company made roughly 30 times more than a production worker. By 1996, this gap had widened to 210 times the average earnings of a production worker.

The magnitude of these pay differentials can be further illustrated by comparing executive pay increases with the growth in other workers’ pay. From 1982 to 1994, the average CEO’s pay increased 17% or approximately 8.8% per year. If total wealth increases are measured by including the change in the value of stock options, then average CEO wealth increased by 269.7% or 11.5% annually. By contrast, the rate of increase for average compensation for all workers during that same time period was only 0.6% a year. . . . Only Major League Baseball players and National Basketball Association players achieved annual increases of similar size to those of CEOs.

The pay gap between CEOs and line workers is . . . many times greater in the U.S. than elsewhere. At large Japanese firms, the average CEO earns only 17 times more than the average worker. German and French firm CEOs make about 24 times more than those firms’ average worker.²

Although the differential in compensation between the CEO and the average worker is large in all societies, it is significantly greater in the United
States than in comparable western societies. Scholars explain that the disparity between the American experience and that of other countries is due to greater reliance in the United States on stock options as a core feature of the executive's compensation package.5 But this explanation is not totally convincing. In the United States, but not in Europe, 60 percent of the average CEO's compensation is derived from gains garnered in the exercise of stock options, or some other stock-based compensation.6 If this factor were removed entirely from the comparisons, the American CEO's compensation is still approximately ninety times that of the average worker; this means that American CEOs are compensated more than five times that of their French or German counterparts relative to the pay of their average worker. This suggests that something more is at work here than just the popularity of stock-based compensation.

The disproportion of CEO compensation reflects the growing income disparity within the United States. It is a component of a larger societal development—the growing economic gulf between the top 10 percent and the 90 percent income strata. This is illustrated in the following graph.5

This graph reports growth in hourly wages adjusted for inflation between 1969 and 1996 as a function of income strata. Several points are to be observed. First, during this period income has actually declined for
about one half the workforce. That is, to the question “Are you better off today than you were when President Nixon was first elected?” one-half of the workforce should answer “No.” Second, the growth in inequality among workers of different income strata is pervasive. The income growth for those in the top 10 percent grew at a faster rate than that of the next 10 percent, and so forth, all down the scale. This is not a bimodal situation where one half of the households are pulling away from the other half. What we see are multiple sets of households pulling away from others, only to discover that the income of those above them is growing faster than their own. A rising tide is not lifting all boats; the tides are placing some boats at very safe anchorages while stranding others on tough economic shoals.

II. The Rise of Stock Options

It would be unfair to investment bankers, doctors, and Donald Trump to attribute the top 10 percent of the graph solely to well-compensated ceos or to the enriching effects of their stock options. There certainly are a good many vocations that place one in the top echelons. But we expect to find today’s ceo in the top deciles of such a graph and stock options can explain the momentum placing executives there.

Like so many questionable commercial developments, the initial impetus for stock options was the Internal Revenue Code. In an era where capital gains were taxed at a substantially lower rate than ordinary income, the stock option was a means for executives to receive compensation at a much lower effective tax rate. But the real impetus for stock options came from the academy. In a highly influential article, Professors Michael Jensen and William Meckling provide a rigorous and universal description of the separation of ownership from management in public companies. Jensen and Meckling identify agency costs as the central problem of public companies. That is, because managers customarily have a small ownership percentage of the public companies they manage, their natural tendency is to maximize their own utility, for example, by shirking, and not that of the firm’s owners.

Managerial shirking is not the sole concern. Managers were also said to be often reluctant to undertake high risk, high return projects that could maximize the company’s value and increase shareholders’ wealth. Jensen’s and Meckling’s proposal to align more perfectly the interests of managers
and owners is performance-based compensation, particularly arrangements that link executive pay to positive changes in shareholder wealth. At the time of their article, stock options were not a significant component of the CEO’s compensation package. When Jensen and Meckling put forth their model of the firm, it was possible to point toward the dramatic example of the power of performance-based compensation existing in leveraged buyouts. In leveraged buyouts, public companies were being converted into private ones by sophisticated buyers who perceived that the targets of their takeovers were undervalued by the stock market. Such buyouts were funded by large lenders. High-level managers were then generally rewarded with large equity positions to provide incentives to increase the value of the newly privatized firm. Evidence indicated that the assets of firms “bought out” in this way were managed more successfully after the buyout. The chief difference was said to be the improvement in the incentive structure for managers. From this experience with the leveraged buyout, one could see stock-based compensation as at least a partial remedy for the agency problem. Today, stock-based compensation is generally a significant component of the CEO’s compensation package and the chief mechanism for linking CEO compensation to firm performance.

