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CHALLENGES TO EXECUTIVE COMPENSATION: FOR THE MARKETS OR THE COURTS?

by

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I. Introduction

Tremors here and there indicate that a new wave of concern about the generosity of management compensation may be on the way. From the courts one observes a string of cases attacking compensation practices, particularly stock options and other stock plans.[1] The Securities and Exchange Commission has stirred up the waters with endeavors to extract a more meaningful type of disclosure from the managements of publicly held corporations.[2] Proxy contestants seem to be putting more weight on what they claim to be their opponents' excesses in rewarding themselves financially.[3] Even some business writers have arched eyebrows over the recent surge in management compensation that has carried the best paid executives to well over the one million dollar line, which seemed for years—like the stock market's Dow Jones "one thousand"—to serve as a psychological barrier to advances.[4]

Changes in the economy may have an impact on the national mood as to lavish compensation. American management is perceived as not keeping pace with management in Japan, Germany, and elsewhere, yet it is asserted that executives in those countries pay themselves much less than their American counterparts.[5] The most publicly visible contrast is in the automobile industry, where pay has been substantially higher for the major U.S. firms than their foreign counterparts even while competitive success has eluded us. Excessive executive compensation may be more objectionable in an atmosphere in which a concentration on expanding the economic pie is shifting towards concern about how it is to be divided.[6]

At the same time there are conspicuous moves in the other direction. Congress has, amid its general tax largesse of 1981, given relief to execu-

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1. *See infra* notes 136-48 and accompanying text.
2. *See infra* notes 168-73 and accompanying text.
3. *See, e.g.*, Connelly, *Battle in the Boardrooms*, TIME, Feb. 9, 1981, at 72 (charged Kennecott management with overcompensation); Boston Globe, Feb. 6, 1981, at 39, col. 1 (dissident shareholder criticized management for "having the highest salaries and related expenses among the major New England bank holding companies," namely a 17% increase in 1979 and a further increase of 27.8% in 1980).

Even institutional investors have shown concern about the compensation practices of firms in which they have a stake. *See* INVESTOR RESPONSIBILITY RESEARCH CENTER, THE 1979 PROXY SEASON: HOW INSTITUTIONS VOTED ON SHAREHOLDER RESOLUTIONS AND MANAGEMENT PROPOSALS 59-60 (1979) (hereinafter cited as THE 1979 PROXY SEASON).

4. Kraus, *Executive Pay: Ripe for Reform?*, HARV. BUS. REV., Sept-Oct. 1980, at 36; Baker, *Are Corporate Executives Overpaid?*, HARV. BUS. REV., July-Aug. 1977, at 51; McLaughlin, *Surging Executive Pay: Where is it Going?*, MGMT. REV. Jan. 1978, at 8. From an earlier time, compare P. DRUCKER, THE NEW SOCIETY 92-94, 251 (1950): "[I]t is the salaries of a few top executives as much as anything else that confirm the worker in his opposition to profit as 'exploitation' and his conviction that profits must be exorbitant."
5. *See infra* note 99 and accompanying text.
6. Rising executive compensation will certainly provide a greater incentive for those dissatisfied with the comparative salary structure to push towards ensuring that jobs held by women are paid as well as jobs of comparable worth held by men, regardless of job title. The issue posed by the comparable worth theory was avoided in County of Washington, Oregon v. Gunther, 452 U.S. 161 (1981). For reference to the literature on the theory see *id.* at 166 n.6. Although focused on hiring and promotion practices more than compensation, Bartholet, *Application of Title VII to Jobs in High Places*, 95 HARV. L. REV. 945 (1982), has implications for compensation, particularly in its rigorous skepticism about the possibility of proving differences in individuals' capacity.

tives, particularly in the revival of the tax-sheltered option.[7] On the other hand, within the last few years Congress has done some negative things about executive pay. Even as Congress revived the option it imposed a new $100,000 per year limit on grants. Congress has also tried to hold the salaries of officers of government-controlled corporations such as Amtrak[8] and Synfuels to a $60-85,000 per year level,[9] has moved backwards and forwards as to the tax status of executives (and other Americans) who work abroad,[10] and has set a $75,000 a year limit on pensions entitled to ERISA benefits.[11] All of that congressional activity indicates that the effective political power in the United States is not aligned with any general drive towards income equalization but that unhappy investors and other protestors will meet with some receptivity as they attack at least the most lofty and conspicuous peaks of management self-indulgence.

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7. *See* I.R.C. § 422A (West Supp. 1982) (added by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, Title II, § 251(a), 95 Stat. 256 (1981)).

8. National Railroad Passenger Corporation Act, § 303, 45 U.S.C. § 543(d) (1976). The first salary limit came in the 1972 amendment that tied executive compensation to the salary received by cabinet officers, then $60,000. S. REP. No. 756, 92d Cong., 2d Sess. 8 (1972). Congress believed "this amount is sufficient to attract able and dedicated individuals to the top position of Amtrak. Certainly such a salary limitation is in keeping with an undertaking such as Amtrak, which is being largely financed with public funds." *Id.* Amtrak protested, pointing to a Mckinsey & Co. survey showing that the median salary for chief executives was $105,000 among railroads and $129,000 in airlines (exclusive of supplements). Amtrak had relied on that data and planned a salary of $125,000. It stressed that salaries must be "fixed by the workings of the marketplace. We do not believe that Congress would attempt to fix salary levels for Amtrak anymore than it does for any other branch of the transportation industry . . . ." *Id.* at 27. A 1975 amendment permitted Amtrak's board to offer a higher salary "if necessary" than line I of the Executive schedule but not more than $85,000. H.R. REP. NO. 119, 94th Cong., 1st Sess. 6 (1975). It was noted therein that the railroad executives on the board of the Association of American Railroads average $140,000 and that the president of Amtrak had taken office with an understanding that the administration would support a higher salary level. *Id.* at 6. Interestingly no such limit is applied to Conrail. *See* 45 U.S.C. §§ 741-42 (1976). Between 1936 and 1952 Congress similarly limited the compensation of executives of subsidized shipping corporations to $25,000. Perhaps moved by the obvious inadequacy of $25,000 after World War II, one court held that a stock option was not "compensation" within the Act. Spirt v. Bechtel, 232 F.2d 241, 244 (2d Cir. 1956). Congress repealed the limit in 1970. *See* 84 Stat. 1034 (1970).

9. In authorizing the Synthetic Fuels Corporation in 1980 Congress made it clear that employee compensation should be comparable to civil service rates as far as possible. Proposed compensation above those rates required submission by the board to the President. 42 U.S.C. § 117(b)(2) (1976). Pozen, *Synthetic Fuels Corporation—Investment Bank or Government Agency?*, 36 BUS. LAW 953, 964-65 (1981). In February 1981 President Reagan ordered a cut of the pay of senior executives of Synfuels to cabinet member level ($69,360). N.Y. Times, Feb. 27, 1981, at 17, col. 1.

For a comparable Congressional attitude see 22 U.S.C. § 262e (1976) directing the President to cause action to be taken to see that salaries of international financial institution executives are kept at "levels comparable with the salaries and benefits of private business and United States Government employees in comparable positions." *See* H.R. REP. No. 544, 95th Cong., 1st Sess. 11 (1977).

10. *See* I.R.C. § 911 (West Supp. 1982) as amended by the Economic Recovery Tax Act of 1981. For earlier amendments and counter-amendments see Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for its Repeal*, 65 VA. L. REV. 1093 (1979).

11. I.R.C. § 415(b) (1976) provides that the benefits in a defined benefit plan cannot exceed the lesser of $75,000 or the "participant's average compensation for his high 3 years." For defined contribution plans the limit is a contribution of no more than the lesser of $25,000 a year or 25% of the participant's compensation. *Id.* § 415(c). The Secretary is authorized to adjust the $75,000 and $25,000 for increases in the cost of living. *Id.* § 415(d).

As compared with the depression-era focus on executive pay,[12] the present epoch comes after a long period of increasing information about what managers in fact receive, a type of data once kept rigorously private. What is not uncovered by SEC-required reports and filings can be unearthed through surveys, articles by specialists in the field, and other sources. New bodies of theory that try to link pay to the judgment of the market have made claims that their teachings explain and justify compensation practices. Thus, the time is ripe for a new look at what is known about the field and about the implications of that knowledge for the legal rules that operate to restrain excesses. This seems all the more true since the recent legal literature has been devoted to the tax aspects of compensation schemes, chiefly the more complex types, and not the corporation law questions, which are more apt to generate challenges to the amount of compensation and the ways in which it has been calculated.[13]

This article, which concentrates on the pay of chief executives of very large corporations, starts with a review of the theory that has been developed to tie compensation to the markets. It moves on to survey the history and present practices in the field including differentials that relate to the size and prosperity of the firm, the nature of the industry, and the type of position. It then proceeds to examine the record of the rather halting attempts of the courts to put limits on compensation. There is some consideration of the role of internal corporate procedures in controlling compensation. Finally, the article determines if the new learning affords either a basis for assuming that the situation is in fact under control through the market's invisible hand, or a standard by which courts can detect departures from the norm.[14] It does not attempt to tackle underlying questions about social equality at large, though the materials here presented may have some bearing on those issues.[15]

II. Market and Compensation Theories

A. Market Theory

Defenders of the current high level of executive compensation generally justify the amounts being paid as the equilibrium reached by the operation of "the market." The case is made simply in corporate public relations work and with varying degrees of subtlety in the professional literature.[16] It is an

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12. *See infra* text accompanying notes 100-03.

13. The sheer bulk of the literature on the tax aspects of corporate compensation is overwhelming. *See, e.g.*, S. M. YONG, BUSINESS ORGANIZATIONS: PENSION AND PROFIT-SHARING PLANS (1980) (4 volumes); PENS. PLAN GUIDE (CCH) (loose leaf 5 volume service).

14. These two points, of course, interrelate. If the markets are reasonably effective they make it easy for courts to detect and deal with occasional deviations. If they are not, the courts have a task at once more important and more difficult.

15. General treatments of economic equality issues in recent years include: C. JENCKS, INEQUALITY (1973); A. OKUN, EQUALITY AND EFFICIENCY (1975); P. GREEN, THE PURSUIT OF INEQUALITY (1981); L. RAINWATER, WHAT MONEY BUYS (1974); L. THUROW, GENERATING INEQUALITY (1975).

16. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Crain, *Can Corporate Executives Set Their Own Wages?*, in THE ATTACK ON CORPORATE AMERICA 272 (M.B. Johnson ed. 1978); Thomas, *Is Corporate Executive Compensation Excessive?*, *id.* at 276; Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 398, 402-06 (1962); Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975-78 (1980). For a business statement see GE Investor, Summer, 1980, at 23 (Chairman points out "if we didn't have stock

attractive linkage, given the current popularity of market theory in both political and academic circles. To examine the issues of executive compensation one must stand at the intersection of not one but three related markets: the labor, product, and capital markets. For analytical purposes, the single unit "firm" is envisioned as a series of contracts whereby the factors of production—land, capital, labor, and management—are combined in an attempt to maximize return on investment. The theoretical work devoted to market theory assumes that there stands at the intersection of the markets a surrogate for the investors who bargains on their behalf with the providers of the factors of production for the maximum return for the firm's output and the lowest cost for its inputs.[17] While it is generally obvious who bargains for the suppliers of the factors of production—including managers who bargain for themselves—it is not so evident who represents the investors in a publicly-owned corporation. In legal theory the board of directors is the body that operates on behalf of the investors.

The separation of ownership and management[18] implies that there may be a conflict of interest when determining executive compensation; that in some sense management, on behalf of the shareholders, will be buying its own services and setting the price for them. It is an assumption underlying the market theories that the investor is entitled to any residual value resulting from the interaction of the markets that exceeds the normal rate of return (rents, monopoly profits, and so forth). The conflict over salaries is but one example of numerous differences that inhere in the relationship between managers and investors. Because it enhances their power and their claims to compensation, managers might seek growth. Investors, however, might prefer high current profitability and less growth. Managers might prefer to retain earnings to nourish such growth when shareholders might prefer dividends.[19] Managers might wish to diversify to protect their own careers, which are tied to the fortunes of the firm. Investors, however, might prefer to reduce their risks by simply acquiring for their portfolios the securities of other firms.[20] There is substantial controversy as to the extent to which management generally pursues "managerialist" goals different from those a shareholder-oriented control group would follow.[21] In those situations where

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option plans, we couldn't be competitive in the compensation market."). For a more sophisticated look at relations between the management and other labor markets, see Scheideman, *The Supply and Demand for Executives,* in CHIEF EXECUTIVE OFFICER COMPENSATION 42 (H. Wattel ed. 1978).

17. *See* Fama, *supra* note 16, and sources cited, particularly Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976); Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship,* 10 BELL J. ECON. 55 (1979).

18. The recognition of the separation of ownership and management has long been accepted. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

19. *Compare* Brudney, *Dividends, Discretion, and Disclosure,* 66 VA. L. REV. 85 (1980), *with* Fischel, *The Law and Economics of Dividend Policy,* 67 VA. L. REV. 699 (1981).

20. A recent extensive review of managerialism concludes that "the broad objective of both large managerial and owner-dominated firms tends to be profitable growth." E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 246 (1981). For a brief summary and citations, see Fama, *supra* note 16, at 289.

21. *Compare,* Comment, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach,* 88 YALE L.J. 1238 (1979) *with* Brudney & Clark, *A New Look at Corporate Opportunities,* 94 HARV. L. REV. 998, 1060 n.161 (1981); M. SALTER & W. WEINHOLD, DIVERSIFICATION THROUGH ACQUISITION 37-38 (1979).

there is truly no gap between ownership and management, that is, a single entrepreneur or several partners who share work, investment, and return, the question of dividing the net income between return on the investment and return on endeavor is of interest neither to the parties nor to theoreticians, but only to the Internal Revenue Service.

The markets with which we are concerned are analyzed with the use of conceptual systems that have certain common qualities but also peculiarities of their own. Some markets are more "perfectly competitive" than others, meaning that they can respond more quickly to changes on either the supply or the demand side. Such perfection is directly related to the number of parties on each side. Market perfection is also influenced by the ease of entry into the market and the amount of information available to the market. In the securities markets, a special body of learning called the "efficient markets" theory has been developed.[22] Whether the market for managers shares the relevant special characteristics of "efficient" securities markets—a ready availability of information, a large body of interested analysts, a continuous flow of comparable trades, and equality of buyers and sellers—remains to be seen.

1. *The Labor Market*

Despite the Clayton Act's[23] assertion that labor is not a commodity, economists have built up an extensive body of literature on the labor market.[24] The literature shows that forces of supply and demand do shape the number of persons employed, and the terms and conditions of their employment. According to such analysis, a firm would be willing to pay a manager up to the marginal increment in its net revenue that would result from his employment. In other words, the upper limit that a firm would pay *A* is set by the amount by which the firm's net revenue is increased by hiring *A* as opposed to hiring *B*, the next best candidate.[25] An employee would be willing to work for any wage that exceeded the rate that was offered by the next most generous firm. In an effectively competitive market with enough employment opportunities and enough units of suitable labor, an equilibrium should result as the upper and lower limits converge.

Labor economics, as developed in the texts, has its own peculiarities. The unwillingness of individuals to move geographically or to shift between different types of functions, the presence of labor unions that bargain for a large number of individuals, and the enactment of minimum wage laws all help to ensure that the rules governing the labor market are different from those that prevail when bags of coffee pass from hand to hand. The labor market does not always operate rationally. Evidence of the market's irrationality can be found in the studies that analyze differentials between pay in fields traditionally dominated by men and in fields dominated by women.

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22. For a useful summary of efficient market literature, see Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (May 1970).

23. 15 U.S.C. § 17 (1976).

24. C. MORGAN, LABOR ECONOMICS (3d ed. 1970); A. REES, THE ECONOMICS OF WORK AND PAY (2d ed. 1979); P. SAMUELSON, ECONOMICS ch. 29 (10th ed. 1976).

25. D. ROBERTS, EXECUTIVE COMPENSATION 95 (1959); Gwartney, Asher, Haworth & Haworth, *Statistics, the Law and Title VII: An Economist's View*, 54 NOTRE DAME LAW. 633, 634 (1979).

