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## The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?

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# The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?

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## I. THE "EXCESSIVE" EXECUTIVE COMPENSATION PROBLEM

Although the issue of "excessive" compensation for senior corporate executives is not new,<sup>1</sup> in recent years the problem of overindulging top corporate executives with annual million-dollar compensation packages<sup>2</sup> has received considerable attention.<sup>3</sup> Such factors as escalating

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1. In the years following the Great Depression, for example, President Franklin D. Roosevelt spoke of the "entrenched greed" of corporate executives making more than \$15,000 per year. As a result, the Securities and Exchange Commission began requiring corporations to disclose executive compensation to their shareholders. Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28-29.

2. In general, compensation packages of top corporate executives vary according to the particular needs of both the executive and the corporation. Ideally, an independent compensation committee establishes an executive's compensation package. Such packages typically include base salary, fringe benefits, perquisites, cash bonuses, long-term incentives such as stock options, and compensation for termination of employment (possibly in the form of golden parachutes). See generally GEORGE T. WASHINGTON & V. HENRY ROTHSCHILD II, COMPENSATING THE CORPORATE EXECUTIVE (3d ed. 1962); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991); ELLEN L. PAVLIK & AHMED BELKAoui, DETERMINANTS OF EXECUTIVE COMPENSATION (1991). Some compensation packages include other forms of nonfinancial incentives that are virtually impossible to value—prestige, challenge, and power. See Sidney Finkelstein & Donald C. Hambrick, *Chief Executive Compensation: A Synthesis and Reconciliation*, 9 STRATEGIC MGMT. J. 543 (1988).

3. This comment contains a nonexclusive catalogue of some of the more outspoken critics of

CEO salaries and a recessionary economy coupled with increasing lay-offs<sup>4</sup> has caused many to scream, "Unfair!"<sup>5</sup> Furthermore, because of the excessive sums being paid to American CEOs, foreign executives, particularly the Japanese, have questioned American competitiveness.<sup>6</sup> As a result, governmental bodies have made numerous attempts to address executive compensation, an issue typically reserved for the shareholders of a corporation.<sup>7</sup>

Critics see the salaries paid to senior executives as just too high.<sup>8</sup>

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"excessive" executive compensation. These commentators hail from a variety of settings, including the media, politics, investment organizations, corporations, and the American workplace.

4. Another factor that has brought the executive compensation dilemma to the forefront is the struggle for corporate control.

Now that the tender offer wave of the 1980s has subsided, institutional investors, who control on average over 50% of the voting stock of the largest U.S. corporations, cannot rely on raiders or takeover fears to "discipline" management. Instead, they promote various techniques—such as proxy rule reform, shareholder resolutions, and shareholder services groups—to gain access to the boardroom and make their positions known.

Brownstein & Panner, *supra* note 1, at 28.

5. *Id.* The problem of excessive executive compensation was highlighted when President Bush and his entourage of "overpaid, underperforming executives" traveled on a trade mission to Japan in January of 1992 to meet with their Japanese counterparts, who earned only a small percentage of the American executives' total compensation. See James R. Healey & Michelle Osborn, *Bush Contingent Takes Heat Over CEO Pay*, USA TODAY, Jan. 8, 1992, at B1 (quoting Professor Graef Crystal, an outspoken critic and expert in the field of executive compensation, who was referring to the 21 executives, including the CEOs of the "Big Three" automobile manufacturers, who accompanied President Bush); see also DEREK BOK, *THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA* 95 (1993); Jill Abramson & Christopher J. Chipello, *High Pay of Chief Executives Traveling With Bush Touches a Nerve in Asia*, WALL ST. J., Dec. 30, 1991, at A1.

6. Brownstein & Panner, *supra* note 1, at 28. Japanese executives argue that "huge pay lowers employee morale and reduces corporate savings." Healey & Osborn, *supra* note 5, at B1. The Japanese executive compensation system, however, has not escaped criticism. Some argue that "[l]ow pay in Japan fosters expensive gift-giving and lavish expense accounts. Some Japanese executives have even succumbed to taking kickbacks from suppliers and accepting sweetheart stock deals." Abramson & Chipello, *supra* note 5, at A6.