Current data suggest that 98 percent of the correlation between CEO pay and firm performance is attributable to stock options or other stock-based rewards. But today we can more appropriately conclude that performance-based compensation is both a remedy for the classic agency problem, and too frequently a glaring manifestation of the agency problem itself. Furthermore, no strong empirical support has emerged for the proposition that high compensation or stock-based compensation is correlated with above-average performance of the firm.

Further momentum for compensation by stock options was provided in the 1980s and 1990s by the increasing acceptance of the premise that corporations are but a web of contractual relations among owners and managers, to which other constituencies are only occasional parties. The agency costs thesis wed easily to this contractual perspective of the firm: if the firm is a mere nexus of contracts, compensation should naturally enough be linked to the performance of the contract. Monitoring efforts by owners or their stewards to reduce the agency costs of managerial self-aggrandizement cannot be expected to reduce those costs to zero. So a useful complement to monitoring is to structure the executives’ incentives in such a way as to increase the costs to themselves of shirking.
Jensen’s and Meckling’s description of agency costs and the emerging "nexus of contracts" definition of the firm each helped explain the rise of another contemporary development, namely, the movement to include more outside directors on the boards of public companies. A central purpose of the outside director is to monitor management’s stewardship of the firm. Poorly performing managers are presumably more likely to be removed when the board is "independent" of management than when it is not. From this, it is but a small step to the conclusion that independent directors will represent stockholders’ interests by contracting with management to provide optimal incentives for managers to overcome their natural aversion to risk and to pursue promising projects, and otherwise to dedicate themselves to maximization of the firm’s value.

This vision of a vigilant, supervisory board of directors assumes that independent directors do not themselves suffer from the same agency problems as the managers they are charged with monitoring. The pecuniary and nonpecuniary rewards of being a director are well understood and their realization is dependent on a measure of support from the CEO. This dependency results from the importance of the CEO in the selection of the independent directors who are nominated to sit on the board. Monitoring can thus be understood as akin to managers and their monitors each looking into the same mirror and assessing their joint reflection.

The pervasive use of stock options cannot be attributed merely to the force of intellectual perspectives of the firm advanced by academics. An important if unintended nudge came from Congress when it addressed the problem of executive compensation. In 1993, in response to the growing furor over the size of executive pay packages, Congress enacted section 162(m) of the Internal Revenue Code, which prohibits the deduction of compensation in excess of $1 million per year for any of the top five executives of any corporation. Importantly, that provision does not apply to "performance-based arrangements." A natural, but unexpected, consequence of section 162(m) was a broad movement toward pay packages that are performance-based.

Although the work of academics and experience with leveraged buyouts provided a theoretical and empirical framework for incentive pay, the question presented by the congressional reform of the tax laws was: what should be the device to assure performance-based compensation? There are a good many possible mechanisms to link the executive’s compensa-
tion to changes in firm value, for example, through cash bonuses tied to changes in the firm's value or a grant of shares of stock upon meeting certain performance levels or achieving specified objectives.