The vagaries of labor markets should be evident to lawyers who look at differences in earnings achieved by the group of young J.D.s who head for the 100-plus lawyer firms and those who handle the run-of-the-mill accident, probate, and real estate cases.[26]

We should thus regard the market for high level executives as even more imperfect than the general labor market. Most obviously, there are greater complexities in arranging a fit between divisional managers and their slots than in finding cooks for McDonald's. As one moves up the hierarchical ladder one finds the functions that bear one title in company *X* moving farther and farther away from similarly labelled functions in company *Y*. The chief executive officer's position is the most unique of all, one for which the job description must always be tailor-made. Some employees with abstract tasks, however, such as those of internal auditor, financial vice president, or legal counsel, may have more mobility from one firm to another than, say, certain types of production engineers that are skilled in tasks not only special to a given industry but to one of the firms in it. In some cases the professional market, as for lawyers or engineers, may have more effect on the salaries of specialized managers than does the market for executives in general. The market for senior executives is not a continuous auction because most vacancies are filled from within.[27] Quite different compensation results seem to follow from the promotion of vice president *A* to the president of corporation *X* and from the hiring of outsider *B*. Quite often the outsider can negotiate a bargain.[28] News of the outsider's bargain can cause reverberations in the internal executive markets. Some firms design their compensation strategies to make it difficult for executives to go elsewhere, thus diminishing the efficiency of the executive market.

When recruiting additional lower level employees, a firm usually cannot entice them by offering more than its going rate without giving the same pay increase to all its employees, thus lifting its overall cost curve. While there are relationships between the pay of executives at the same or different levels, there is much play in the structure. There is relatively less mobility among wage employees; both their basic attitudes and the costs of relocation

26. The market for lawyers has not been closely analyzed. What is known about it is mostly derived from the new weekly professional journals. The ability of some firms to generate earnings far above the average very likely rests on the same willingness to pay for the perceived "best" as explains the high revenues of public performers. Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981). For a data study of compensation of lawyer-executives, see Nat'l L.J., Apr. 23, 1979, at 3, col. 1.; Legal Times of Wash., Aug. 4, 1980, at 6, col. 1.

27. Of 818 CEOs listed in the annual survey in FORBES, June 18, 1981, at 114, evidently 121 had become CEOs without prior service in that firm. However, 6 of the 10 best paid had been hired directly as such.

28. Upon moving from ITT to Revlon, Jacques Bergerac's contract was thought to have a worth of over $5 million—a lump sum of $1.5 million on coming to work plus an option on 70,000 shares in addition to a base salary of $325,000. Bender, *Bonus Baby in the Executive Suite: Revlon's Super Package*, N.Y. Times, May 11, 1975, at F2, col. 1. For other examples of large payments upon transfer see Hourihan & Kuhns, *Executive Compensation: Transition or Repetition*, DIRECTORS & BOARDS, Winter 1978, at 4, 7. Of course, an executive moving to a new firm takes a higher risk than one accepting a promotion from within and that necessarily affects compensation. *See* Roche, *Compensation and the Mobile Executive*, HARV. BUS. REV., Nov.-Dec. 1975, at 53. Supposedly there is a rule of thumb that an executive must be given a 25-40% increase in compensation to move to another company. *Compensation Currents*, COMPENSATION REV., 4th Quart. 1976, at 2.

tend to make it harder in the short-run to cause employees to move from one region to another than it is in the case of executives. In many industries, the total cost of labor in relation to the whole net income of the firm is high, much higher than is the cost of the chief executive or even of the top dozen executives. Thus, wage level employment is a much more uniform matter and more amenable to the aggregative methods ordinarily employed by economists than is the question of executive compensation.

These complexities are mirrored on the other side of the bargaining—it is an illusion to think that all executive jobs seem the same to their incumbents in every respect but pay. In fact, a recent sampling showed that nineteen percent of those executives transferring to different firms took a cut in salary.[29] The degree of risk of frustration and failure, the pleasantness of the human and physical environment, and many other factors serve to make some positions more appealing at the same wage level than others.[30]

The survey of labor economics indicates that there is clearly some sort of market, that some compensation policies are simply not going to attract competent takers, and that participants on the markets are aware of what is happening elsewhere. Labor transactions, however, are more idiosyncratic than those on the securities markets, and one is left with a conviction that the discipline of the labor market is at best a loose one.

2. *The Product Market*

The labor market is in turn linked to the market for the goods or services produced by the firm. The cost of labor forms part of the cost curve that the firm must consider in selecting its optimum level of output and of product pricing. A firm that uses more expensive labor than its rivals or uses labor wastefully might be unable to match its competitors in selling its product. For example, American automobile manufacturers are losing sales to the Japanese. The labor cost differential between Japan and the United States has been estimated to be $800 to $1,000 per car.[31] It is not clear, however, that overpaying top management, even by a substantial amount, will competitively damage a large firm. For example, if a corporation with sales of eight billion dollars a year pays an excess of $500,000 in compensation to its president, it would be only a 1/16,000th part of sales. That might, for example, add twenty-five cents to the price of a car; given the quirks of oligopolistic competition—and the tendency of other similar firms to match compensation practices—that twenty-five cents is not likely to pose problems to a firm's competitive position. In all but a few cases, the product market will not impose tight restraints on the management compensation process.

3. *The Capital Market*

Recently a great deal of attention has been paid to the operations of the securities market and to the implications of those operations for the

29. *See* Roche, *supra* note 28, at 58.

30. The classic statement of the differences in attractiveness of jobs—butchers, hangmen, barkeepers—is found in A. SMITH, WEALTH OF NATIONS 99 (Random House ed. 1937).

31. Letter to editor from David Potter, General Motors Corp. Vice President, HARV. BUS. REV., Nov.-Dec. 1981, at 74. For data as to the impact of labor cost differentials on the world automobile industry, see SUBCOMM. ON TRADE, HOUSE COMM. ON WAYS AND MEANS, 96TH CONG. 2D SESS., AUTO SITUATION: 1980 40-41 (Comm. Print 1980).

management of corporate enterprise.[32] The securities market is an especially sensitive barometer—efficient market—for several reasons. It furnishes and digests an enormous amount of information. Transactions are more or less continuous and are so equivalent as to be comparable. Thus, the market ensures that the information is widely and quickly disseminated to a large number of analysts who are familiar with the item being marketed, who in fact cancel out each other's efforts by the sophistication of their analysis. Repeated studies of different aspects of the market show that it operates in such an efficient way that nobody is consistently able to clear a significant profit by superior study or analysis.[33]

It has been suggested that the efficiency of the securities market in effect carries over into the management labor market. That argument involves a further layer of theory that has been built upon the general theory of the securities market: the market for corporate control.[34] According to that literature, analysts are capable of detecting a firm whose management is failing to wring the maximum financial results out of the firm's potential opportunities. The securities of such a firm will have lost ground in relation to comparable investments, as shareholders come to recognize that the prospects are unpromising. Ultimately the gap between the market price for the firm's securities and the potential value becomes so great that another firm decides to capitalize upon that gap by acquiring control of that target and improving its management. Extensive studies of tender offers indicate that the price of a security will respond swiftly and dramatically to the prospect of a change in management.[35] Thus, while resort to the proxy machinery to replace an inefficient management is a rare and improbable contingency, the prospect of being displaced by a tender offer is a real threat to incumbents.[36] Reports differ as to whether the impact falls largely upon incompetent managements or more upon those simply unfortunate enough to be in control of attractive assets. In any case, ineffective management is one factor that tender offerors look for. Salary excesses may play a part in such deficient performance but rarely a determining one. If one assumes that the cost of mounting an effective tender offer against resisting incumbents might be as much as fifteen million dollars, the likelihood of recovering that sum by saving salaries, for example, by cutting the CEO from one million dollars a year to $600,000 and saving another one million dollars by cuts among vice presidents, seems small.[37] As compared with what can be lost by non-

32. *See infra* note 34 and accompanying text.

33. For a review of the leading writing that raises certain doubts of its own, see Foster, *Briloff and the Capital Market*, 17 J. ACCT. RES. 262 (1979). An unusual view of the implications of efficient market theory for individuals' compensation appears in L. THUROW, GENERATING INEQUALITY 148-54 (1975). In that view, success in gaining great wealth is usually accomplished by a random winning gamble in the efficient market and shows no superior capacity. My own analysis of the great fortunes Thurow cites is that they mostly were built up over fairly protracted periods of enterpreneurial leadership and not by sudden lucky gambles; as this article attempts to show, the entrepreneurial markets are very different from the securities markets.

34. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

35. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1187 (1981). *See also* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 106-09 (1979).

36. *See* E. HERMAN, *supra* note 20, at 99-101.

37. For a recent report of costs ranging from $6 million to $17 million, see Metz, *Outside Professionals Play an Increasing Role in Corporate Takeovers*, Wall St. J., Dec. 2, 1980, at 1,

competitive management the sums involved when a competent management is overgenerous with itself—seldom more than a few cents a share—are not apt to be worth the expenditure of large efforts for their recovery by shareholders.[38] Again, one finds the discipline exerted by the securities market too loose to obviate the necessity for judicial authorities to make judgments about concrete cases involving sums that are important in terms of individual morality if not of the markets.

The market rationale for executive compensation is complicated by transactions that are not simple, contemporaneous work-for-cash exchanges. In the name of motivation, complex contingent schemes involving cash or securities have become familiar.

B. *Motivation and Managerial Theory*

The sale and purchase of executive services is a more complicated matter than the sale or purchase of a commodity. What a firm is trying to acquire is in fact human time and effort, or, put differently, a contribution to marginal revenue, not the mere presence of a body. Accordingly, much time and effort are spent on attempts to devise methods that will assure the firm that it is receiving those best efforts. Note how the question of motivation is tied in with the question of measurement of "just" compensation. In theory, a contingent compensation plan may do two things: (1) measure the contribution of the manager to the enterprise and (2) motivate the manager to activate the contingencies in the plan so as to receive the maximum reward. As the managers performance is measured *ex post* rather than *ex ante*, as in the case of a fixed salary,[39] the contingent plan shifts some of the risk as to what the manager will achieve from the firm to the manager. Theoretically, it should be a more accurate measure than any *a priori* estimate. A contingent plan also sends a message to the executive about the firm's goals; its formula thus communicates, by itself, a standard against which he may measure himself from time to time, or at least reinforces other messages conveyed by the firm's management. Furthermore, the plan should be calculated to extract the maximum effort from the executive to achieve the goals so described. While all compensation has an incentive element, if only by fear of its cessation, it is thought that contingent plans have a sharper incentive effect. The validity of the contingent compensation theory is initially suspect as the strength of that impulse is subject to dispute. The most scientific research—studies of the effect of piece work and similar types of pay—were done with persons at a level of operation where tasks, and presumably motivational links, are much simpler and more direct than in executive offices.[40]

The different contingent plans can, for our purposes, be characterized

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col. 6. It has been estimated that a firm can lose up to 13% of its value before facing a tender offer risk. Smiley, *Tender Offers, Transactions Costs and the Theory of the Firm*, 58 REV. ECON. & STATISTICS 22 (1976).

38. One exceptional situation in which the damage to shareholders was quite high in proportion to share value was that of Bethlehem Steel. Its executives received $31 million in a 17 year period when dividends came to $44 million. Mautz & Rock, *The Wages of Management*, 11 U. FLA. L. REV. 474, 479 (1958).

39. *See* Fama, *supra* note 16, at 296.

40. For a survey of the literature on incentive pay and motivation, see K.S. MURTHY, CORPORATE STRATEGY AND TOP EXECUTIVE COMPENSATION ch. 2 (1977).

by two criteria: their measure of achievement and their medium of reward. Achievement may be measured by some standard related to company earnings—including earnings per share or rate of return on investment—or by a standard derived from the performance of the firm's securities on the market.[41]

Earnings are a natural measure of stewardship since they are so widely accepted as the final, "bottom line" summary of the firm's own success during the period under review. If earnings can measure achievement then an executive's marginal worth can be quantifiable. Unfortunately, the problems of such a test are numerous. First, the earnings performance of the firm may have varied due to external influences that pervaded the whole economy or the entire industry in which it operates and that are, therefore, not connected with the abilities of its management.

A more sophisticated analysis may attempt to counter that problem by relating the performance of the firm to its competition. If the earnings of all firms in the field went up twenty-five percent what is to be said for the performance of one that advanced fifteen percent?[42] Unfortunately, data for comparisons often is difficult to find. In the age of conglomerates, it is not readily apparent who the competitors are, nor when the competition is identified as a group of divisions of different enterprises is it easy to isolate their performance from that of the overall enterprises. More generally, the base line situation of each corporation is different. Some executives have more unused resources at hand than others to meet a sudden rise in demand; sometimes that preparedness is their doing but sometimes it is not. The Bible reminds us that at times "the race is not to the swift."

Second, concentration upon improving the earnings performance of a firm during a given year may not be in harmony with the interests of the shareholders in maximizing the value of their securities, a value that depends upon the stream of earnings expected to be derived over a number of years. Thus, it has been asserted that the willingness of American managements to invest firms' resources in the expansion or replacement of fixed assets has been undermined by the pervasiveness of compensation schemes based on short-term earnings.[43] Even though accounting rules for the determination of annualized income attempt to distinguish between capital expenditures and current expenses, there are many rough edges to the distinction, such as in the treatment of research and development costs.[44] In any event, no earnings currently flow from those investments as they would from short-term asset acquisitions or improvements. Of course, the gap between short-term and long-term horizons can be narrowed by extending the term of the

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41. There are at least 17 varieties of formulae relating compensation to net income. B. ELLIG, EXECUTIVE COMPENSATION—A TOTAL PAY PERSPECTIVE 189 (1982).

42. Stata & Maidique, *Bonus Systems for Balanced Strategy*, HARV. BUS. REV., Nov.-Dec. 1980, at 156.

43. Hayes & Abernathy, *Managing Our Way to Executive Decline*, HARV. BUS. REV., July-Aug. 1980, at 67, 70; Rappaport, *Executive Incentives vs. Corporate Growth*, HARV. BUS. REV., July-Aug. 1978, at 81; Meadows, *New Targeting for Executive Pay*, FORTUNE, May 1, 1981, at 176; Lohr, *Talking Business with Jones of G.E.*, N.Y. Times, Jan. 27, 1981, at D2, col. 1 (remarks of retiring GE president).

44. For examples of how accounting standards affect managerial resource allocation, see Rappaport, *supra* note 43, at 86-87.

manager's employment and the corresponding operation of the plan over several years. In that way, a manager is more likely to reap what he has sown. There are, however, limits to that procedure since the average tenure of a division executive in a given post is quite short—three to five years.[45] At best, longer range incentive programs tied either to earnings or to the corporation's stock market results cannot extend the management's time horizon out beyond that of the market which incorporates the stockholders' time-discount factor. There are serious implications if that sense of time does not extend out far enough to cause the initiation in 1983 of the projects essential to industrial competitiveness in 1995.

Third, whatever the merits of earnings as a measure for the chief executive officer of the firm, they are clearly not an accurate fit for executives whose responsibility extends only to a limited portion of the firm's whole activities.[46] Sometimes the firm is decentralized enough in its style of managerial control so that a manager can be judged on the basis of the performance of his profit center. Of course, the computation of results for profit centers poses severe administrative and interpersonal problems when it depends on establishing artificial transfer prices for goods and services moved from one center to another. In addition, the parts of the firm may be so tightly interrelated that the incentive program may have to be based on some other, more subjective, criterion as to each individual manager's performance or may have to be based on the assumption that the top managers constitute a team working together so closely that they each deserve to share in the benefits and detriments. That problem will always arise in setting the compensation of senior staff officers—such as the general counsel, comptroller, head of research and development—whose efforts may be critical to the firm's success but are not measurable according to any calculable formula.

Fourth, studies of income accounting agree that, in any event, annualized earnings figures are subject both to deliberate manipulation and to unintended biases arising from the arbitrary character of the assumptions that underlie the conventions of accounting.[47] The validity of the earnings test is thus undermined at its source.

Last, the outsider notes that earnings-based compensation plans do have a tendency to push executives towards actions calculated to enhance the earnings of their profit center even though they are contrary to public policy and perhaps even illegal.[48]

Confronted with these difficulties, the compensation practitioner may turn

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45. *Id.* at 83.

46. Salter, *Tailor Incentive Compensation to Strategy*, HARV. BUS. REV., Mar.-Apr. 1973, at 94; Dearden, *How to Make Incentive Plans Work*, HARV. BUS. REV., July-Aug. 1972, at 117, 122.