7. The problems associated with allowing corporate democracy to set executive compensation are discussed further in part II. For a complete discussion in the inherent problems in allowing corporate democracy to decide executive remuneration, see Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1 (1993).

8. In 1993, for example, Michael D. Eisner, chief executive officer of the Walt Disney Company, earned combined salary, bonus, and stock options of \$203,010,590. John A. Byrne, *That Eye-Popping Executive Pay: Is Anybody Worth This Much?*, BUS. WK., Apr. 25, 1994, at 52-53 (noting that Eisner's pay is nearly equal to the gross national product of Grenada); see also Steve Twoomey, *Slipping Virginia A Mickey*, WASH. POST, Jan. 24, 1994, at D1.

Eisner is not alone. For instance, in 1993, Joseph R. Hyde III, chief executive of Autozone, Inc., made over \$32 million, while Sanford I. Weill of Travelers Corp. made over \$52 million. Byrne, *supra*, at 53. In 1992, the winner of Forbes' annual survey of top executive pay was Thomas Frist, Chairman of Hospital Corporation of America. Frist's total compensation for 1992 was \$127 million. *What 800 Companies Paid Their Bosses*, FORBES, May 24, 1993, at 124.

"[T]here is a point at which compensation goes beyond what we normally think of as the cost of doing business, and moves into the range of executive greed and ego gratification."<sup>9</sup> Accordingly, these extravagant compensation packages have raised concern over whether an executive is really worth what the corporation pays him.<sup>10</sup> A 1991 study performed by compensation expert Professor Graef Crystal illustrated that the average CEO earned \$2.8 million per year in salary (\$1.4 million per year in salary and bonuses plus \$1.4 million in long-term incentives such as stock options).<sup>11</sup> While most Americans consider top corporate executives overpaid,<sup>12</sup> not all agree.<sup>13</sup> These extravagant salaries have even caused some to comment, "anyone who makes that kind of money must be doing something either illegal or immoral."<sup>14</sup>

Professor Charles Yablon recognizes two basic arguments for the proposition that corporations pay their CEOs too much: "unfair price" and "unfair process".<sup>15</sup> The "unfair price" argument maintains that "cur-

9. 139 CONG. REC. H2170 (daily ed. Apr. 29, 1993) (statement of Rep. Hoagland). Furthermore, in responding to the problem of "conspicuous compensation," Senator Baucus stated, "Our incomes are like our shoes, if two small they gall and pinch us, but if too large, they cause us to stumble and to trip." *Hearings on Executive Compensation Before the Subcomm. on Taxation of the Senate Comm. on Finance*, 102d Cong., 1st Sess. (1992), reprinted in 92 TAX NOTES TODAY 120-47 (1992), available in LEXIS, Fedtax Library, TNT file (quoting Charles Colten, an English clergyman) [hereinafter *Hearings on Executive Compensation*].

10. Gender-based discrimination in promoting and hiring top executives is beyond the scope of this comment. In reality, however, except for one woman who shares the position with her husband, all CEOs of *Fortune* 500 companies are male. *Women in Management: The Spare Sex*, *ECONOMIST*, Mar. 28, 1992, at 17. Thus, the remaining gender references in this comment shall be masculine.

11. CRYSTAL, *supra* note 2, at 27-28. Crystal notes that the figures do not even accurately account for the magnitude of the problem. Many CEOs receive far more than the average total compensation. *Id.* at 28. Furthermore, the \$2.8 million compensation figure does not include the "values for perquisites and for both regular and supplemental fringe benefits—such as pension and profit-sharing plans, and life and medical insurance coverages." *Id.* at 204-05.

A *Business Week* survey noted that in 1992, the average CEO of a large corporation earned more than \$3.8 million. However, this figure is inflated due to the value of stock options exercised in a response to President Clinton's efforts to reform the income tax laws. John A. Byrne, *Executive Pay: The Party Ain't Over Yet*, *BUS. WK.*, Apr. 26, 1993, at 56-57.

12. In fact, a Gallup Poll conducted in 1990 revealed that the actual percentage of Americans who considered executive pay "too much" was 71 percent. Jay Schmiedeskamp, *Majority of Americans Think That Top Officials Are Overpaid*, *GALLUP POLL MONTHLY*, Dec. 1990, at 21-22.