Stock options became the prevalent means to link pay and performance in large part because of their favorable accounting treatment. When a firm pays a cash bonus to its executive for meeting some reward benchmark, accounting principles require the full amount of the bonus to be reported as an expense on the company's financial statements. The same treatment occurs if the executive is awarded shares of the company's stock; this is seen by the tax collector as merely a substitution of one form of payment—stock—for another—cash. In either case, an accruing expense results in a reduction of reported net income in the fiscal period when the bonus is paid or the shares are issued. In contrast, the alchemy of stock options sweeps the accounting of the grant of options into the footnotes of the firm's financial statements. Within the footnotes one can glean an estimate of the ultimate value of the options to the employee and the for-gone opportunity of the corporation to have received cash equal to their future worth at the exercise date. But this can best be seen as delayed pain to the corporation. Importantly, no reduction in net income occurs when the option is granted to the executive. Simply put, by issuing stock options in place of cash, firms reduce their compensation expense and thereby increase their current apparent profitability above what could have been claimed had another form of compensation been used.19

It was this powerful alchemy that prompted efforts in the mid-1990s by the Financial Accounting Standards Board (FASB) to require that stock options conferred on management be reported as an expense.20 Instead, the Senate passed a sense-of-the-Senate resolution, sponsored by Senator Joseph Lieberman, opposing such a requirement. The Senate's action reflected the disturbing effects of pressure by executives who feared that the FASB was about to take away a good thing, something that enabled corporations to seem more profitable than in fact they were and that resulted in a general inflation of the stock market. Contemporary estimates are that expensing options would reduce 2004 earnings per share for the S&P 500 by 7.4 percent.21 We might reasonably conclude that treating managers' stock options as expenses would correct by 7.4 percent the amount by which public companies have systematically overstated their earnings.

Stock options as a form of executive compensation act as a one-way street for the corporation. The executive incurs no diminution in her net worth if the firm's price declines so that the option is "out of the money."
When the value of the firm declines, the executive is disappointed but her compensation is not diminished. Thus, accounting practices that prevailed until recently led to the perverse result that the actual expense of management was not measured. Management compensation was therefore poorly managed.

Another harmful feature of poorly designed stock options is the strong incentive they create to massage the financial reports or other activities of the firm to enhance the options’ value on their exercise date. Unexercised options near or past their exercise date, or substantial shareholdings that arise via options, both provide perverse incentives to the executives who hold them. Thus, the executive whose options are exercisable on April 1st and who is not limited as to when she can resell her shares has a conflict regarding whether to announce the loss of a major customer on or before April 1st. Similarly, the executive has a special interest in finding, say, another $.05 per share of earnings for the first fiscal quarter so as to surpass the earnings forecast by outside analysts. Indeed, the executive may adopt a more buoyant tone in her discussions with analysts if she has just received valuable stock per options recently exercised.

III. Who’s Minding the Store?

How is it that the absence of accounting metrics explains the failure of companies to manage their executive pay packages? A central feature of today’s corporate governance model is a critical mass of outside directors and increasing reliance upon a committee system within the boardroom. Under the received model the most important charge for the independent directors is evaluation of management’s stewardship of the firm. A central component of this evaluation is rewarding or penalizing the executive based on his performance via the compensation approved by the board or one of its committees. In light of the wide condemnation of executive compensation, even from executives themselves, and the absence of visible support for the status quo, it is easy to conclude that the model is not working. Why is this so?

The responsibility to determine the amount and components of the executive’s pay package rests with the board of directors. This task is customarily delegated to the board’s compensation committee, composed of outside directors, giving it an aura of independence from the CEO whose pay the committee regulates. But the work of the committee is compro-
mised in a number of ways. The compensation committee is not expected
to devote a lot of time to its task, and it seldom disappoints in this
regard. Moreover, compensation committees are rarely proactive; they
customarily react to proposals by managers or the compensation consult-
tant retained to guide the committee. The role of the compensation con-
sultant is fraught with conflicting interests because he sees himself as
representing both the executive and the committee. He is customarily
retained or recommended by the CEO and is often also a vendor to the
corporation of a wider range of human resource consulting services.
This tightly tethers the economic interests of the compensation consultant to
the CEO. It is not unusual for the compensation consultant to garner reve-
 nues from the firm for other services that are several orders of magnitude
greater than the revenues received for advising the compensation com-
mittee regarding the CEO’s pay package. This no doubt explains why there is
not a rich history of compensation consultants opining that the CEO is
overpaid or is compensated at just the right level. If the compensation
consultant’s recommendations do not further the CEO’s quest to earn
more money, the consultant will be rapidly shown the door.