47. *See, e.g.*, Rappaport, *supra* note 43, at 86-87; Salamon & Smith, *Corporate Control and Managerial Misrepresentation of Firm Performance*, 10 BELL J. ECON. 319 (1979); Thomsen, *The Case Against Mixing ROI with Executive Compensation*, COMPENSATION REV., 3d Quart., 1973, at 18.

48. Sonnenfeld & Lawrence, *Why Do Companies Succumb to Pricefixing*, HARV. BUS. REV., July-Aug. 1978, at 145, 149; Bower, *An Inquiry into the Social and Political Consequences of Efficiency* in THE CORPORATE SOCIETY, 178 (R. Marris ed. 1974). The suggestion that bonus systems should be required to give weight to other factors—such as safety performance—is discussed in Coffee, *"No Soul to Damn: No Body to Kick" An Unscandalized Inquiry Into the Problems of Corporate Punishment*, 79 MICH. L. REV. 386, 456 (1981).

to a securities-based standard. At first blush that seems less less than helpful. If quite a few factors interfere with the relationship between an executive's achievement and the earnings of the firm, even more intervene between achievement and the price of the firm's securities. An illness of the President of the United States can, for the moment at least, more than wipe out the stock market gains resulting from a year's strenuous efforts by a talented executive. The upshot of empirical investigation is that more than half of the fluctuation of the market value of a given security is attributable to factors quite outside of its own special intrinsic qualities.[49] The great merit of a securities-based standard, on the other hand, is that it avoids some of the problems associated with annualized net earnings. If the securities market in question is operating efficiently, the price for the stock reflects a collective estimate as to what management's present efforts promise or threaten to do to the future earnings of the firm. Thus, a manager is not penalized for foregoing present earnings to invest in resources for future profitability, if the market thinks that the future returns—after discounting for the delay—will be more rewarding.[50]

Although incentive plans geared to either profits or earnings are the norm,[51] there are firms that continue to rely on judgments made by individuals about the performance of other individuals. That is necessarily an uncomfortable task, one from which boards and managers naturally shrink. Such subjective judgments are made, however, in other contexts, such as promotion or discharge, and they may well be preferable to any mechanical formula even though the literature on management appraisal shows that it is something less than a science.[52]

The second distinguishing criterion of an incentive plan, the medium of payment, also varies the effects of the compensation. If cash is paid, the transfer signals the completion of the incentive effect. Of course, if the payment is postponed, a desire to keep the firm able to pay when due may exert a marginal degree of pressure. With securities arrangements the manager continues to receive an incentive so long as he holds the security (whether because of the requirements of the plan or otherwise). In fact the motivation thus exercised should in theory be parallel to the interests of the equity security holders, which is the proclaimed purpose of such plans.[53]

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49. "[A] rough surmise is that between one half and one third of the variability of most stocks . . . is attributable to events which occasion price increases in the entire market." V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 1153 (2d ed. 1979). From another perspective, there are many events that affect the entire industry and not just the CEO's own company. In fact, one analyst believes that managerial performance "has no direct effect on the market price of securities. Roberts, *Tie Bonuses to Corporate Profits*, FIN. EXECUTIVE, June 1973, at 12, 14.

50. Rothschild, *Financing Stock Purchases by Executives*, HARV. BUS. REV., Mar.-Apr. 1957, at 136; Masson, *Executive Motivations, Earnings, and Consequent Equity Performance*, 79 J. POL. ECON. 1278, 1282-83 (1971).

51. In the 50 large companies surveyed by one writer there were 47 stock option plans and 46 bonus plans. *See* Baker, *supra* note 4, at 51, 52. The Conference Board in, Fox, TOP EXECUTIVE COMPENSATION in CONFERENCE BOARD RESEARCH REPORT 4 (1978), found that of a sample of 1492 corporations, 82% of the manufacturers and construction firms had annual bonuses, as did 74% of the retailers and 40% of the insurance firms.

52. *See, e.g.*, H. KOONTZ, APPRAISING MANAGERS AS MANAGERS (1971); H. SMITH & P. BROUWER, PERFORMANCE APPRAISAL AND HUMAN DEVELOPMENT (1977).

53. Ford, *Stock Options Are in the Public Interest*, HAR. BUS. REV., July-Aug. 1961, at 52.

Payment in securities adds another variable to the equation: the valuation of the security the executive receives. Of course, if the stock is simply handed over presently with a full right to resell it, the market's pricing of the security will adequately fix its value for that purpose. If, on the other hand, the executive receives a right to purchase the stock at a specified price during some specified future time, he is not now receiving the stock but rather an option that has special qualities that would cause a market to value it differently from the stock. The differences between market options and executive options can cut in either direction: an executive option tends to be open for a longer period and hence more valuable than a market option, but an executive is usually not free to resell for some time after exercising the option, a restriction that reduces its value. In any case, the value assigned to options for a corporation's securities by the market is only a rough indicator of the value of the options typically given to its executives. Considerable ingenuity is being employed on establishing a clearer relationship[54] without as yet a conclusive outcome.

The relative simplicity of these compensation plans has been blurred by the problems of sharing the income with the Internal Revenue Service. Executives have different family concerns, life expectancies, and streams of outside income; they will thus have different preferences as to the timing and form of the compensation to which they are entitled. It has been suggested that the most effective mode of resolving such differences is to offer a "cafeteria" approach, a system in which the executive is awarded N points to spend according to his preferences on units of items such as current cash, a pension, and life insurance.[55] That approach, however, presents some difficult questions of reducing disparate, contingent receipts of value to a single common denominator at the cash register of the cafeteria.

In concluding this section on motivation and compensation, let us be clear that we are not ignoring incentives that do not take monetary forms. They are important but not within the scope of this article. There are elements in the American corporation system that tend to downplay other motivations, abetted by a type of egalitarianism that makes it difficult to use honor and distinction. Other societies have been able to couple financial and prestige rewards more smoothly; thus when Browning accused Wordsworth of selling out the liberal cause he included in the price not just the "handful of silver" but also the prestige accompanying his official post, "the ribband to stick in his coat."

Having rehearsed the various market theories that constitute the framework for the executive compensation problem, we are now ready to undertake a messier task, that of examining the large body of available data

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54. On the impossibility of valuing options, see Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403, 1423 (1953); *but see* Campbell, *Stock Options Should be Valued*, HARV. BUS. REV., July-Aug. 1961, at 52; Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973); Foster, *How Cost-Efficient are Stock Options?*, COMPENSATION REV., 2d Quart., 1973, at 11 (advocating opportunity cost measure). Various assumptions about options are used in the retrospective surveys of management compensation discussed *infra* at notes 72-80. These calculations all depend on hindsight as to time of exercise and increases and declines in value.

55. Lewellen & Lanser, *Executive Pay Preferences*, HARV. BUS REV., Sept.-Oct. 1973, at 115.

as to what actually happens. Our quest is for a sense as to whether the inefficiencies that seem to be possible under the theories do in fact produce major real world inequalities and discrepancies from what one judges to be acceptable solutions.

III. Compensation Practice

A. *History and Development*

Modern executive compensation patterns have evolved over the last century in response both to developments in the sociology of management and to legal, fiscal, and public relations trends outside the firm. As of 1900, an observer would have found the salaries of executives of the major corporations not excitingly lavish. Salaries of $5,000 to $10,000 for presidents of significant firms were common.[56] After the turn of the century, however, notions of corporate privacy that balked even at revealing net sales left executive compensation shrouded in the darkest mystery. There is evidence from biographies, litigation, and other irregular sources that salaries of $75,000 to $100,000 occurred occasionally although they were regarded as enormous.[57] More generosity appeared as the structure of American firms changed; salaried executives began to replace founding fathers who had preferred gain on their stock investments to salaries. Thus, during the period between World War I and the crash of 1929, some executives received very large annual salaries. Eugene Grace had received more than one million dollars in some years before 1920 from Bethlehem Steel and Charles Schwab had earned a similar sum from United States Steel.[58] At the same time, corporations began to develop incentive compensation plans that fit into the new style of rational management that was identified with DuPont and then the General Motors of Alfred P. Sloan.[59] These plans were based on varying versions of profits, with adjustments for return on invested capital, depreciation, and so forth. A number of these plans have been revealed to us through the litigation they aroused. The Bethlehem system provided a sliding scale of bonuses with the percentage of profits growing from 3.4 percent on the first two million dollars to 8 percent on all profits above thirty-six million dollars.[60] The American Tobacco plan brought George Washington Hill to $1.3 million in total compensation and gave several vice presidents substantially similar sums.[61] Cash compensation in excess of $500,000 accrued to General Motors executives and over one million dollars accrued to Mr. Mitchell, president

56. The first known executive salary survey, that in Taussig & Baker, *American Corporations and their Executives: A Statistical Inquiry*, 40 Q. J. Econ. 1, 19 (1925), reported the average salary of presidents of large manufacturing corporations before World War I was about $9,500.

57. A court in 1892 described a salary of $75,000 as "enormous." Beers v. New York Life Ins. Co., 20 N.Y. Supp. 788 (1892).

58. Balkcom, *Executive Compensation: A History of Imbalance in Public Controls, Shareholder Interests and Executive Rewards*, Directors & Boards, Spring 1977, at 4, 4-5.

59. A. Sloan, Jr., My Years with General Motors 407-10 (1964).

60. Balkcom, *supra* note 58.

61. *See infra* notes 100-05 and accompanying text.

of National City Bank.[62] The size of these rewards can be appreciated when compared with sums of less than $100,000, which in the 1920s represented average presidential earnings even in large industrial corporations.[63] Those sums are astonishing when recalculated into a figure that would bring similar benefits to the executive in 1980 after allowing for the much heavier income tax burdens and the very large measure of inflation since 1929.[64]

The stock market crash and the ensuing depression had milder effects on executives than one might have anticipated. Of course, compensation from bonus schemes tended to disappear as earnings fell off. Salaries, however, seem to have remained stable and were even occasionally increased to make up for lost bonuses.[65] Problems did not really begin to affect the executive until late in the 1930s. Public outcry over the grandeosity of 1920s compensation that was unearthed in shareholder litigation, bankruptcy and reorganization proceedings, congressional hearings, and studies of the Federal Trade Commission made directors more cautious in their largesse. Salary stabilization was in effect during both World War II (1942-1945) and the Korean War (1951-1953). The tax rates in effect during World War II and thereafter severely trimmed executives' take-home pay. Thus, in 1922 Mr. Carpenter of DuPont received $78,570 and took home $60,843, but in 1947 he was paid $175,000 yet took home only $48,251.[66] It took until 1955 before real after-tax compensation for a sampling of top executives returned to 1940 levels.[67] By another calculation, management compensation after both taxes and inflation, declined by almost sixty percent during the period 1939-1950. The rate of growth of such compensation between 1940 and 1963 was less than one-half the growth of corporate assets and less than one-third of the market value of common stock.[68]

After 1950, stock options became increasingly popular for both tax and public relations reasons. After 1964, changes in the tax rules tended to draw attention away from options and back to cash.[69] During the period 1968-1972,

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62. *See infra* notes 105-07 and accompanying text. In that case Mr. Mitchell delivered himself of the sentiment, appropriate to the 1920s, that the "entire organization was spurred to endeavor by a general knowledge that prevaded the institution that I was receiving a very substantial compensation." 2 G. WASHINGTON & H. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 890 (3d ed. 1962).

63. J. C. Baker's pathbreaking study found the median compensation of 100 top industrial CEOs to be $69,728 in 1929, the peak year. J. C. BAKER, EXECUTIVE SALARIES AND BONUS PLANS 261 (1938). Data for those years was hard to come by, even the FTC's official investigation encountered difficulties. 78 CONG. REC. 8481-85 (1934).

64. *See infra* note 111 and accompanying text.

65. *See* Balkcom, *supra* note 58, at 7; R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 282-83 (1945). J. C. Baker, *supra* note 63, at 25, found "amazing steadiness" in executive pay. *See also id.* at 25-26, 179-80, 222-26.

66. 1 WASHINGTON & ROTHSCHILD, *supra* note 62, at 9.

67. Lewellen, *Executives Lose Out, Even With Options*, HARV. BUS. REV., Jan.-Feb. 1968, at 127, 130-31.

68. For data pertaining to the 1939-1950 period, see Balkcom, *supra* note 58, at 19. Meanwhile, the pay (in nominal terms) of management had gone up about one-third while that of hourly and white collar workers had doubled. *Id.* The compensation growth from 1940-1963 is included in Lewellen, *supra* note 67, at 135 (Exhibit XI).

69. McLaughlin, *Compensation, Executive* in ENCYLOPEDIA OF PROFESSIONAL MANAGEMENT 157, 159-60 (L. Bittel ed. 1979).

an annual survey indicated a two-percent increase in executive pay, which moved up dramatically after 1972 to a rate of some six percent—despite the stock market's 1973 setbacks. In 1976 executive compensation jumped 14.3 percent, representing the greatest increase in the twenty-three years of the McKinsey & Co. survey.[70] Post 1976 trends are rather difficult to decipher in the ups and downs of these turbulent years. Because of inflation and the tendency of cost of living increases to be eaten up by income taxes as one moves into higher brackets, hardly any class of wage or salary earner has been exempt from real losses during the 1978-1980 period—and in those terms shareholders have suffered severely. These losses extend to middle management. Only the top level of management seems to be gaining ground—impressively in nominal terms, modestly in real terms.[71]

B. Compensation Surveys and Correlations

At present, there exist elaborate sources of information on executive compensation. Annual surveys emanate from various sources, most conspicuously the Conference Board, American Management Association, McKinsey & Co., Hay Associates, and *Forbes*.[72] Since these surveys vary widely in methodology, a comparison of their outcomes can be confusing. There are differences in the number of companies they cover, the members of "top" executives at each such company, and the way they classify compensation, particularly as to contingent benefits. The very existence of such authoritative sources, which are widely read by both grantors and grantees of executive compensation, is a factor in the functioning of the executive market.

A closer look at three of the surveys may be helpful. Because the annual *Forbes* report[73] is picked up in the nonspecialized press, it receives considerable publicity. Its methodology, however, is rather limited. It reports the salary, bonus, benefits, contingent remuneration, and stock gains of the chief executives—by name—of 818 companies that appear on one of the two *Forbes* lists of the 500 largest companies. The remuneration of "the Top Ten" is highlighted. A few medians are calculated.[74]

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70. McLaughlin, *supra* note 4, at 8.

71. *See Fourth Annual Hay Report on Management Compensation*, WHARTON MAG., Fall 1977, at 26, 27; *The Middle Ranks Get Furious Over Low Raises*, BUS. WK., Nov. 5, 1979, at 158. The record for 1981 seems to be following similar patterns. Compensation of the top officers of the 288 companies in an annual survey went up 15.9% in 1981 as compared with 13.7% in 1980. *No Sign of Recession in Pay at the Top*, BUS. WK., May 10, 1982, at 76, 76. On the whole, however, executive compensation, when larger groups of executives are taken into account, did not do so well. In the Hay Associates Report for 1981 senior industrial management gained only 5-8%, well behind the inflation rate (13.5% in 1980). *Fifth Annual Hay Report on Executive Compensation*, WHARTON MAG., Fall 1981, at 50, 50-51.

72. *See* Conference Board, TOP EXECUTIVE COMPENSATION; American Management Association, TOP MANAGMENT REPORT; McKinsey & Co., EXECUTIVE COMPENSATION SURVEY; Hay Associates, ANNUAL REPORT ON EXECUTIVE COMPENSATION. Results of the McKinsey Survey are often interpreted in articles by executives of that firm; *see, e.g.*, McLaughlin, *supra* note 70. For years the Harvard Business Review carried an annual summary; *see, e.g.*, Patton, *Annual Report on Executive Compensation*, HARV. BUS. REV., Sept.-Oct. 1957, at 125.

73. *How Much Does the Boss Make?*, FORBES, June 8, 1981, at 114.