13. For example, professor Kevin Murphy of the Harvard Business School maintains that top executives deserve their compensation. Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, *HARV. BUS. REV.*, Mar.-Apr. 1986, at 125. Professor Murphy argues that CEO compensation is strongly correlated to corporate performance, that incentive plans benefit shareholders, and that a shift toward long-term incentive plans such as stock options "links compensation closely to shareholder wealth and motivates managers to look beyond next quarter's results." *Id.*

14. Brownstein & Panner, *supra* note 1, at 29.

15. Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1871 (1992) (book review of GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1991)).

rent levels of executive compensation are dramatically out of line with some relevant basis of comparison."<sup>16</sup> Three of the more widely mentioned bases for comparison are: (1) comparing the executive compensation with that of the average worker;<sup>17</sup> (2) comparing American

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16. *Id.*

17. *Id.*; see also CRYSTAL, *supra* note 2, at 27 (discussing the increasing ratio of CEO pay to average worker pay). Proponents of executive pay reform recognize the "increasing divide between the most highly-compensated in our economy and the average American." *Hearings on Executive Compensation*, *supra* note 9 (statement of Sen. Boren). During the 1980s, for example, CEO compensation rose 75% in real terms while the average real wage for American workers declined. *Id.* In addition, a *Business Week* survey noted that in 1980, a CEO earned approximately 42 times the pay of a factory worker. John A. Byrne, *What, Me Overpaid? CEOs Fight Back*, BUS. WK., May 4, 1992, at 143. In 1991, this ratio had increased to approximately 104 times. *Id.*; see also *Hearing on Executive Compensation*, *supra* note 9 (noting the ratio of CEO pay to average worker pay had increased from 35-100 in ten years); CRYSTAL, *supra* note 2, at 27 (same). In 1993, the average CEO earned nearly 150 times that of an average factory worker. Byrne, *supra* note 8, at 55.

Senator Boren probably best expressed the "populist" viewpoint when he described the consequences of a widening gap between the economic classes.

As incomes and lifestyles become increasingly divergent, the sense of community, the feeling that all Americans are working together as one team in a common effort to improve the economy and our society for ourselves and for future generations, is lost. Instead, the average worker feels alienated, permanently excluded from the American dream that is a reality for fewer and fewer of our citizens.

*Hearings on Executive Compensation*, *supra* note 9.

Professor Crystal describes how U.S. tax policy during the 1970s and 1980s helped to spread the wage gap between executives and average laborers:

The total tax load on highly paid executives has declined substantially at the same time that the total tax load on the average worker has increased—though only by a little. The result is that . . . the pay of the average worker, expressed in inflation-discounted dollars and adjusted for taxes, has dropped around 13%, whereas the pay of the average CEO of a major company, also expressed in inflation-discounted dollars and adjusted for taxes, has risen more than four times.

CRYSTAL, *supra* note 2, at 27. In addition, Professor Crystal provided a brief history of the philosophical debate over the worth of one's labor.

Plato told Aristotle that no one in a community should earn more than five times the pay of the lowest-paid worker. . . . During the Middle Ages, Catholic philosophers were caught up in debates over the doctrine of just price, which rested on a belief that there was a divine justification for why one type of labor commanded more pay than another. . . . At the end of the nineteenth century, J.P. Morgan decreed that chief executives of the Morgan enterprises should not be paid more than twenty times the pay of the lowest worker in the enterprise. (Of course, he may have had a method to his madness, because by keeping a lid on executive pay, he successfully lowered costs and increased profits. And guess who owned all the shares?)

*Id.* at 23-24.

In order to combat the widening pay-gap problem, Representative Martin Sabo of Minnesota sponsored legislation which would have limited the tax deductibility of executive salaries to 25 times the salary of the lowest paid worker. Income Disparities Act of 1991, H.R. 3056, 102d Cong., 1st Sess. (1991). However, Congress did not adopt this particular method to address the problem of executive compensation. Instead, Congress opted for the current provision generally limiting the deductibility of executive remuneration to \$1 million. 26 U.S.C. § 162(m) (Supp. V 1993).

executives' compensation with that of their foreign counterparts;<sup>18</sup> and (3) comparing the executive's compensation to sports figures, entertainers, and professionals such as attorneys and investment bankers.<sup>19</sup> Indeed, only a brief glance at these three statistical comparisons, particularly the first two, indicate that the executive compensation process needs drastic reform.