Compensation consultants have a variety of strategies they can employ
to gerrymander the process of setting, or more likely raising, an executive’s
compensation. Evidence reveals that when firms have been performing
well, compensation consultants compare compensation levels to those at
less well-performing firms to justify awarding greater executive compensa-
tion. But when a firm has not performed well, the reference group is not
selected on the basis of relative performance. Instead, a peer group that
the consultant opines is within a comparable industry group is used.
Consultants seldom recommend, and boards seldom approve, executive
compensation packages that compare unfavorably with those of executives
in rival firms.

Boardrooms continue to be congenial locations and a critical consider-
ation for board membership continues to be a board nominee’s ability to
work within a group to reach a consensus. For this reason the use of board
committees to nominate new directors has not removed the CEO from the
nomination process. This is also the reason that more than 16,000 com-
ment letters were received by the Securities and Exchange Commission
when it proposed modestly to reform the nominating process; its propos-
als identify fairly narrow instances in which stockholders owning 5 percent
of the company’s shares would be able to nominate for election a distinct
minority of the board.
IV. From Shaming to Lake Wobegon

The problems of setting CEO compensation were exacerbated in 1992 when the SEC amended Item 402 of Regulation S-K in order to expand the disclosure requirements of public companies regarding executive compensation. The new requirements mandate: (1) disclosure of the amounts awarded, (2) disclosure of the types of compensation (cash, bonus, stock option), (3) an elucidation of the company’s general compensation policies, (4) discussion of the relationship between company performance and executive compensation awarded in the most recent fiscal year, and (5) a five-year line graph of company performance comparing executive compensation to cumulative returns to shareholders, which in turn is compared to a broad market index. These rules seek the disclosure of useful information to investors, but also seek to stimulate self-regulation. We can see in the Commission’s disclosure requirements the wisdom of Louis Brandeis: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”

Theoretically, the benefits should occur on several levels. First, they provide a template for directors approaching compensation decisions. This process could, it might be hoped, lead to thoughtful decisions. At a minimum, when directors are required to gather information to fulfill their disclosure obligations they might be assembling and analyzing information they otherwise would not have before them. So the increased disclosure obligation might cause directors to monitor executive compensation from a different perspective than otherwise. You manage, we are told, what gets measured.

Second, the compensation report required by Item 402 includes the names of directors who serve on the compensation committee. Thus, the disclosure regulations can give rise to a fair amount of shaming of compensation committee members who brazenly award the underperforming CEO scandalously high compensation. Thus, facing the humiliation of failing to link compensation to the firm’s performance, directors might more closely hew the compensation of the individual executive to his contributions to their firm.

Finally, shareholders armed with information can see when a disconnect exists between the firm’s (and therefore its executives’) performance and its executives’ compensation, and can withhold their support for the directors in the next annual election. It is pertinent that on the same day
that Item 402 was amended the Commission greatly liberalized its proxy rules to permit stockholders to communicate among themselves. This reform enables stockholders more easily to encourage their fellow holders to withhold their votes for management’s nominees to the board.\textsuperscript{35}

But what actually has happened in the wake of the 1992 amendments to Item 402 is to the contrary. To meet their obligations under Item 402, the compensation committees needed guidance. Therefore, the enhanced disclosures made reliance on compensation consultants even more prevalent. Whatever misgivings may have existed regarding the role of compensation consultants prior to the amendment of Item 402 were heightened in the wake of the enhanced disclosures. Item 402 made benchmarking the order of the day for compensation committees. Executives who eyed their rivals’ Item 402 disclosures became competitive with respect to salaries. And, more importantly, boards did not feel comfortable learning from their consultant that the firm’s CEO’s compensation was in the bottom half of a cohort of peer firms. A CEO compensated within the top half or quartile of his peers is believed to make the company appear strong.\textsuperscript{36} Paying the CEO below the average strikes a blow to institutional pride. Thus, a significant percentage of the firms whose consultants use peer groups in setting executive compensation place their executives’ compensation at or above the fiftieth percentile level.\textsuperscript{37} Thus, CEOs were transformed by Item 402 to children of Lake Wobegon—whether CEO or Wobegon child, each was above average.