74. *See generally id.*

The annual *Hay Associates Management Compensation Survey*[75] is much more sweeping in its methodology and much more oriented to practical use. It covers 700,000 persons in more than 850 firms. It attempts to evaluate jobs not based on titles, but on "units" of job content. After being evaluated for factors such as know-how, problem-solving, and accountability, jobs are assigned points ranging from 300 points for the chief operating officer of a firm with over two to five billion dollars in sales to 200 points for a foreman. It presents median, highest, and lowest ten percent of the major categories of job units. It also presents data on particular industries and examines trends.[76] Since the survey is quite influential in setting salary levels, the Hay staff and approach have been used by the Internal Revenue Service and by litigants in sex and racial discrimination cases.[77]

The American Management's Top Management Report is in a different class. Unlike the *Forbes* and Hay reports, it is not published generally. Its recipients are requested to keep all information in strict confidence. Furthermore, its cost—in the range of several hundred dollars—restricts circulation. It is sent, however, to more persons having a role in actual decision-making than any other survey. Thus, the methodology used in the Report is important. First, the companies surveyed—2,053 in all—are divided into seven general categories and then into about forty subcategories. The jobs surveyed—16,628 in all—are analyzed to insure comparability of responsibilities. The Report presents separately by each subcategory of industry, data showing general trends in salaries and bonuses and average compensation for various executive posts categorized by size of sales. A statistical supplement contains graphs correlating salary or total compensation to company sales or revenues, segregating bonus and nonbonus companies. An appendix instructs a firm to first find the best-fitting industry application and then the best-fitting sales volume size group. Furthermore, by adding and subtracting twenty percent of the average figure given, a firm can establish a fifty percent range so that it can decide where on the range it wishes to compete in the executive market. The *Compensation Review* published quarterly by the same organization ordinarily provides glimpses of its overall conclusions, as well as a stream of articles, news items, and other data.

From these surveys one can derive various statistical data and correlations that may be helpful in our search for market standards for top executive compensation. In 1980 the most highly rewarded executive was Thomas Pickens of Mesa Petroleum who received $7,865,831. Of that sum, $7,235,549 represented value realized from stock options and stock appreciation rights granted in prior years and only $415,000 represented salary and bonus. The highest cash pay out was $1,825,000 going to Milton Rosenthal at Engelhard Minerals.[78] In 1981 the palm went to Steven Ross of Warner Communications

75. *Fourth Annual Hay Report on Executive Compensation*, WHARTON MAG., Fall 1980, at 42. It is important to understand the section, "How the Hay Job Unit System Works," before reading the rest of the Report. *Id.* at 46-67.

76. *See generally id.*

77. *See, e.g.*, Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1156 (1980), discussed *infra* footnote 124 and accompanying text; Vuyanich v. Republic Nat'l Bank, 505 F. Supp. 224, 248-49. (N.D. Tex. 1980).

78. *See How Much Does the Boss Make?*, *supra* note 73, at 115, 122.

who picked up $19,421,000 in stock gains, $1,954,136 in salary and bonus, plus incidentals for a record $22,554,000.[79] The median for the *Forbes* group was $351,945 as compared with Hay Associates median figures of $398,600 for industrial executives at the 300 point level and $386,500 for comparable financial institution executives.[80]

Some type of correlation is necessary if the market data is to indicate whether a particular firm's compensation is out of line with others. Investigators, however, have had difficulty in imposing patterns on the data. They have tried to correlate executive compensation with such factors as firm size, industry, profitability, and organizational structure.

First, one turns to the size—generally measured by sales—of the paying company. In general categories, there is a strong correlation. *Forbes* notes, for example, that the median salary and bonus of the chiefs of firms with sales between $500 million and $1 billion was $300,000 and at firms over $5 billion in sales it was $589,000.[81] Within the categories, however, there are wide disparities between firms.[82] Indeed, on reflection one sees that too close a correlation would have unfortunate aspects. It might cause executives to seek expansion of their firms at the expense of other goals, and it might devalue the work of executives doing exceptional jobs in developing smaller firms vis-á-vis managers of large, steady-state institution.

Second, one looks at the correlation between compensation and specific industries. Plainly there are differences there but they can be complex. Industries can change relative positions as one moves from the upper to the lower end of the executive pay scale. Thus, heavily unionized industries, such as steel, pay high salaries near the bottom to maintain a differential above highly paid nonmanagerial employees, but then fail to keep pace at the top.[83] Public utilities, for various reasons including regulatory restraints, pay at

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79. *Who Gets the Most Pay*, FORBES, June 7, 1982, at 75. In 1981 Pickens ranked number 144, *id.* at 90, and Rosenthal's successor number 109, *id.* at 83. The Business Week Survey for 1981 produces somewhat different results. It notes that the highest 1980 figure could not be included in its 1980 survey because the proxy—like those of other high-paying firms—was very late. By its standards the 1981 top was only $5,658,000 ("nothing to sneeze at") paid by Schlumberger to its executive vice president Roland Benin. BUS. WK., May 10, 1982, at 76.

80. *How Much Does the Boss Make?*, *supra* note 73, at 114; *Fourth Annual Hay Report*, *supra* note 71, at 42.

81. *How Much Does the Boss Make?*, *supra* note 73, at 114.

82. The Hay Associates point system includes size (measured by sales) as an important element in measuring the weight of a job. In an earlier report, Hay Associates noted that "differentials based on size alone are discernably narrowing." *First Annual Hay Report on Executive Compensation*, WHARTON MAG., Fall 1977, at 26, 27. In Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142 (1980), discussed *infra* note 124 and accompanying text, the court rejected the Hay approach insofar as it indicated that the compensation paid by taxpayer was excessive because it was more than paid by larger, established retailers. *Id.* at 1161-62. A comparative study of compensation research indicated that "chief executive officer compensation is based on company size rather than on sale productivity." Meyer, *Sales*, in CHIEF EXECUTIVE OFFICER COMPENSATION 100, 105 (H. Wattel ed. 1978). Another study in the same volume indicated that "[t]he relationship of profits to CEO compensation becomes insignificant when the influence of size upon both profits and executive compensation is taken into account." Emigholz, *Chief Executive Officer Compensation and Profits*, in *id.* 176, 182. Various writers suspect that the surveys themselves have created an excessive emphasis on sales in determining compensation. Patterson, *Chief Executive Officer Compensation As A Research Focus* in *id.* 1, 20.

83. First Annual Hay Report, *supra* note 82, at 30.

the lower end of the scale.[84] Financial institutions pay somewhat less than manufacturers.[85]

Third, one looks at the correlation of compensation with profitability measured by rate of return on investment, increases in returns, and stock market appreciation. Analysts have examined these relationships because of their interest in determining the extent of the gap in goals between the hired executives of a modern corporation and the shareholders. Three studies regarding that question are particularly significant. The Lewellen and Huntsman study concluded that "both reported profits and equity market values are substantially more important in the determination of executive compensation than are sales. . . ."[86] A second review concluded that "the relationship of profits to CEO compensation becomes insignificant when the influence of size upon both profits and executive compensation is taken into account."[87] Another study examines the relationship between percentage changes in executive compensation and the percentage changes in their firm's sales and earnings, concluding that executives' financial incentives are primarily geared to stock market performance. Therefore, changes in sales and earnings are not significant in that context. The study found that firms "with executives whose financial rewards more closely paralleled stockholders' interests performed better in the stock market. . . ."[88] When the earnings on stock already held by executives are included, the link between their compensation and the firm's earnings seems stronger, though varying from time to time as stock

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84. Utilities have traditionally paid less than firms of comparable size, partly because of regulation and partly because the tasks of top utility executives were not regarded, before the energy crisis, as particularly challenging. One survey by McKinsey & Co. found the typical utility CEO received 60% less than comparable manufacturing CEOs. Enshwiller, *Job of Managing Utility Loses Its Allure, A Victim of Industry's Mounting Problems*, Wall St. J., May 18, 1981, at 29, col. 4. Observers are concerned that that has resulted in managements who are unprepared to cope with the problems utilities face in the 1980s. *Id. See also* Khokha & Walker, *A New Approach to Executive Compensation*, PUB. UTIL. FORT., May 25, 1978, at 26. For information on utilities compensation see generally Sicoli, *Chief Executive Officer Compensation In The Utilities Industry* in CHIEF EXECUTIVE OFFICER COMPENSATION 367 (H. Wattel ed. 1978).

Although recently consumer groups have been challenging compensation paid by utilities to management as an ineligible cost for rate-making purposes, commissions have generally rejected such attacks as lacking sufficient evidence of salaries paid to comparable managers, while reiterating the propriety of inquiries into the issue. *See, e.g.*, Long Island Lighting, 24 PUB. UTIL. REP (PUR) 131, 145 (N.Y.P.S.C. 1978); Niagara Mohawk, 16 PUB. UTIL. REP. (PUR) 317, 322 (N.Y. 1976); New England Tel. & Tel., 11 PUB. UTIL. REP. (PUR) 297, 303 (Mass. P.U.C. 1976). In a 1965 case, a regulatory commission was reversed for cutting a president's compensation of approximately $75,000 despite the absence of comparative evidence. Latourneau v. Citizens Utility Co., 125 Vt. 38, 45-49, 209 A.2d 307, 314-15 (1965). Occasionally, small salaries are disallowed at very small utilities, usually for failure to explain them. *E.g.*, Southeast Nebraska Tel. Co., 17 PUB. UTIL. REP. (PUR) 312, 314 (Neb. P.S.C. 1976) ($7,200 disallowed as unexplained by company records); Rangely Power Co., 9 PUB. UTIL. REP. (PUR) 289, 296 (Me. 1975) ($23,000 too much for part-time president of utility with 2945 customers and 25 employees).

85. *First Annual Hay Report*, *supra* note 82, at 27. The Report notes some exceptions such as the major multinational banks based in New York.

86. Lewellen & Huntsman, *Managerial Pay and Corporate Performance*, 60 AM. ECON. REV. 710, 718 (1970).

87. Emigholz, *supra* note 82, at 182; Roberts, *A General Theory of Executive Compensation Based on Statistically Tested Propositions*, 70 Q. J. ECON. 270, 275 (1956).

88. Masson, *Executive Motivation, Earnings, and Consequent Equity Performance*, 79 J. POL. ECON. 1278 (1971). By focusing on changes in profits the study seems to avoid the problem of earnings being related to size.

market conditions change.[89] The ultimate results of the studies are uncertain and the implications for our work are unclear. If some element of profit-sharing is conducive to good management, how large need that share be? Does an executive who takes over control of a large, well-managed enterprise deserve as large a share of the profits as one who inherits a troubled enterprise that was going down? Should the executives be allowed to continue sharing when profits decline and even become negative as they did in the 1930s?[90]

Analysts have attempted to develop other relations with mixed results. Studies comparing executive compensation levels in firms with inside directors and those with outside directors have yielded conflicting results: (a) that inside directors were more generous to themselves, (b) that they were less generous, and (c) that there was no statistically significant relationship.[91] One analyst thought he found a significant positive correlation between industrial concentration and barriers to entry on the one hand and high pay on the other.[92] A later study failed to produce similar results.[93] One theory, without careful recent statistical work, is that the levels of hierarchy between shop floor and the chief executive's suite determine the pay at the top since pay intervals must reflect hierarchical intervals.[94]

Other studies relate the type of compensation system and the type of corporate organization. As firms move "toward more advanced stages of corporate development," that is, towards an autonomous, divisional, and diversified, or conglomerate level, compensation tends to be determined by formal measurement systems.[95] Other studies relate compensation approaches to the risk inherent in the corporate situation, finding more compensation, and particularly more bonuses, in the corporations in fast growing stages than in those with older product lines and stable market shares.[96] While most large firms have some incentive plan, these seem to be more widely used in some industries, referred to as natural incentive industries (chemicals, pharmaceuticals), as opposed to those (banking, insurance, and mining) with a few long-term decisions.[97] At the lower levels of the organization, the way in which it allocates its functions necessarily influences the way in which the performance of those functions is measured.[98]

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89. HERMAN, *supra* note 20, at 95; W. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT 156 (1971).

90. *See supra* text accompanying notes 60-64.

91. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1054-55 (1963). Correlations were found between high compensation and inside board membership in highly concentrated industries. Auerbach & Siegfried, *Executive Compensation and Corporation Control*, 13 NEB. J. ECON. & BUS. 3, (Summer 1974), at 3, 10, doing a similar study found the outcome not statistically significant. *See also* Williamson's response, *id* at 17. M. NEWCOMER, THE BIG BUSINESS EXECUTIVE 128 (1955), found inside boards less generous. Schmidt, *Does Board Composition Really Make a Difference?*, 12 CONF. BD. REC. 38 (Oct. 1978) found a slight indication that outside boards were less lavish.

92. Williamson, *supra* note 91, at 1043.

93. Auerbach & Siegfried, *supra* note 91.

94. Simon, *Compensation of Executives*, 20 SOCIOMETRY 32, 35 (1957).

95. Salter, *Management Appraisal and Reward Systems*, 1 J. BUS. POL'Y. 40, 45 (1971).

96. Ellig, *Compensation Elements: Market Phase Determines the Mix*, 13 COMPENSATION REV. 3d Quart. 1981, at 30. Thurston, *Relating Executive Compensation to Managerial Performance and End Results* in COMPENSATING EXECUTIVE WORTH 84 (R. Moore ed. 1968).

97. Patton, *Why Incentive Plans Fail*, HARV. BUS. REV., May-June 1972, at 58, 58-60.

98. On the differences between top level and lower level incentive programs, see, e.g., H. VON KAAS, MAKING WAGE INCENTIVES WORK (1971). For case studies of plant-wide incentive and evaluation systems, see F. FOULKES & E. LIVERNASH, HUMAN RESOURCES MANAGEMENT Ch. IV (1982).

Finally, some, though inadequate, data illustrates the compensation behavior of foreign industrial states. What does emerge from that data, incomplete and anecdotal though it is, is that European and Japanese pay levels do not follow American levels beyond the $500,000 per annum mark, that they in fact rarely exceed $300,000. The proposition holds true even though European intermediate salary levels sometimes equal or exceed the American equivalents.[99]

With a sense of both the theory of management compensation and the corresponding data, this article now examines the case law. Most of it antedates the coming of the modern literature and the associated data. Thus, the case law often suggests that the whole field is one where intuition is the only guide and that judges should keep their distance and defer almost without reservation. A few modern cases, especially in the tax field, more closely reflect current practice. The case law thus raises the question: what can courts make of the resources of the modern literature?

IV. THE CASE LAW

A. The Large Corporation Overcompensation Cases

Only a handful of cases actually show the courts grappling with the

99. The data seem to support the proposition that executive salaries outside of the United States do not reach the levels ($500,000 and up) that the best compensated Americans attain. The proposition is true even though industries in various countries sometimes pay as much or a little more than we pay at middle-management levels. *Hay Associates Report Part II: International Executive Compensation*, WHARTON MAG., Winter 1978, at 58. Parker, *The Effective Executives: What is he Worth?*, MCKINSEY Q., Winter 1976, at 22. For earlier studies, see Patton, *Executive Compensation Here and Abroad*, HARV. BUS. REV., Sept.-Oct. 1962, at 144; Rock & Sym-Smith, *Incentives for Foreign Nationals*, HARV. BUS. REV., Mar.-Apr. 1973, at 32. There are several obstacles to a more rigorous investigation of the comparison since most other capitalist countries have not emulated the SEC in mandating disclosure of compensation.

Thus, while Germany requires disclosure of the total remuneration received by supervisory and management boards en bloc, it does not require a per person breakdown. Aktiengesetz §§ 87, 160 (1965) I BGBl 1089. In fact, an attempt by a shareholder to wrest such data at the annual meeting might be a violation of the manager's constitutional right of privacy. Decision of October 13, 1967, 1967 Das Betrieb 1844, 1846. Resorting to calculations of the average gap between the lowest and the highest paid board members, German analysts have computed the top German salaries to be in the $300,000 to $400,000 range. *See* Frankfurter Allgemeine Zeitung, April 17, 1980, at 4; Die Zeit, Aug. 29, 1980, at 19.

For other countries the data is strictly anecdotal but sufficiently strong to imply that $400,000 is the highest pay level and $250,000 more usually the ceiling. As to Japan, see *Compensating Executives in Japan*, BUS. INT'L (1970); Fallows, *American Industry; What Ails It, How to Save It*, 246 ATLANTIC 35 (Sept. 1980) (president of Nissan earns $140,000); *How the Japanese Manage in the U.S.*, FORTUNE, June 15, 1981, at 97, 103.

As to France, note that after the acquisition of Texasgulf by the French firm ELF, a decision was made to retain the American president at $311,000 per year with misgivings because his salary exceeded all other salaries at ELF. *See ELF's Adventures in the USA*, FORTUNE, Sept. 7, 1981, at 91, 96.