A final feature in the apparent failure of Item 402 was the booming economy. Warren Buffett observed that even scrawny ducks that can’t swim or quack rise in a swollen pond.\textsuperscript{38} Executives with stock options found their wealth skyrocketing with the unprecedented rise in the stock market in the second half of the 1990s. A survey of Fortune 200 firms found that between 1992 and 1997 CEO compensation nearly doubled, with most of the increase being related to stock options exercised in the booming market.\textsuperscript{39} Thus, any imbalance between performance and pay was exacerbated by the rapid rise in stock prices.

Nevertheless, boards and their compensation committees do not appear to be totally immune from the publicity that can surround executive compensation. For example, executives receive smaller pay increases and their pay becomes more sensitive to the firm’s financial performance following negative media coverage regarding their executives’ compensation arrangements.\textsuperscript{40} Moreover, executives of firms that experienced shareholder proposals critical of executive pay found their pay packages
reduced in the years following the shareholder proponent’s efforts. But such events are episodic and can be seen as focusing more attention on the compensation arrangement than the more bland disclosures compelled by Item 402.

V. Is There a Referee for This Game?

The courts have not only failed to be a restraining force on executive compensation, but they have in their wayward tacts contributed to the insularity of the compensation-setting process. A review of the history of the courts’ interface with executive compensation reveals that excessive executive compensation has long been a subject of public debate. During the Great Depression there were many judicial attacks on executive compensation, especially bonus and incentive compensation arrangements. The concerns of these suits and reactions to compensation-related abuses were captured in extensive congressional hearings leading up to the enactment of the federal securities laws.

The most famous of the suits attacked the bonus awarded the executives and directors of the American Tobacco Company. The CEO of American Tobacco, in addition to receiving an annual salary in excess of $1 million, had been granted an immediate option to purchase shares for an amount $1,169,000 below their then current market value. As part of the same option arrangement, the approving directors awarded themselves handsome options as well. The case ended triumphantly for the plaintiff in the U.S. Supreme Court. The Court concluded that even though the arrangement had been approved by the stockholders and was therefore “supported by the presumption of regularity,” that presumption nevertheless would not

justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. . . . If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.

The substantive reasonableness focus embodied in the American Tobacco case has since been replaced by an emphasis on process. The result of the shift from substance to process is that suits against executive compensa-
tion have their highest chance for success in close corporations and a much lower probability of success in public corporations. This is because process is more likely overlooked in close corporations whereas process is almost always present in public corporations due to their ability to retain talented and compulsive counsel. Consider that, in their study of all litigated compensation disputes between 1912 and 2000, Professors Thomas and Martin report that plaintiffs' success is about 50 percent greater in close corporations than it is in public corporations when the complaint is substantively based and 100 percent greater when the complaint focuses on process.44 Because Thomas and Martin do not identify the 124 cases captured in their study, it is only possible to state that it is likely that the public company cases are typical of the time period of their study and therefore do not reflect the more contemporary emphasis on process over substance. If their data are so skewed, which this author believes is highly likely, then, even though their data reflect slim odds of success to be enjoyed by plaintiffs attacking compensation decisions in public companies, those slim odds would be even slimmer today when the emphasis on process produces even greater insularity for compensation decision making.

The greatest barrier a plaintiff faces in litigating executive compensation claims is satisfying the "demand requirement." Under Delaware law, for example, a shareholder may not begin most derivative suits before making a demand on the board, which can refer the matter to a committee of disinterested and independent directors that is empowered to dismiss the suit as harmful to the corporation's best interests. This demand requirement is excused if the shareholder can allege facts establishing a reasonable doubt either that the directors were disinterested and independent or that the action challenged was facially harmful to the corporation.