As to England, see Companies Act, 1967, §§ 6-8 for disclosure requirements. R. PENNINGTON, COMPANY LAW 521-22 (4th ed. 1979). The president of ICI was reported to earn only about $200,000—before very high income taxes. Die Zeit, Jan. 5, 1979, at 18. Considerable agitation was caused by the decision to offer to Lazard a package that could amount to as much as $4.1 million for the release of one of its executives to head the troubled nationalized steel industry. *British Steel Gets a Yank*, TIME, May 12, 1980, at 62. By contrast, English executives are in general the most poorly paid of all major industrial states. Hay-MSL Ltd., Analysis of Managerial Compensation in the United Kingdom and Overseas 32 (Royal Comm'n on Distrib. of Income and Wealth, 1976).

question—how much is too much—in the context of a large public corporation. Most of the cases arise from the discovery by shareholders during the 1930s of the lavish sums paid management before the crash. As we have seen, some of these sums in inflation-adjusted, after-tax, terms exceed anything that has been paid since then. Top executive compensation was thus particularly vulnerable to attack during the depression years. Unfortunately, the cases are short on analysis. The Supreme Court's review of the American Tobacco case, for example, concluded that these amounts are subject to examination and revision in the district court.[100] The opinion spoke of "waste" and "spoilation," and of payments that have "no relation" to the value of services for which they were given and thus amounted to a gift.[101] These standards, which put a greater burden on the shareholder, applied, rather than "fairness," since the executives had not paid themselves directly. The particular compensation challenged included $1,300,000 received by American Tobacco president George Washington Hill in 1930—largely due to the operations of a 1912 percentage-of-profits bonus that had not been revised despite a long period of steady growth for the firm and the industry. Unfortunately, the matter was settled before the district court had occasion to try its hand at establishing a bench-mark application of the Supreme Court's broad language.[102] We do know that in terms of industry standards, a parallel case involving Reynolds Tobacco indicates that the pay was higher at American Tobacco, and the performance was less impressive than that of its rival.[103] For whatever it may prove, the settlement brought six million dollars back into the coffers of American Tobacco. A new group of shareholders then brought an action to challenge bonuses paid in the 1930s. This time, the New York state judge confronted with the problem threw up his hands with a classic statement of the complexity of the issue:

> Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity? Equity is but another name for human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing that corporation than its stockholders?
>
> Yes, the Court possesses the *power* to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is not reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blue-

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100. Rogers v. Hill, 289 U.S. 582, 592 (1933).

101. *Id.* at 591-92.

102. *See* 2 WASHINGTON & ROTHSCHILD, *supra* note 62, at 883-84.

103. *See* Bookman v. R. J. Reynolds Tobacco Co., 138 N.J. Eq. 312, 48 A.2d 646 (1946). The court noted that Reynolds never paid any executive more than $508,000 per year and that it outpaced American Tobacco both in returns on invested capital and in dividends on shareholders' investment. *Id.* at 392-93, 48 A.2d at 690-91. The court's comparison was on data compiled in part after the American Tobacco case was heard. *See also* the tax cases involving Reynolds, *infra* note 121.

> prints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.
>
> If comparisons are to be made, with whose compensation are they to be made—executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Manifestly, the material at hand is not of adequate plasticity for fashioning into a pattern or standard.[104]

The judge did find, however, that the compensation formula had been misapplied in various, significant respects. The result was a paring away of two million dollars in payments found not to be authorized by the "percentage-of-profits" agreement.

The *General Motors* court also resorted to finding a formula misapplication instead of attacking the amount of compensation received. Largely as a result of a bonus plan, several executives were drawing more than $500,000 in overall cash remuneration. The federal district court found, however, that there was nothing inherently wrong with such a figure, which was only half the sums attacked in other cases.[105] Judge Leibell noted that there was "keen rivalry for executives in the automobile industry,"[106] and in particular that GM had lost Nash to become head of Nash Motors and Walter Chrysler and K.T. Keller to Chrysler Corporation. He also referred to the high performance of GM even during the depression period as shown by a 14.3% average return on stockholder equity and compared the relative rise in market share of GM as opposed to Ford, which had been dominant in 1923. Nevertheless, the decision did trim various items from the bonus earnings base.

In the National City Bank litigation,[107] an attack was made on salaries that exceeded the one million dollar mark. The New York court followed the Supreme Court's language in the American Tobacco case closely in saying that sums of such dimensions warranted investigation. It referred both questions of overall amount and of certain alleged miscalculations in the formula to a referee to hear and report; the report found generally for the defendants.[108]

Since that time there have been few reported cases involving the cash compensation of large or publicly-held corporations.[109] Even a careful watch for newspaper accounts turned up only four cases since 1970, each of which

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104. Heller v. Boylan, 29 N.Y.S. 2d 653, 679 (Sup. Ct. 1941), *aff'd mem.*, 263 App. Div. 815, 32 N.Y.S. 131 (1941).

105. Winkelman v. General Motors Corp., 44 F. Supp. 960, 969-70 (S.D.N.Y. 1942). The court cites, inter alia, Heller & Gallin v. National City Bank, 152 Misc. 679, 273 N.Y. Supp. 87 (Sup. Ct. 1934). *Id.* at 970.

106. *Id.* at 969.

107. *Gallin*, 152 Misc. 679, 273 N.Y. Supp. 87.

108. Gallin v. National City Bank, 155 Misc. 880, 281 N.Y. Supp. 795 (Sup. Ct. 1935). The referee did decide for the plaintiff on several bonus computation issues. *See* 2 WASHINGTON & ROTHSCHILD, *supra* note 62, at 892-93.

109. For a full listing of other compensation cases in publicly owned corporations up to 1960, see 2 WASHINGTON & ROTHSCHILD, *supra* note 62, ch. 19.

was settled before any law could be made.[110] What guidance the aging case law would give a 1980s court is doubtful. In nominal terms, salaries are again coming back up to and over the one million dollar mark. Will courts read the old cases as conveying so crude a message as that more than one million dollars per year is questionable? As we have seen, it is a very much smaller sum in real terms than it was forty years ago. On the other hand, the climate intellectually and emotionally is not what it was in 1929 (or in 1939); one doubts whether a present-day court would tolerate the ten million dollar pay that represents the real purchasing power equivalent of the highest pay in the 1930s.[111] If a court could be persuaded that the compensation under attack was substantially out of line with the existing consensus for executives of firms of like size it might well be energized to use that standard to break away from the path of caution indicated by existing case law.

The task remains a difficult one despite the increase in available information. Businessmen and market analysts regard chief executives of these major corporations as very different and as capable of having a very sharp impact on the fortunes of their employers. As each situation is hard to compare with any other in the small universe of firms of like size and character, the simple standard that might be derived from old case law is clearly inadequate. Thus, the wage-fixing function is still a difficult one for boards or courts. We now, therefore, look at other categories of compensation decisions, largely from smaller corporations though also from mutual fund litigation, to see whether they furnish the guidance that the obsolescent case law fails to provide.

B. The Close Corporation Overcompensation Cases

During decades in which a mere handful of cases challenged the compensation of executives in large, publicly-owned corporations—even though the figures were in the hundreds of thousands of dollars—a different drama has been played on the small corporation stage. There has been a steady flow of cases in which the members of small corporations, similar to partnerships, came to blows over salary figures under $50,000. Indeed, there is a case centering around a refusal of the board of a company to allow a raise from $15,000 to $18,000.[112] Some reasons for the more frequent resort to the courts in the close corporation setting are fairly obvious. A difference in salary of

110. On settlements of recent shareholder compensation suits see Gilbert & Gilbert's report of 1977 actions in 38TH ANN. REP. OF SHAREHOLDERS ACTIVITIES 130-31 (1978) (settlements by Norton Simon and National Gypsum) and 39TH ANN. REP. OF SHAREHOLDER ACTIVITIES 117 (1979) (involving M-G-M). *See* N.Y. Times, July 15, 1976, at 49, col. 2 (Rapid American). What settlements prove is always doubtful; the rather substantial reductions in percentage awarded both in contingency schemes and in absolute cash terms suggest that defendants did not regard the suits as wholly baseless. *See also* Citron v. Merritt-Chapman & Scott Corp., 407 A.2d 1040 (Del. 1979) (unsuccessful attempt to forfeit salary of executive convicted of federal crime).

111. The calculation is arrived at in several steps. From American Tobacco President Hill's $1.284 million gross income in 1930 one subtracts $250,000 in 1940 federal income taxes. See 45 Stat. 797 (1926), which established a top bracket of 20%. That leaves a net after taxes of about $1,050,000. Taking a 5 to 1 cost of living adjustment over the 50 years results in a net of $5,250,000 in 1981 dollars. The pretax income needed in 1981 to produce that net at the 50% marginal tax rate would be about $10,500,000.

112. Jackson v. Nicolai-Neppach Co., 219 Or. 560, 348 P.2d 9 (1959).

$10,000 a year might amount to five or ten percent of the net return on the company's stock. That stock in turn is held by such a small group of investors that the amount at stake on the part of the objecting party becomes appreciable. By contrast, a $100,000 difference in the pay of a chief executive officer of one of *Fortune's* five hundred would only be 1/50 of one percent of the corporation's net earnings and few investors, if any, would have more than $100 at stake. Additionally, the salary issue in small corporations becomes a focus for deep-seated emotional reactions. Typically, the objection is made by a family member who is not himself or herself active in the business and whose relations with the active managers are not good. In some instances the objectors are the heirs of former active managers who no longer have a common interest with the survivors.[113] During the period in which the members of the founding generation had been working together, the issue of compensation had remained dormant. It was a matter of indifference to owner-managers whether they received their share in the form of salaries or dividends and they were thus entirely willing to follow the tax advice of their counsel whereby a return via salary was more favorable than a return via dividends.

The courts in these cases typically do not throw up their hands and avow that the compensation question is too intractable to handle. They tend to roll up their sleeves and grapple with the task of finding a fair market value for the services rendered. They insist that the parties bearing the burden of proof come up with some pertinent evidence as to prevailing comparable rates.[114] Parties tend to respond with some data as to what firms of a comparable size within the geographical area in question are in fact paying. Sometimes they have evidence as to the pay that had been received by the executive in a prior employment. When not satisfied that the burden of proof has been borne, courts do not hesitate to slash.[115]

One is left with the impression that although the material for a comparison of salaries is now about equally available for the small and the large corporation, it is easier to make a comparison of functions performed in the smaller corporation. In other words, it is evidently easier to persuade a court that *A's* functions in a small handbag manufacturer can be fairly compared with *B's* function in a small manufacturing concern in a similar industry.[116] Whereas the courts are apt to feel that the problems facing one of the top executives of the American Tobacco Company or of Exxon are unique, they have less trepidation about analyzing what the handbag executive is really doing and how worthwhile it is. In addition, it is much more readily apparent when salaries in small firms are seriously out of line. Cousin *A* may be on

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113. *E.g., In re* Random & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563, *reh'g denied*, 307 N.Y. 701, 120 N.E.2d 865 (1954).

114. *E.g.*, Ruetz v. Topping, 453 S.W.2d 624, 631 (Mo. App. 1970); Fendelman v. Fenco Handbag Co., 482 S.W.2d 461 (Mo. 1972).

115. The following recent closed corporation cases considered varying amounts of compensation: Goldman v. Jameson, 290 Ala. 160, 275 So. 2d 108 (1973) ($60,000 and $43,000); Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974) ($26,000); Ruetz v. Topping, 453 S.W.2d 624 (Mo. App. 1970) ($26,000); Binz v. St. Louis Hide and Tallow Co., 378 S.W.2d 228 (Mo. App. 1964) ($6,000). For other close corporation cases, see F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS, § § 3.07-3.08 (1975); 2 G. WASHINGTON & H. ROTHSCHILD, *supra* note 62, at 570-73.

116. *Fendelman*, 482 S.W.2d 461.

the payroll because of Uncle *B* as that solution involved fewer tax difficulties than handing *A* some shares of stock. Whereas the bureaucratic systems of firms such as Exxon will at least produce a pay level in general conformity with that of comparable firms, however lofty that level, no such safeguards exist at many smaller firms. Indeed, the recitals of the courts in some of these cases make it quite clear that the directors had taken no steps to set up the defense of sound business judgment.

Despite these differences, the experience of the courts in the close corporation cases encourages one to think that the task of dealing with large corporation cases is not wholly beyond judicial capacities, at least in the sense that it is possible to recognize clear abuses. For example, an insider acquiring control of a large corporation may adjust his compensation beyond any justification offered by performance or comparable industry salaries. In such cases the judicial aggressiveness applied in the close corporation setting may be equally applicable to large corporation overcompensation cases.

C. The Tax Cases

After our review of the corporate law materials, which reveal an unwillingness by the courts to directly attack alleged overcompensation in large corporations, the tax cases come as something of a surprise. There is a large and varied body of authority applying the mandate of section 162 of the Internal Revenue Code allowing corporations a deduction only for "reasonable" expenditures for compensation. The tax court and district court judges show no special trepidation about plunging in and deciding how much compensation is too much. They acknowledge that the issues are complex, that the exercise of judgment is necessary, and that the outcomes will lack precision. Nevertheless, they then proceed to exercise that judgment.

A few points are necessary to put the tax materials in context. First, it should be recognized that the primary motivation of the Internal Revenue Service in pursuing these cases is to prevent owner-entrepreneurs from passing to themselves, in the guise of salaries (which are deductible by the corporation), sums that would otherwise be dividends (not deductible by the corporation). Furthermore, earned income was subject to a maximum fifty percent tax rate, whereas passive income, such as dividends, was subject to higher rates. That factor pushes the Service towards the pursuit of the corporations that are so closely held by their managers that it is plausible to suspect them of planning such a policy. The IRS is thus preoccupied with the relation of salary policy and dividend policy; salaries that seem to be more closely related to stockholdings than to effort or ability are viewed with suspicion.[117] Salaries that always seem to be just sufficient to soak up the amounts otherwise available for dividends are also likely to draw attack.

The second distinguishing feature of the tax cases is that the statutory

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117. *See, e.g.*, Gary N. Cromer, 40 T.C.M. 701, 705 (CCH) (1980). In that case petitioner took 99.7% of the corporation's net income as salary and bonus. The court noted that a sole owner needs no additional incentive plans, and therefore the high salary was designed to minimize the owner's tax by coming under the 50% tax limit. The crucial significance of dividend policy in tax cases has been well illustrated. McCandless Tile Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970). *See* Hoffman, *Heeding Significant Factors Improves the Odds for Reasonable Compensation*, 50 J. TAX'N 155 (1979).

test is one of reasonableness, and its interpreters take a rather free, one might say impressionistic, view of that concept. It is clearly not identical in their minds with an amount dictated by the market. Although judges in tax cases frequently say that the salaries of the most comparable executives are the best single guide to the amount that should be allowed, the courts always emphasize that other considerations are also taken into account. A market theorist might object that a reasonable salary is what a reasonable board of directors would pay, which in turn is what that board would find was being demanded by the market. Such a theoretician might add that the other elements listed by the tax judges would also be factored into an analysis of the amount a reasonable employer of executive talent would be willing to pay. Nonetheless, it is important to know that the concept of comparable salary is kept separate and distinct from other considerations in the minds of those who apply them.

Despite the differences in context, the investigations depicted in the tax cases do constitute the largest, most varied, and interesting store of information about markets for executives and their compensations that is available. The literature is vast. In their 1964 study, Halsey and Peloubet list 482 cases in tabular form.[118] The Prentice Hall 1979 *Federal Taxes* service devotes forty pages to brief capsules under the heading "Compensation Paid for Services—Reasonableness." The Commerce Clearing House service uses fifty pages to present the cases in compact form, including a subsection on those cases in which reasonableness in comparison with other firms' pay was judged to be a critical factor.

From that large body we cull a few cases to illustrate the general methodology used by the courts to determine what is unreasonable compensation. There will be discrepancies in application: the tax system is not rigid enough to produce a totally uniform policy. One observer noted that figures that would pass without comment in the metropolitan area of Chicago would cause difficulties with agents in smaller cities and towns.[119] Nor do all of the district court, tax court, and court of claims judges see the problem in the same way.

We first consider three cases involving publicly traded corporations. The scarcity of cases in that area is a drawback as there is little opportunity to observe limitations being placed on the compensation of executives atop the pyramids of the largest publicly held corporations. One case that reached the issues we are examining is *Pfeifer Brewing Co.*[120] That case may have been selected by the Service because of some of the other issues it raised, such as a large and debatable deduction for an embezzlement loss. The salaries challenged were those of the President and the Executive Vice President. The President's salary had grown from $44,000 in 1939 to $62,000 in the war years, while the Executive Vice President's salary went from $6,500 to 25,000. Furthermore, the Vice President was not a full-time employee and received income also from Drewerys. He returned to full-time status at the latter firm at $50,000 per year in 1946.

118. C. HALSEY & M. PELOUBET, FEDERAL TAXATION AND UNREASONABLE COMPENSATION 22-93 (1964).

119. Murdock, *A Primer for Compensating Executives in Closely-Held Corporations*, 50 CHI. B. REC. 146 (1968).

120. 11 T.C.M. (CCH) 586 (1952).

The Tax Court's analysis took a comparative approach, leaning heavily on surveys by the Service of 27 members of the brewing industry as revealed in their SEC filings (since these are before the Securities Exchange Act 1964 amendments, one infers they were corporations with securities listed on an exchange). Judge Rice focused on the comparison between Pfeiffer and Goebel Brewing Company because their net sales were almost the same. Pfeiffer's selling, general, and administrative expenses were only $4,957,000, against Goebel's $5,933,000; that amounted to 23.9% of their net sales as against Goebel's 28.9%. Accordingly, Pfeiffer's operating profit and net profit exceeded Goebel's and its net profit as percentage of net sales was 12.2% as opposed to Geobel's 10%. The court also took into account offers the two executives received from other breweries and the fact that Pfeiffer's president also served as a brewmaster, thus enabling the firm to save $15,000 to $30,000 by not having to pay the $30-40,000 salary normally accorded such an expert while paying a superintendent only $10-15,000. The court found that Pfeiffer paid "top salaries in the industry" but "secured therefore top performance." Based on its comparative analysis, the court concluded that the compensation was reasonable.

A second case in which the IRS applied its "reasonable" standard to the compensation received by the top executives of a publicly traded company involved the R.J. Reynolds Tobacco Co.[121] That firm's compensation practices were based on a bonus bylaw quite similar to that involved in the classic American Tobacco case. Unfortunately, the case is defective from the perspective of the seeker of standards that determine when compensation is excessive. The ruling, adverse to the taxpayer, turns basically on the plan's allocation of stock according to the employee's previous stockholdings rather than in proportion to earnings. The court found these distributions to be more like dividends than salaries. In any case, it could not be demonstrated that compensation was based on the services performed. Therefore, the compensation was unreasonable even though there was testimony from impressive sources that Reynolds' executive compensation, taken as a whole, was less than that of its major competitors. Indeed, according to the testimony, the relatively lower compensation paid for a distinctly superior performance in terms of profitability, market share, and other criteria.

The last publicly held company to be discussed is Brown-Forman Distillers Corp.,[122] a corporation listed on the American Stock Exchange, although the Brown family held 51% of its voting stock. During the years in question (1943-1950) it was highly successful. Its earning before taxes went from $668,000 in 1942 to $5,621,000 in 1950 on sales that rose from $11.2 million to $45.7 million. Its stock rose from $1.25 a share to about $75. The two Browns who were the vice presidents were paid at a rate that ranged from $50,000 to $160,000 each per year, including incentive elements. The Court of Claims regarded them as "top men in their field . . . entitled to compensation commensurate therewith."[123] It concluded that the pay was not unreasonable. It referred to general testimony about compensation in other whiskey businesses, but concentrated on one competitor, Glenmore Distilleries.

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121. R.J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889 (Ct. Cl. 1957); R.J. Reynolds Tobacco Co., 15 T.C.M. 810 (CCH 1956), *aff'd.* 260 F.2d 9 (4th Cir. 1958).
122. 132 F. Supp. 711 (Ct. Cl. 1955).
123. *Id.* at 716.

Glenmore had comparable sales but much smaller profits. Although at the start of the comparison period it paid its officers only half of Brown's compensation, it actually passed Brown by the end. Glenmore's president, called as a government witness, not suprisingly termed Brown's plan reasonable and advantageous.

Another tax case, although not involving a publicly held corporation, is included because of the amounts of compensation involved and the Commissioner's use of comparative data.[124] The court found Mrs. Crowley principally responsible for the success of a firm called Home Interiors, which she founded in 1957 with $41,400 of capital from her own sources. Its method of operation was to sell home decorations and accessories through the "hostess plan," that is, through hostesses who would invite potential customers to see the displays in their homes. Through immense personal effort and skill, she expanded the firm so that by 1975 it had 17,733 displays, $97,500,000 in sales, and $6,860,000 in net income after taxes. Her rewards—aside from her share of the $300,000 to $500,000 annual dividend—were handsome. During the years in question, 1971 to 1975, her compensation ranged from $566,000 to $1,566,000.

The Commissioner relied in part on a Hay Associates survey of 800 firms that reported the salaries paid to chief employees. The study gave particular attention to six direct selling corporations and ten high growth companies, and computed a ratio between the compensation of CEOs and the firm's sales and profits. On that basis the Hay study concluded that reasonable compensation would be below the amount actually paid, although higher than the Commissioner's own computations.

Judge Simpson, however, considered the firm's compensation figures to be reasonable. He agreed that the Hay figures "represent the norm for their services," but held that the study was not "dispositive," as even "abnormally high compensation" could be "reasonable" under section 162(a)(1).[125] Factors justifying that conclusion included the judge's personal impression of Mrs. Crowley as a witness, the spectacular rate of ascent of the firm's earnings and assets, and the compensation allocated to other managers without familial ties.

What does one conclude from that decision? Perhaps it means no more than that the standard for tax purposes is not "reasonable," but rather, "not outrageous." On the other hand, the standard of applying the marginal utility of the executive's services may not have been violated. If the contribution made by Mrs. Crowley is measured by comparing the rate of growth of the corporation under her leadership with that of other corporations one might well infer that her services were more irreplaceable and vital than were the services of CEOs at larger retailing concerns in a "steady state."

This survey of the tax literature plainly indicated that it is often possible to make a convincing-sounding analysis of the reasonableness of the amount of compensation paid by a firm in relation to its peers. That is what expert witnesses who appear before the tax tribunals do both in their general practice and in their testimony. While the art is obviously less than precise, it seems to work as well as the methods of resolving other difficult issues of fact. There is probably no greater margin of error than that which attends,

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124. Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142 (1980).
125. *Id.* at 1162.

for example, the valuation for estate tax purposes of the stock of closely held corporations. It is clearly possible to identify cases in which a management is paying itself noticeably more than its close competitors. In some cases the revenue authorities have been able to cast their nets more widely and identify comparable positions in a substantial number of firms (ten to thirty) that can be used as benchmarks. The courts show that they can appreciate differences in the work actually done by executives whose titles and slots in organization charts appear to be the same—at least in cases involving small or medium-sized firms. The question, collateral to our purposes, that remains without a direct answer is whether the tax system could cope with the special issues raised by the compensation practices of large publicly owned corporations. The reasonable inference is that the difference in difficulty is only one of degree. In fact, there may be as many workable grounds for comparison in some large firm cases as there have been in some of the smaller firm cases successfully handled by the courts.

D. The Incentive Plan Cases

From time to time the courts have tackled issues arising from incentive plans involving provisions such as percentage bonuses, stock options, and stock appreciation right schemes. In general, the outcome has been either a success for the defenders of the program or a success for the challengers on some peripheral technical issue. One cannot say that they represent a major contribution to learning in this field.

1. Percentage bonuses

Several of the 1930s cases involved cash bonuses calculated on the basis of a percentage of profits. The American Tobacco case emphasized the staggeringly large total figure produced by the unvarying application of a formula for twenty years.[126] In several later cases the stress fell upon computation; challenges arose over the inclusion of proceeds of sales of treasury stock, of blocked revenue of overseas subsidiaries, and gains upon sales of assets outside of the ordinary course of business.[127] Correspondingly, questions have arisen as to the deductibility of taxes, the compensation of other executives, and the losses upon the confiscation, destruction, or sale of assets. One is inclined to dismiss most of these questions as drafting quirks. The issue of the inclusion of "extraordinary items" as a basis for compensation, however, does have a deeper meaning. At first blush, it appears that the managers should be rewarded for results that can be linked to their decisions. It would follow that the gains or losses that result either from forces beyond their control (casualty losses) or from decisions made before their time (for example, the purchase of a business that they now feel called upon to sell) should not affect current compensation. On the other hand, it can be

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126. Rogers v. Hill, 295 U.S. 582 (1933).

127. Post World War II cases on the calculation of percentage bonuses include: Bookman v. R.J. Reynolds Tobacco Co., 138 N.J. Eq. 312, 48 A.2d 646 (1946) (refund of A.A.A. processing tax properly included in income); Maguire v. Osborne, 384 Pa. 430, 121 A.2d 147 (1965) (net profits means before taxes); Schwartz v. Miner, 37 Del. Ch. 575, 146 A.2d 801 (1958) ("net profits" means without capital gains or losses); Smith v. Dunlop, 269 Ala. 97, 111 So. 2d 1 (1959) (gain from sale of investment not included); Frey v. Gender, Paeschke & Frey, 4 Wisc.2d 257, 90 N.W.2d 765 (1958) (distinguishing between "normal" and other taxes).

argued that exclusion of such items further exaggerates the emphasis on short-term results. Suppose that a division has been making a small and comparatively inadequate return on the investment. A decision to sell it and reinvest the proceeds in another project that after a few years will produce a high return may not produce those returns in time to benefit the decision-maker personally. Arguably, sharing the gain on the divestiture would serve to counter-balance the loss of a percentage of the division's earnings. That argument does not consider that if the sale took place at a loss the deduction from the bonus would make the manager all the more reluctant to sacrifice the current return.

2. *Stock options*

In the early 1950s there was a spate of cases about executive stock options that caused considerable alarm. In the years following World War II the effects of inflation and high taxation on executives' real compensation were painfully felt.[128] One of the avenues of relief explored was the stock option, a device that before 1950 could, according to some cases, be fitted into a favorable niche in the tax system as a "noncompensatory" option.[129] After 1950, stock options were accorded specific and favorable treatment in the Internal Revenue Code.[130] In fact, the intensity of the attention given to the tax aspects seems to have drawn the attention of the drafters away from the corporate aspects of the option plans so that the linkage between the work to be done and the options received was obscured. Actually, none of the cases got the courts directly into the ticklish business of judging how much value in a stock option plan is too much.[131] Rather, they went off on tangents. In some cases the courts found that the contractual arrangements did not compel the recipient to stay and contribute services as a condition to receiving the benefits of the options.[132] In other cases, they found that the burden of proof, which rested on the complaining shareholder if there was no self-dealing and on the defendants if there was, had not been borne.[133] It has been conjectured that other factors moved the courts, as in the *California Eastern Airways* case when the court found the defendant executives had claimed too much for their corporate rescue efforts, having arrived on the scene when the enterprise had already been given a gratuitous boost by the impact of the Korean War.[134]

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128. *See supra* notes 66-68 an accompanying text.

129. The early status of stock options under the Internal Revenue Code is summarized in Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403, 1406-18 (1953).

130. *See*, 64 Stat. 942 (1950) adding I.R.C. § 130A. For subsequent history, see Jassy, *Incentive Stock Options: The Reincarnation of Statutory Stock Options under ERTA*, 37 TAX L. REV. 359 (1982).

131. The major cases in this series were Gottlieb v. Heyden Chem. Corp., 34 Del. Ch. 84, 99 A.2d 507 (Ch. 1953); Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (Super. Ct. 1960); Kerbs v. California Eastern Airways, Inc., 33 Del. Ch. 69, 90 A.2d 652 (Super. Ct. 1952). *See also* DEL. CODE ANN. tit. 8, § 157 (1975) enacted in the hope of solving these problems. The code provides that "[i]n the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive." For a full listing of the cases, see 2 G. WASHINGTON & H. ROTHSCHILD, *supra* note 62, at 906-07.

132. *See, e.g., California Eastern Airways, Inc.*, 33 Del. Ch. 69, 90 A.2d 652.

133. *See, e.g., Heyden Chem. Corp.*, 34 Del. Ch. 84, 99 A.2d 507.

134. *See* Dwight, *Employee Stock Option Plans: The Clydesdale Rule*, 52 COLUM. L. REV. 1003, 1013 (1952) (commenting on *California Eastern Airways*).

These cases thus had no particular impact on the generosity with which boards of directors rewarded their employees. One can assume, however, that some downward pressure was exerted by the criticism of option grants expressed by such writers as Dean Erwin Griswold.[135] Furthermore, Congress moved to restrain stock options by restricting the advantages of such plans. Tax breaks were given only to plans that were limited in terms of the option price, the percentage of the firm's stock under option, the timing of the option's exercise, and the sale of the stock.

Most of the option cases in which shareholders brought charges of self-dealing involved situations in which the corporation had granted options on its stock at one price and then, after a sharp fall in the market, issued new options at a lower price. A number of these episodes grew out of a general stock market break that made option prices that were too close to the market in 1973 far above the market price in 1974.[136] That circumstance points to a major weakness in the theoretical fit between stock options and management performance. Shareholders can point out that managers get the benefit of a rise in the general market due to no skill of their own, but can escape the negative consequences when the market drops. Of course, defendants have noted that the important incentive effect of the option plan vanishes when there is no significant hope of the market price surpassing the breakeven point. Courts have not found such reissuances bad per se, but have applied the standard tests of waste, self dealing, and shareholder ratification. Perhaps the most revealing of the cases is *Cohen v. Ayers*,[137] which arose from a Sears, Roebuck and Co. stock option plan that began in 1967 and was renewed in 1972. The market price of Sears stock had followed the general market trend and declined after 1973. As a result, some options were cancelled and replacement options at lower prices were granted at the then current market. Aside from arguments about the adequacy of the proxy materials through which shareholder approvals were obtained, the plaintiff shareholder attacked the option grants on the basis of self-dealing. Twelve of the twenty-three Sears directors were beneficiaries of the stock plan.

As the court summarized plaintiff's argument, the directors may not lower the option price "because that would not be supported by consideration. It may also be argued that lowering the price excuses poor performance by the optionees."[138] The court then stated the standard by which the director's action would be judged:

> The New York legislature has long since modified the common law and lowered the degree of loyalty owed to a corporation by its directors from "the punctilio of an honor the most sensitive, " *Meinhard*

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135. Griswold, *Are Stock Options Getting Out of Hand?*, HARV. BUS. REV., Nov.-Dec. 1960, at 49.

136. Post-1973 cases involving the issue of new options include Galef v. Alexander, 615 F.2d 51 (2nd Cir. 1980); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1980); Jacoby v. Averell, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,360 (S.D. N.Y. 1974); Waltzer v. Billera, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,011 (S.D. N.Y. 1973); Michelson v. Duncan, 386 A.2d 1144 (Del. ch. 1978), *modified* 407 A.2d 211 (Del. 1979). Older cases include Dann v. Chrysler Corp., 41 Del. Ch. 438, 198 A.2d 185 (Ch. 1963), *aff'd*, 205 A.2d 343 (Del. 1964), *cert. denied*, 380 U.S. 973 (1965); Amdur v. Meyer, 15 A.D. 2d 425, 224 N.Y.S.2d 440 (App. Div. 1962).

137. 449 F. Supp. 298 (N.D. Ill. 1978).

138. *Id.* at 310.

> *v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928) (Cardozo, J.) to a standard of reasonableness.[139]

Applying their standard, the court found the consideration for reissuing the options was sufficiently reasonable to fall within the protection of the business judgment rule. The court noted:

> The stock option cases have evolved a flexible concept of consideration, and hold that it is adequate if the corporation receives something of value, usually the continued services of the employees. . . . More precise balancing between the value flowing to the corporation and the value flowing to the optionee is impossible. Not only are courts ill-equipped to undertake such a task, but commentators have noted that there is no realistic method for arriving at a dollar value for stock options. *Therefore, if minimal consideration is present, courts defer to the business judgment of the board of directors.* This judicial caution is consistent with a long line of cases holding that boards of directors have the power and authority to manage the affairs of the corporations, and that their decisions will not be questioned when they act in accord with their best judgment.[140]

The court also observed that director-employees were treated proportionately "less generously" than the other employees and that all employees had to remain longer to qualify under the new, longer priced options. The district court thus granted summary judgment to the defendants, and the Court of Appeals affirmed.[141]

3. Other Stock Plans

Almost coincidentally with the option cases of the early 1950s, two courts had occasion to pass upon the validity of "phantom stock" plans. These plans awarded executives cash credits equivalent to the amount of dividends paid out to shareholders on a specified number of shares, plus the market appreciation on that number of shares as measured from the time of grant to a date connected with retirement. The Delaware Supreme Court found "no difference between the Deferred Compensation Unit Plan and the ordinary stock option plan."[142] On the other hand, a federal district court in Ohio struck down a similar plan for various reasons. The court did not accept the argument that the plan was related to merit:

> But the provision of the plan awarding further compensation equal to the increased value of the common stock at the time employment terminates has no relation to the value of services. . . . Heretofore it has been considered that only shareholders were entitled to such [capital] gains. The provision in question introduces a new concept and places unit holders on a parity with shareholders in respect of capital gains and provides for their payment under the guise of compensation having no relation to services rendered.[143]

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139. *Id.* at 312 (emphasis added).
140. *Id.* at 312 (citations omitted).
141. 596 F.2d 733 (7th Cir. 1979).
142. Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596, 601 (Del. 1959).
143. Berkwitz v. Humphrey, 163 F. Supp. 78, 92-93, (N.D. Ohio 1958).