A leading Delaware case, Aronson v. Lewis,45 reflects how high a hurdle the demand requirement places in the path of the derivative suit plaintiff when the focus is executive compensation. Aronson involved a challenge to the employment contract awarded to Leo Fink, the owner of 47 percent of the firm's voting stock. When Fink was seventy-five years old, the firm granted him an employment contract that would pay him $150,000 a year (plus 5 percent of the firm's pretax profits above $2.4 million). Fink could terminate the contract at any time and would receive a six-figure consulting payment for the remainder of his life; the payments would be made even if he became incapacitated. The board also approved interest-free loans to Fink that totaled $225,000. The Delaware Supreme Court dis-
missed the action, announcing that the suit could proceed without
approval by Fink's handpicked board only if the plaintiff's complaint
alleged facts that created "reasonable doubt" regarding the board's inde-
pendence or the reasonableness of the compensation arrangement. Nei-
ther the dominant stockholdings of Fink nor the one-sided employment
and loan agreements were sufficient to raise a reasonable doubt about
either issue.46 Post-Aronson decisions support the view that the decision
was not a mere aberration.47 One observable impact of Aronson is the
greater prominence of the demand requirement in Delaware post-Aron-
son. Prior to Aronson, defendants made motions to dismiss the derivative
suit challenging executive compensation for failure to make a demand on
the board in roughly the same percentage of cases in Delaware (14 per-
cent) as outside Delaware (18 percent). After Aronson, such motions in
executive compensation cases are made in 75 percent of the Delaware cases
compared with only 14 percent of non-Delaware cases.48

In re The Walt Disney Co. Derivative Litigation49 might be seen as an
important first step toward closer judicial scrutiny of executive compensa-
tion decisions. This recent (2003) case arose from the Disney board's
approval of an executive compensation contract with Michael Ovitz and
its implied approval of a no-fault termination of Ovitz resulting in his
receiving in excess of $140 million after barely one year of employment.
The Chancery Court held, based on facts set forth in the complaint that
could not have been more egregious, that the plaintiff's complaint with-
stood the defendant's motion to dismiss. The facts alleged in the com-
plaint include, among other things, the following:

• Ovitz was hired pursuant to pressure from Disney's CEO, Michael
  Eissner;
• Eissner and Ovitz had been close friends for twenty-five years;
• Ovitz had never been an executive for a publicly owned entertain-
  ment company;
• Internal documents had warned that Ovitz was unqualified;
• A member of the compensation committee received a $250,000 fee to
  secure Ovitz's employment with Disney;
• Neither the compensation committee nor the board had received, or
  had an opportunity to review, either the draft or final employment
  contract with Ovitz;
• The compensation committee and the board had devoted hardly any
time at their meetings to reviewing and approving the employment
of Ovitz;
The compensation committee and the board had delegated the
details of the transaction to Eisner;
The board did not condition the employment contract becoming
effective upon their final review or approval;
The final version of the employment contract varied significantly
from the drafts earlier summarized for the compensation committee;
From the outset of his employment Ovitz performed poorly;
No experts were consulted at any time in either the employment or
termination of Ovitz;
The terms for Ovitz's departure were entered into without express
committee or board approval; and
The severance agreement entered into by Eisner, acting for Disney,
awarded significant financial benefits to Ovitz more quickly than if he
had remained with Disney.

The Chancellor observed:

These facts, if true, do more than portray directors who, in a negligent or
grossly negligent manner, merely failed to inform themselves or to deliber-
ate adequately about an issue of material importance to their corporation.
Instead, the facts . . . suggest that the defendant directors consciously and
intentionally disregarded their responsibilities, adopting a "we don't care
about the risks" attitude concerning a material corporate decision. Knowing
or deliberate indifference by a director to his or her duty to act faithfully
and with appropriate care is conduct, in my opinion, that may not have
been taken honestly and in good faith to advance the best interests of the
company. Put differently, all of the alleged facts, if true, imply that the
defendant directors knew that they were making material decisions without
adequate information and without adequate deliberation, and that they
simply did not care if the decisions caused the corporation and its stock-
holders to suffer injury or loss. Viewed in this light . . . [the] complaint
sufficiently alleges a breach of the directors' obligation to act honestly and
in good faith in the corporation's best interests for a Court to conclude, if
the facts are true, that the defendant directors' conduct fell outside the pro-
tection of the business judgment rule.69

The facts alleged in Disney reflect not just sloppy procedures, but noth-
ing less than an abdication of the board's monitoring role. It is not to be
expected that in most instances the flagrantly dominating CEO, perhaps
supplemented by cronyism as appears to have been the case in Disney, will
be present. Instead, the record will be painfully constructed to support results that may not be far from the windfall garnered by Ovitz. The facts alleged in Disney served up a nice softball for the Chancery Court to knock beyond the park's typical walls. It remains to be seen whether that court or any other court can make contact with the curve balls that are more frequently pitched.

Courts have insulated pay challenges from meaningful attack through shareholder suit by fallacious obeisance to the demand requirement. Even in the rare case where demand is excused, the court's focus is on process so that only in the truly extreme situation immune to the contrivances introduced by lawyers and other consultants to the board, exemplified by Disney, will the compensation decision be subject to review. By devoting their scrutiny to process rather than substance, courts provide a compelling incentive for compensation committees to rely upon the advice of compensation consultants whose own interests, as noted, conflict.

Another and more important consequence of the courts' emphasis on process is that there is no legal standard by which compensation decisions are to be judged. To be sure, compensation is to be "fair" and not "wasteful." But these are merely code words for "deliberate," "thoughtful," and "reasonably examined." These are expressions of process devoid of substance. In analogous areas where the courts are called on to assess the fairness of transactions because they involve obvious self-dealing on the part of officers or even directors, their inquiry is more substantive. Thus, whether a building rented from a company controlled by the lessee's CEO is fair to the lessee is determined by comparing the lease's terms with leases of comparable properties.51

This approach works poorly for CEO compensation. It entails the risk of the same mischief presented by the compensation committee's encounters with their consultants. And compensation practices within an industry or across many referent industries may be so out of line that the resulting reference is untrustworthy. But the greatest concern simply is that CEOs are not like apples or even prime real estate among which crisp comparisons can be made. When challenging an executive's compensation the issue is complicated by the unique endowments of the executive as well as the equally unique challenges that confront the firm. Third-party reference points may prove helpful, but only as a starting point. In the end, the courts are likely to defer to the compensation committee's judgment regarding just how myriad intangible variables are to be weighed in setting executive compensation.
VI. Is There a Standard to Be Found? Maximizing Firm Value by Minimizing Income Disparities

Post-Enron, much attention has been paid to strengthening the corporate governance of public companies by enhancing the independence of their boards of directors. Listed companies now are required to have a majority of their directors be independent and their compensation committees are to be composed of independent directors. One proposed additional reform is the institution of a rule requiring the nomination of directors to be insulated from the CEO. This may occur, but the earlier response to more modest Commission proposals suggests that this is not likely.

It may be that the heightened board independence and post-Enron ethos will cause boards to turn away executives' requests for ever fatter paychecks. But determining what is excessive is not easy in the abstract. Indeed, the indeterminateness of the fairness of executive compensation remains a problem at the root of the matter. Some rigor is needed in the establishment of substantive standards against which executive compensation decisions could be made. Lacking that, we have only process to assure fair treatment of the corporation's interests.

It might help to focus more attention than is presently customary among American boards on the impact of a new compensation package on the gap between the compensation of average workers and those in the higher reaches of management. The aim would not be wealth redistribution but maximizing for the firm's owners the value of the services it is buying. There is a fairly consistent body of scholarship, both empirical and theoretical, tending to confirm that increased wage disparities between executives and other workers result in greater personnel turnover, lower employee morale, poorer product quality, and lower productivity. Therefore, take note: an astonishing disparity between the average worker's compensation and that of executives may tend not to maximize the value of the firm. So even we who favor the shareholder primacy model, which obligates directors to maximize profits, may perceive that a failure to fairly reward those down the hierarchy is not in the shareholders' best interest.
NOTES

1. The author is grateful for the research assistance of Messrs. Paul Castle and Raegan Watchman, and Ms. Yi Wang.


ceo garners $1.25 million via stock options or other stock-based rewards, and this amount is 53 times greater than increases reaped via salary increase or a bonus as a result of positive changes in the firm's value).