It seems that the court overstates the matter. Clearly there is *some* relation, if not a precise one, between the functioning of management and the market price of its corporation's stock. Furthermore, the capital gains argument should logically affect stock option plans as well, for they too cause management to share in market gains.

In *Ash v. Brunswick Corp.*, shareholders challenged both a "1974 management non-qualified stock option plan"[144] and stock appreciation rights.[145] One argument was that there was no reasonable relationship between the value of the benefit passing to the corporation and the value of the options. The statutory provision pertaining to that issue, section 157 of the Delaware General Corporation Law, made the judgment of the directors as to consideration conclusive in the absence of actual fraud.[146] Thus, the court examined the record for evidence as to whether the committee made its awards in the exercise of its independent business judgment or whether the awards were the products of control or domination by the Chairman and the President of the Company. The record indicated that the President had solicited recommendations from division heads, that the Chairman and President had consulted with the committee but did not vote or participate in its deliberations, and that the committee did change recommendations the Chairman and President had made. It appeared, however, the the committee spent little time on the questions, that the President attended all the committee meetings, which were held in his office, and that some questions as to stock appreciation rights were decided by the Chairman and President without committee discussion. Although the court refused to grant summary judgment, the dissidents still had the burden of proving fraud in order to overcome the statutory business judgment rule.

Freedman v. Barrow[147] involved a shareholder challenge to Exxon's incentive program. The opinion explained the incentive program and the procedures within Exxon in considerable detail. The court first expressed sympathy with the needs of corporations to retain their executive talent:

> The larger, more profitable American corporations which have achieved their success against over-whelming international competition, have done so through the efforts of highly skilled, experienced managerial and executive personnel who generally have little or no ownership of the business and no share in the customary rewards of shareholders. Keeping the high level of motivation of these employees, retaining their loyalty in the future, and protecting their skills, experience and specialized knowledge from raids by competitors or others, is the biggest single responsibility of top management, which naturally is also interested in its own compensation. Vengeful, progressive income taxes directed against the managerial class have made it impractical to motivate and reward solely with large salary payments. Their net effect after taxes soon becomes marginal, costing the corporation more than it brings to the executive. Also, other incentives costing less may be more effective than mere salary, or may be tied in more direct-

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144. 405 F. Supp. 234 (D. Del. 1975).
145. *Id.* at 236.
146. DEL. CODE ANN. tit. 8, § 157 (1974).
147. 427 F. Supp. 1129 (S.D.N.Y. 1976).

ly with such matters as corporate earnings, and stock market performance.[148]

Exxon had a full time "Senior Adviser Executive Compensation" who with a staff of eight or nine employees, fixed the salaries of three thousand senior executives and developed incentive programs. In addition, a Committee on Executive Development and Compensation, consisting of the "inside" board members, considered incentives for all employees other than directors. Employee-directors were handled by the Board Compensation Committee, which consisted of outside directors.

For internal purposes the management had calculated that a possible rise of Exxon stock to $110 from option price levels of approximately $90 and $75 would result in compensation of $39 million. The court found that the internal assumptions were too questionable for management to be obliged to disclose them to the shareholders. It noted the impact of Exxon's earnings would be "very slight"—actually on the order of .003%.

After dealing with a whole series of challenges under the proxy rules and the short-swing insider trading clause of section 16(b),[149] the court considered a claim that various extensions of five-year qualified options to ten-year programs amounted to common law waste or gifts. The court rejected that attack on a "shareholder-approved, impartially administered stock option plan" as the plans were not defeated by the fact that there was no measurable and definite consideration passing to the corporation.[150] The minimal consideration requirements were satisfied, as the great majority of grantees whose options were extended stayed in Exxon's employment. In the case of a president whose option was extended to one year after retirement, the court noted that "the next chief executive officer is likely to work that much harder believing and trusting"[151] that he would receive fair treatment on his own retirement. Exxon had bought an "image" for fair dealing, "and cheaply" the court adds.[152]

E. The Mutual Fund Compensation Cases

The last group of authorities touched on are the cases passing upon the alleged excessiveness of the fees charged mutual funds by their investment advisers. It was argued that although the compensation of mutual fund advisers was set in various funds at levels that were quite comparable to each other, the payments were uniformly too high. In other words, the situation that is analagous for our purposes is one in which the market operates with apparent evenhandedness but arguably without the degree of downward pressure that a truly competitive market would exert.

In the early 1960s a series of suits attacked the compensation of mutual fund investment advisers on state law grounds similar to the "waste" standard or "unreasonableness" test used in management compensation cases. Three reported cases emerged from that series of lawsuits, each decided

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148. *Id.* at 1136.
149. 15 U.S.C. § 78p(b) (1976).
150. 427 F. Supp. at 1155.
151. *Id.* at 1156.
152. *Id.*.

adversely to the plaintiff's claim. The two suits that were brought under Delaware law received the most in-depth treatment. The exemplary case is *Saxe v. Brady*,[153] in which Chancellor Seitz considered the evidence in considerable detail. He noted that 58.3% of all active funds charged a flat 1/2 of 1% of net assets and that the charges of 29.1% were above that figure. Of the eighteen funds having more than $200 million of assets, however, twelve charged less than 1/2 of 1%. Three of six funds above $500 million, however, were at 1/2 of 1%. It was argued that costs should be scaled down as the size grew. Chancellor Seitz responded:

> It may be argued that all these larger funds paying fees of 1/2 of 1% are subject to judicial attack on the ground of waste and further that the directors of each of these funds should not be permitted to justify the advisory contract of their fund by pointing to the rate paid by any of the others. In effect an argument of this type would challenge the validity of any test based on comparisons of funds of the same size. The answer to this must be that the court cannot assume that each of these comparable funds paying 1/2 of 1% is thereby wasting its assets.[154]

The chancellor thus found that there was no basis for concluding that the payment structure, which had been approved by an overwhelming majority of the fund's shareholders, was excessive. He did warn, however, that the profits realized by the manager were "certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort *even in a legal sense*."[155]

Although the courts upheld the compensation structure, the mutual fund fees were attacked by the academic world, abetted by the SEC.[156] Critics argued that since studies showed that funds do no better than a portfolio simply based on market averages and, indeed do worse after deducting fees and commissions, *any* compensation to managers was excessive. The fee structure was also condemned as there were significant institutional hindrances to arms-length bargaining. Independent directors were labelled unattentive and ineffectual, in practice being merely nominees of the adviser. The investors had no incentive to attack the fee structure as their costs were insignificant in relation to their investment and returns. Analysts unfavorably compared the advisory fees charged to funds with those charged pension funds by banks and other institutions that had to compete for the business of large, skeptical clients.

The upshot was a general "voluntary" paring down of fees by mutual fund managers and Congressional enactment of section 36(b) of the Investment Company Act, which made fees a federal fiduciary question and disavowed the "corporate waste" test.[157] While there has been no significant

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153. 40 Del. Ch. 474, 184 A.2d 602 (1962).

154. *Id.* at 489, 184 A.2d at 611.

155. *Id.* at 498, 184 A.2d at 616 (emphasis added).

156. Developments up to 1970 are summarized in Glick, *Mutual Fund Management Fees: In Search of a Standard*, 25 BUS. LAW. 1471 (1970).

157. Section 36(b), 15 U.S.C. § 80 a-35 (1976). To date, the most authoritative reading on section 36(b) is in Gartenberg v. Merrill Lynch Asset Management, Inc., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,386 (S.D.N.Y. Dec. 28, 1981). Judge Pollock concluded

litigation under that provision, which sets no specific standard, it stands as a sign of discontent with management fees that were justified by the market. Indeed, one may well ask the question whether the market can be a meaningful control on compensation in any context if not so in the field of mutual fund management fees where the investors confront the question of compensation in a more direct, uncomplicated way than do shareholders of an operating business.

The incentive plan cases, in sum, show the courts to be reluctant and uneasy when dealing with the problems of overcompensation even though in some situations they are clearly aghast at the results that, predictably or not, flowed from compensation plans. On top of all the uncertainties about the worth of the work done, the courts have recognized that it is very difficult to assess the initial worth of contingent remuneration and that it is essentially unfair to condemn using one's subsequent knowledge. Rather than attack the compensation problem head-on, the courts have focused on what was done inside the corporations by the board of directors, by committees, and by the shareholders. We turn to that topic in the next section.

V. CORPORATE INSTITUTIONS AND SAFEGUARDS

Since judging the reasonableness of executive compensation is too imponderable or specialized for them to handle, the courts tend to defer to the established corporate mechanisms. Through these mechanisms, the courts hope to purify the process without involving themselves in the decisions.

The first line of defense has been the board of directors. Charged by a statute with the management of corporate affairs in general, the board has the clear responsibility for setting managerial salaries.[158] That responsibility must be executed according to three standards. First, there is the "waste" standard. Even though there is no conflict of interest involved, the directors may not give away corporate property even in the form of a salary or bonus payment. Generally the waste standard is a barrier only when the court sees the payment as absolutely unjustifiable. Second, there is the "fairness" standard. Under the variants of the rule limiting self-dealing, interested directors are, while not generally prohibited from acting, at least subject to scrutiny as to the fairness of their actions. Third, there is a general requirement that the board act with due care, which should include due care in setting com-

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that the new section intended to impose a standard stricter than "waste" but less strict than "reasonable." The court's focus was on the behavior of the parties involved in setting the compensation, their diligence in arguing the relevant information about comparable costs, and the independence and maturity of their deliberations. Unfortunately for legal science, the plaintiff appears to have challenged one of the lowest cost money market fund managements. *See also In re* Gartenberg, 636 F.2d 16 (2d Cir. 1980) (jury trial not available in § 36(b) case); Markowitz v. Moneymart Assets, Inc., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,360 (S.D. N.Y., Nov., 1981) (settlement of derivative suits held investment advisor and fund administrator responsible); Grossman v. Johnson, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,950 (D. Mass. April 7, 1981) (dismissal of § 36(b) case appropriate after study by disinterested directors); Krasner v. The Dreyfus Corp., 500 F. Supp. 36 (S.D.N.Y 1980) (settlement approval withheld for failure to share economies of scale with fund). *See generally* Note, *Mutual Fund Advisory Fees—Too Much for Too Little,* 48 FORDHAM L. REV. 530 (1980); Note, *Mutual Fund Advisory Fees and the New Standard of Fiduciary Duty—Interpreting the 1970 Mutual Fund Act,* 56 CORNELL L. REV. 627 (1971); 2 T. FRANKEL, THE REGULATION OF MONEY MANAGERS, ch. XI B (1978).

158. *See, e.g.,* DEL. CODE ANN. tit. 8, § 141(a) (1974 and Supp. 1980).

pensation. Most commentators assume that the defense that business judgement was exercised will block shareholder recourse to the standard. More and more, however, due care is being expected of boards and of their outside directors. Surely outside board members must be impelled to wonder about the levels of pay that management is receiving.

The evidence as to the impact of outside directors on executive compensation is ambiguous.[159] When the board of directors consists of outside members, the courts feel that they can rely upon the disinterested business judgment of that body in remuneration matters. Indeed, they breathe an almost audible sigh of relief when turning the question over to the board. When the board is wholly an inside board, the courts feel unease. When the strict self-dealing disqualification rule prevailed, courts regarded as inadequate a round robin process in which each officer-director participated in each salary-setting save his own.[160] Over time, the strict self-dealing rule disappeared. Its demise was due partially to statutes aimed specifically at legitimizing salary-fixing votes but more due to a general movement in state statutes and decisional law to drop all constraints on self-dealing except for judicial determination of unfairness.[161] The courts are still faced with a subrule that places the burden of proof on board members who are not disinterested, unless there has been a shareholder ratification. Particularly in the case of stock options, in which the value of both the services and the quid pro quo are imponderables, the result has almost invariably been a defeat for the party left shouldering the burden.

As the practice of delegating the compensation function to a comittee gains greater acceptance, the courts will be faced with the question of the degree of deference to be paid to such a committee.[162] Very likely, that decision will be interwined with the current judicial inquiry into the effect to be given a decision of similar committees as to whether suits against other directors should be continued.[163] The two types of delegated decisions are analagous both in terms of the sharp impact that a denial of the benefits would have on persons with whom the decision-makers have worked, and may have to continue to work, and of the difficulty and sensitivity of the factors to be weighed. Also analogous is the practice of independent directors setting the compensation of investment company managers. That practice, as mandated in the 1940 Act, seems to have more or less satisfied the courts. The 1970 revision of the statute, however, can be regarded as a congressional judgment that the combination of directors and state courts had not proven adequate to the task.[164]

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159. *See supra* note 91.

160. The classic case of director/officer self-dealing is Stoiber v. Miller Brewing Co., 257 Wisc. 13, 42 N.W.2d 144 (1950) (invalidating reciprocal resolutions on salary by insider directors). *But see* Wisc. Stat. § 180.31 (1957). *See also* Savage v. Lorraine Corp., 217 F.2d 378 (9th Cir. 1954); Heise v. Earnshaw Publ. Inc., 130 F. Supp. 38 (D. Mass. 1955).

161. On the loosening of conflicts of interest law see generally Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966). *See also* Amdur v. Meyer, 15 A.D. 2d 425, 224 N.Y.S.2d 440 (App. Div. 1962).

162. For a description of compensation committees, see B. ELLIG, *supra* note 41, at ch. 10. For a critical look, see Kraus, *supra* note 4, at 37-38; McSweeney, *How Much Say-So to Outside Directors?*, COMPENSATION REV., 3d Quart., 1972, at 10.

163. Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981).

164. *See supra* note 157.

To be given maximum reliance by the courts, compensation established by board decisions should be based upon appropriate preparatory work by the corporate staff. A large corporation may have a substantial in-house staff comparing compensation structures and devising plans for the corporation's executives;[165] the presence of such a system is clearly impressive to the courts. A firm that cannot afford such an elaborate, expensive operation may resort to consulting firms that are experienced in devising attractive executive compensation plans. Even a firm with an inside compensation staff may well wish to check its data with an independent consultant.[166] Reliance upon such outside advise would keep the firm from exceeding the prevailing compensation norm.

Outside of the board, the system of corporation law allots residual functions as to compensation to the shareholders. The board of directors may be entirely disqualified by self-interest from such decisions or it may be stripped of the presumption that it has exercised sound business judgment. In some cases, the issuance of the stock comtemplated by an incentive plan requires an amendment to the articles of incorporation and hence a shareholder vote.[167]

In others, the decision to refer the matter to shareholders represents simply prudence on the part of the board. In any case, shareholder votes can be solicited only through compliance with the proxy rules. The SEC has conditioned any election of directors upon the submission of data about compensation.[168] Aside from the impact these rules have upon the vote—and the proportion of management proposals that are rejected must be small indeed—the exposure of the relevant facts is important. The proxy rules have greatly expanded our knowledge of compensation practices since the era when grossly inadequate disclosure was the fashion.[169] Clearly a substantial number of management decisions are affected by the knowledge that the facts will be discussed in the shareholders' meeting and in the press.

It thus becomes important that the materials be presented to the public in the most comprehensive yet comprehensible way that can be devised. From time to time the SEC has sought to perfect that disclosure.[170] In its current form it calls for disclosure as to "each of the five most highly compensated executive officers" of the corporation if they received more than $50,000. That disclosure involves three items: salaries, securities or property, and contingent forms of remuneration. That disclosure does not include all of the data that trained observers, such as Hay Associates, find material. Most significantly it permits the aggregation of all forms of present cash remuneration. Thus,

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165. *See supra* note 147. *See* Freedman v. Barrow, 427 F. Supp. 1129 (S.D.N.Y. 1976).