17. Even when public companies have nominating committees composed exclusively of outside directors, the committee is sensitive to the ceo's views of what qualities are sought in new board nominees and who on the present board should be retained. There is no requirement presently for public companies to advance or even receive nominations from their shareholders, regardless of the ownership interest of any requesting owner. To be sure, dissatisfied owners can launch their own solicitation process to support a nominee or nominees, but they face significant logistical obstacles and incur substantial expenses in doing so. See Lucian A. Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy toward Proxy Contests, 78 CAL. L. REV. 1073 (1990).

18. See I.R.C. § 162(m).


25. See Roundtable (Charles Elson, Moderator), What’s Wrong with Executive Compensation, HARV. BUS. REV., Jan. 2003, at 5, 7 ("Good consulting practice is to provide counsel assuming that we’re 51% working for the board and 49% working for management ... ").

26. Further evidence of the incestuous environment of the compensation consultant and the entire compensation-setting procedure is that the CEO customarily takes the lead in nudging director compensation upward. This process begins by the same compensation consultant benchmarking the board’s current pay against appropriate peer institutions. Thus, the board can eagerly greet the approach of the compensation consultant with the expectation that this will lead to a rising tide that lifts all boats. See id. at 20–21.

27. See id. at 13.

28. See id. at 12.


34. Post-1992 there has been an increase in stockholder proposals on a wide variety of compensation-related issues, such as linking pay to the company’s stock price. However, one study found that only 12.8 percent of the shares were voted in favor of compensation proposals. This compares with 53.7 percent supporting proposals to redeem the company’s poison pill. See Randall S. Thomas & Kenneth J. Martin, Should Labor Be Allowed to Make Shareholder Proposals, 73 WASH. L. REV. 41, 76 (1998) (study of results in the 1994 proxy season).

36. See Brian Hall & Ed Woolard, Jr., What’s Wrong with Executive Compensation? 81 HARV. BUS. REV., Jan. 2003, at 68.


38. See Shawn Tully, Raising the Bar, FORTUNE, June 8, 1998, at 272.

39. See id.


41. See Thomas & Martin, supra note 34.

42. See James D. Cox & Thomas Lee Hazen, Cox and Hazen on Corporations § 11.05 at 567–68 (2d ed. 2003).


46. The plaintiff was allowed to amend his complaint and as amended withheld the defendants’ motion to dismiss. See Lewis v. Aronson, 1985 WL 1153, 11 Del. J. Corp. L. 243 (Del. Ch. May 1, 1985). However, even this subsequent opinion held that demand was not excused by the allegation that Fink controlled a majority of the shares, that the board nominees were his nominees, or that a majority of the directors served in subservient officer positions that could be terminated as a result of Fink’s financial interests in various firms. What permitted the complaint to withstand a motion to dismiss was the allegation that the compensation arrangement was a means of addressing Fink’s concern that he had received too low a price for shares he sold to companies in which seven of the Meyers directors were officers or directors. Thus, the complaint alleged that the consulting contract with Fink was a ruse, being merely a means to use the assets of Meyers to compensate Fink for his sale of these shares. So alleged, the court believed that a demand on the board could be excused since a majority of the Meyers directors were interested in the outcome of the suit. The court also believed reasonable doubt was raised in the amended complaint as to whether the contract with Fink was the product of a reasonable business judgment, given that Meyer’s operations and Fink’s residence were in different states and given that Fink may have been bound under a second contract to provide managerial services to Meyers.

47. See, e.g., Levine v. Smith, 591 A.2d 194 (Del. 1991) (requiring demand because at least twelve of the twenty-one directors of General Motors were believed to be independent).
48. See Thomas & Martin, supra note 44 at 579.
49. 825 A.2d 275 (Del. Ch. 2003).
50. 825 A.2d at 289.
51. See, e.g., Lewis v. S.L.& E., Inc., 629 F.2d 764 (2d Cir. 1980). More generally, related party transactions are evaluated from a host of metrics to assess their overall fairness to the corporation, with the central inquiry being whether the transaction compares reasonably with what would have occurred in arms-length negotiations. See, e.g., Oberly v. Kirby, 592 A.2d 445 (Del. 1991); General Dynamics v. Torres, 915 S.W.2d 45 (Tex. App. 1995).