166. *See* Cook, *The Compensation Director and the Board's Compensation Committee*, 13 COMPENSATION REV., 2d Quart., 1981, at 37.

167. In those cases the disclosure requirement is governed by 17 C.F.R. § 240.14a-101 (1982) (Items 9, 10, 11).

168. 17 C.F.R. § 240.14a-101 (1982) (Item 7, referring to § 229.402 (Regulation S-K)).

169. *See* Rogers v. Guarantee Trust Co., 288 U.S. 123 (1937) (Stone, J. dissenting). For other evidence as to nondisclosure practices, see Mautz & Rock, *supra* note 38, at 475-76.

170. *Uniform and Integrated Reporting Requirements: Management Remuneration*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,765. *See also Uniform and Integrated Reporting Requirements: Directors and Executive Officers Management Remuneration, Legal Proceedings, Principal Security Holders and Security Holdings of Management; Amendments to Disclosure Forms and Regulations*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,649.

it does not separate out bonuses from straight salary or require the corporation to explain how bonuses have been computed although quite a few solicitations do at least give separate cash bonus figures.[171] It is important for purposes of understanding management's overall approach to the running of the corporation to be able to grasp the philosophy that guides it, that enables it to define "success," and that causes it to reward or punish individuals. It is useful to have noncash items included and valued since the path of employing perquisites as compensation can mislead the investor as well as the tax collector, particularly when the perquisites are on as lavish a scale as those bestowed by Playboy upon its presiding genius, Hugh Hefner.[172] Disclosure of contingent remuneration is useful but its informativeness is limited both by the nature of the disclosure and by the modesty of the SEC's demands. Basically, the figure to be reported represents the "amount expensed by the registrant . . . for financial reporting purposes." A disclosure restricted to that amount would not include a substantial exposure for the payment of compensation in the future that had not become sufficiently definite to be expensed.[173] There is an unsolved accounting problem concerning the statements of the cost or value of an option or contingent bonus plan in year 1 when those figures will not become apparent until years 5 or 6; inclusion in the latter year overstates its costs just as omission in the prior year understates its true cost.[174] If shareholder action is solicited with respect to a given bonus, profit sharing, pension, or option plan then additional disclosures are called for, including description of the material features of the plan, an estimate of the amounts payable on normal retirement, or an estimate of the amount that would have been distributed if the plan had been in effect during the current year. For some plans it might be necessary or desirable to have shareholder approval; for others, that approval might have been obtained some years ago so that no current showing need be made even if the current accruals are very large.

VI. CONCLUSION

With what then does this excursion through the growing mass of management compensation literature and the case law leave us? The literature becomes more confusing the closer it comes to the questions with which lawyers are concerned; it was, of course, intended for other purposes, more generalized and less contentious than lawyers' ends. Not only is much of it

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171. Only 12 of the top 25 salary figures listed in BUS. WK., May 10, 1982, at 76-77, separately reported regular salary and bonuses.

172. Matter of Playboy Enterprises, Inc., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,635 (finding over $2 million in undisclosed personal benefits such as free—or below cost—use of company mansion, aircraft, accountants, and lawyers).

173. *See, e.g., Freedman*, 427 F. Supp. at 1129.

174. Accounting for options and other contingent benefits suffers from the difficulty, referred to in note 54 *supra*, that assignment of a value in the year it is earned (and under accounting matching theory should be accrued) is not practical. Assignment of arbitrary terms such as the then prevailing difference between market value and option value does not get to the heart of the problem. The current accounting convention as embodied in A.P.B. No. 25 was deemed not useful to shareholders in *Freedman*, 427 F. Supp. at 1139-42. For a recent review and new proposal, see Noreen & Wolfson, *Equilibrium Warrant Pricing Models and Accounting for Executive Stock Options*, 19 J. ACCTG. RES. 384 (1981). For an earlier discussion of the alternatives, see Ruby, *Accounting for Employee Stock Options*, 37 ACCTG. REV. 28 (1962).

complex and difficult to follow for the lawyer who is not a fully qualified statistician, but much of it seems unsatisfactory in providing the level of certainty a court or legislature would require before taking action. Like so many expert witnesses on the stand, the surveyors so often take slightly different samples or years and come up with very different conclusions. Sometimes they redo the work of others and apply it to that most devastating of rejoinders—that is not statistically significant. At other times they seem to pay no attention to what other surveyors have done; the business literature is as sparse in footnoting as legal writing is generous. Thus, one certainly does not have a sense that a large number of important questions have been put to rest. Some nontrivial conclusions, however, can be derived from the material.

First, one can pull together an overall picture of the market for executives as it presently functions. Then one can put the basic questions: what needs to be done, and by whom, in order to solve whatever problems are left for the legal system by the operations of that market.

A. The Executive Market Mapped

The executive market is an unusual institution, in many ways quite removed from the securities market or a typical commodities market. The services that are the object of the market are very disparate and, while there is now much information as to what is being paid, there is much less about the value of what is being given in return.

The market for executives seems to work reasonably well at more modest levels. When junior executives in large firms are involved, higher level management has little motivation to be excessively openhanded since the impact of junior salaries on their own pay is not likely to be important. There are large numbers of aspirants with similar backgrounds and experience (or lack of it) looking for jobs that are not too widely different. Information about the going rate is readily available and usually is employed. If there is in fact a danger, it is that the differences in productivity are insufficiently recognized and the inefficient are doing as well as the capable. In small, close corporations the market also gives fairly clear signals, though there is a danger that managers' self interest will not let those signals be heard. Some firms and even some industries do not manage their compensation practices well,[175] and other firms let the self-interest of factions and the desire to diminish the share of the Internal Revenue Service in the proceeds skew the compensation picture. The information and the institutional structures necessary to do a competent job of pay-setting are now available.

The market for executives at the lofty peaks occupied by the CEOs of the Fortune 500 does not seem to function as well as the other two. The sums are large and increasing faster than other salaries and inflation. One has no sense that they vary from firm to firm with any particular discernible pattern. The number of firms that can be used for comparison is very small. When one limits the comparison to the same industry, the same regional distribution, the same age and stage of growth, the same profitability history,

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175. *See, e.g.*, J.R Cauvin, A Critical Analysis of Current Executive Compensation Practices in the North American Lodging Industry (1979) (unpublished Cornell thesis).

one is apt to come up with only two or at the most a handful of benchmarks. Each of them is in turn affected by the surveyed and publicized behavior of the others.[176] The upward pressures not to spare relatively small sums on luring "the best" when a second rater might lead the firm to disaster, [177] not to upset close associates by haggling over their pay are difficult to resist. External restraints such as the product market and the securities market do not operate with sufficient precision to prevent extraordinary individual excesses. The variations between firms produced by the market are troubling. It is not that major differences in performance do not exist; the functioning of the market in tender offer situations and the folklore of "turn arounds" are strong evidence of that. The reader of lists of highly compensated executives, however, has no particular sense that the very wide variations at the top reflect thoughtful and objective judgments as to the contribution each CEO made to the success of his firm.[178] Nor is one particularly comforted by the findings that in general the compensation of executives varies with the profitability of their firms—there are many exceptions to that correlation and that finding does not answer the question of the executives' own contribution to company success or failure. Also troubling is the sense, heightened by an awareness of conditions that prevail abroad, that the overall effect of these individual upward movements is a ratcheting of the general top level compensation level to heights hard to justify.

Closely related, as we have also seen, to the overcompensation problem is the formula problem—on what basis should compensation be awarded. Clearly some plans are drafted in ways that produce undesirably lavish results, sometimes by what seems to be inadvertance. At other times, they turn out to skew the incentive path in ways that are not desirable. There is currently a good deal of concern that American incentive plans tend to focus the attention of managers too much on short run results. There are signs that business is itself moving to correct that by shifting the emphasis to long run

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176. It has been thought that the effect of surveys has been to tighten the link between firm size and compensation. *See supra* notes 72-99 and accompanying text. One can infer that "head hunting" firms also tend to exert upward pressures since they are interested in getting managers placed and because their compensation is a percentage of first year salary. Meyer, *Head Hunters Cast a Wider Net*, FORTUNE, Sept. 7, 1981, at 65, 66. Caution is suggested in the use of surveys in Patton, *Building on the Executive Compensation Survey*, HARV. BUS. REV., May-June 1955, at 84; Meyer, *Executive Compensation: Planning for New Directions*, MGMT. REV., Aug. 1980, at 45, 48. *Compare* Howe, *Price Tags for Executives*, HARV. BUS. REV., May-June 1956, at 94.

177. The importance of that stress on having the best in setting compensation for performers in the mass media is studied in Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981).

178. The evidence for the statement is necessarily largely impressionistic and anecdotal. On the 1978 list of the 25 most highly paid executives, BUS. WK., May 14, 1979, at 79, appeared the names of the chief executives of Norton Simon and of International Harvester, two executives of Ford and three of General Motors. By 1981, International Harvester was in desperate straits, a lawsuit over Norton Simon compensation had been settled, see note 110 *supra*, and much of the public was convinced that the management of America's automobile industry was responsible for its failure to match its Japanese competition. Redling, *Myth vs. Reality: The Relationship Between Top Executives Pay and Corporate Performance*, 13 COMPENSATION REV., 4th Quart. 1981, at 16, finds little evidence of a direct relationship between executive compensation and performance measured by earnings growth and return on investment. *See also* Albrecht & Jhin, *The Million Dollar Men*, BUS. HORIZONS, August 1978, at 9. Loomis, *The Madness of Executive Compensation*, FORTUNE, July 12, 1982, at 42. For earlier examples of unexplained differences between comparable firms, see Mautz & Rock, *supra* note 38, at 478-79.

plans, and it may be that the American focus on short run results has more to do with our greater instability of tenure, the greater reliance of firms on public stock market financing than on banking, and on other elements in our business culture.[179]

Are the market shortcomings identified above of sufficient significance to justify legal institutions spending their scarce resources on the problem? One recognizes that intervention into corporate activity ordinarily is at some cost to the efficiency of the business operation. In smaller corporations, the payment of excessive salaries is often a significant, directly felt monetary loss to the investors. Like all other harmful breaches of a fiduciary duty, such violations should be dealt with as effectively as may be. In large corporations, the identifiable harm to any one person is small. A very sizeable overpayment comes to pennies per shareholder. Nonetheless, the law does not ignore thefts of government funds that are almost totally invisible in the state or federal budget or cashier's embezzlements of a few thousand dollars in a bank with billions of assets. The law pursues these crimes, in part, simply because they are violations of the moral system. It takes into account the fact that each unrepressed departure sets an example for others so that the cumulative diversion of resources does become serious. In the case of peak executives in conspicuous corporations the exemplary effect may be very significant. The law needs to consider, however, more than just the signals directed to potential overreachers. The general factor known as "legitimacy" must be considered too.[180] The operation of corporations depends on the cooperation of many parties. Stockholders must buy and hold shares, employees must work, the voting public must at least tolerate a political climate within which corporations can function. Particularly when foreign examples indicate that high salaries are in a comparative sense not necessary and when all the other participants are being asked to tighten their belts, the legitimacy aspect of overcompensation should not be slighted.[181] While predominant public opinion will accept great inequalities if justified by the market and market-related concepts of what is earned and deserved, it is difficult to legitimize any amounts larger than that. In sum, the considerations of corporate legitimacy, integrity, and morale involved are important. They indicate that, even if in the overall economic scheme of things, the amounts of money involved are not of vast importance, the problem is worth expending effort on in order to keep it under control. These problems fall between the meshes of the relevant markets and must be consciously addressed by the responsible institutions.

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179. *See, e.g.*, Meadows, *New Targeting for Executive Pay*, FORTUNE, May 4, 1981, at 176-84. On the growth of long-term plans, see Cook, *Long-Term Incentives for Management*, 12 COMPENSATION REV., 2d Quart. 1980, at 18, 20.

180. For a recent view of corporate legitimacy in general see Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1627-29, 1647 (1981). The more specific question on the impact of pay on the sense of equity of other employees is dealt with in Salter, *What is "Fair Pay" for the Executive?*, HARV. BUS. REV., May-June 1972, at 6; E. JACQUES, EQUITABLE PAYMENTS (1961), is a classic.

181. That consideration evidently underlies the cuts in executive salaries imposed by such firms as U.S. Steel (Lueck, *U.S. Steel to Cut Pay of 20,000 Aides*, N.Y. Times, June 22, 1982, at D1, col. 6), Eastern Airlines, and International Harvester (BUS. WK., May 10, 1982, at 76). For a general protest against executive lavishness in a time of stringency see Green, *Richer Than All Their Tribe*, NEW REP., Jan. 6-13, 1982, at 21.

B. Recommended Action

The question then is who should do what to keep compensation from getting out of control. The first line of defense should be the institutions of the corporation itself, reinforced perhaps by the pressure from the legal system.[182] Self restraint must be the central factor. The burdens fall largely on the board of directors and on its compensation committee. The evidence from the past about the efficacy of disinterested boards is, as we have seen, ambiguous.[183] There is currently some movement in the field of corporate governance as a whole to formalize and make mandatory the trends towards outside boards and outside compensation (as well as audit and nominating) committees, which have become more common in recent years for a variety of reasons.[184] Compensation committees, if they insist on adequate preparation by the compensation staff of the corporation and use the comparative data and advice of compensation experts with cool detachment, potentially can keep the largest corporations more in line with each other. That will help even if they are not likely to exert much restraint on the general level of compensation. In the course of that effort, compensation committees may be able to get a better grip on the general function of setting corporate strategic goals and evaluating how well they have been met. Compensation committees have an advantage over other committees that have more abstract missions and are not required to give dollars and cents answers to questions about performance.

A possible second line of defense is at the shareholder level. Shareholders may be required to approve certain transactions, including compensation plans, and thus will receive information about those transactions. While the present rules have done much to improve the state of information about what is paid, more could be done to clarify the other side of the trade. It could be made clearer, in advance, what the corporation expects of its managers and what tests it will be applying as compensation is awarded. It could be made clearer, in retrospect, how what managers have accomplished compares to what it was hoped that they could do and how that comparison is handled in the administration of the plan. Better schemes for measuring option and other contingent benefit plans must be developed.

As a last resort we look to the courts. To them we allocate several tasks. The first is to see whether the internal institutions have done their allotted tasks with honesty and care. Another is to see that contingent schemes are not skewed so as to warp the judgment of management, about such decisions as resistance or cooperation in takeovers.[185] The schemes should preclude quan-

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182. Fama, *supra* note 16, at 293, suggests another restraint—that lower managers will monitor the upper ranks and prevent excessive compensation. That "mutiny on the Bounty" scenario seems highly improbable and the author knows of no anecdotal evidence of such events. There is no suitable mechanism for such a revolt save possibly an appeal to the board of directors. While one could envisage an appeal on the basis of inefficiency grounds, an appeal on grounds of overpayment is highly unlikely. The normal reaction would be to ask for an increase for oneself.

183. *See supra* note 91 and accompanying text.

184. American Law Institute, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.07 (Tent. Draft No. 1, 1982).

185. Thus, a compensation plan offered by an acquiring firm that assures managers of the target of as good or better terms after the takeover seems improperly to warp their judg-

titatively unjustifiable outcomes. Finally, courts need to understand that while judgments on the excessiveness of compensation are not easy to make, they are usually not impossible. The case law about small corporations, both from stockholder suits and internal revenue proceedings, indicates that it is usually possible to apply comparative data to the judgment of the appropriateness of compensation at that level. That is true even in corporation law cases where the indicia that tend to signal an intent to minimize taxes are not available. In the case of larger corporations and top executives the same factors that make judgments harder for boards tend to make them harder for courts as well. Nonetheless, courts can and should carefully scrutinize compensation that is substantially out of the line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them. If the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocketbooks and egos as much as the executives demand.

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ment. The opinion in Singer v. Magnavox, 380 A.2d 969 (Del. 1977), however, makes nothing of that point. On the other hand, agreements designed to assure incumbent managers better compensation, or that provide compensation if they are discharged or leave after a takeover may warp judgment in other ways. *See* Masters, *Execs' "Golden Parachutes" Await First Court Challenges*, LEGAL TIMES OF WASHINGTON, Nov. 2, 1981, at 1, col. 1.