The second argument that Professor Yablon introduces is the "unfair process" argument.<sup>20</sup> This argument asserts that CEOs, and the corporate boards of directors who generally set their pay,<sup>21</sup> do not par-

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18. Yablon, *supra* note 15, at 1872. The gap between compensation for upper management and compensation for the average worker in the United States is significantly greater than in other countries which compete with the United States in the international economic environment. See generally CRYSTAL, *supra* note 2, at 204-13. For example, CEOs in Japan, one of the United States' staunchest economic competitors, earn only approximately 17 times that of an average worker. In Germany, that ratio is approximately 23 times. See *Hearings on Executive Compensation*, *supra* note 9 (Statement of Sen. Boren). Because of the greater disparity in the United States between upper management's compensation and the average worker's compensation, foreign executives perceive the United States as less competitive. See *supra* notes 5-6 and accompanying text.

A recent example of a major U.S. corporation helping to expand the chasm between the compensation of senior management and that of the average worker is Northwest Airlines. In 1993, Northwest rewarded its top five executives with bonuses totaling more than \$2.3 million. That same year, Northwest Airlines threatened to file for bankruptcy protection if workers did not accept wage concessions. John Dasburg, Northwest's president and chief executive officer, earned more than \$1.6 million in pay and bonuses during the year. Included in the \$1.6 million compensation package was a \$750,000 bonus for getting the workforce to accept pay cuts. *Northwest Gave Hefty Bonuses*, MIAMI HERALD, Feb. 25, 1994, at 3C. In addition, these figures do not include potential benefits from a stock option plan. *Id.* Thus, although the United States prides itself on having one of the only free capitalist economies in the world and generally allows individuals to price their labor on what it is worth in a "free" marketplace, many feel that some mechanism, whether it be government run or not, should control excessive pay practices in order to stifle the widening economic class gap.

19. Yablon, *supra* note 15, at 1872. Some of the more highly compensated CEOs often attempt to justify their exorbitant compensation with comparisons to celebrities such as Michael Jordan, Michael Jackson, or Barbara Streisand. Professor Carl Bogus argues that a more proper comparison would be made between the CEO and the star's manager or agent. Bogus, *supra* note 7, at 7 n.30.

Despite intense debate in Congress over whether the new amendment to section 162 of the Internal Revenue Code, section 162(m), should include sports all entertainment stars, partners in partnerships, and anyone who does not qualify as a "covered employee" of a "publicly held corporation," the enacted provision only includes the CEO and the four highest paid executives of a public corporation. See, e.g., 139 CONG. REC. H6125 (daily ed. Aug. 5, 1993) (statement of Rep. Livingston regarding constituent dissatisfaction with exempting entertainment and sports stars from the \$1 million limitation); 139 CONG. REC. E2460 (daily ed. Oct 15, 1993) (statement of Rep. Solomon discussing the "Friend of Bill Loophole").

20. See Yablon, *supra* note 15, at 1872.

21. Ideally, "independent" directors set CEO pay in accordance with their fiduciary duty owed to the shareholders. In reality, though, the board of directors establishes a compensation committee, consisting of both inside and outside directors, which sets the pay of corporate management. See generally Jaclyn Fierman, *The People Who Set the CEO's Pay*, FORTUNE, Mar. 12, 1990, at 58. However, this system creates several conflicts of interest because the CEO of the

ticipate in "arm's length" negotiations in arriving at a "fair and appropriate" price.<sup>22</sup> Senator Lloyd Bentsen acknowledged that the main problem with the executive compensation determination process lies with the lack of management accountability. "The problem of executive pay points to the larger issue. American corporations are too often managed by executives who are not directly accountable to shareholders and workers but to directors who they typically select themselves. And that lack of accountability makes American companies insular and less competitive internationally."<sup>23</sup> Essentially, CEOs set their own salaries through the use of a submissive board of directors as well as clever compensation consultants who draft compensation packages around the various restraints established for curbing excessive pay.<sup>24</sup> In sum, the lack of management accountability gives rise to a process "relatively unconstrained by market forces or arms-length bargaining"<sup>25</sup> by which corporations disburse "excessive" pay to its executives.

Another problem closely related to Yablon's "unfair process" argument is the surprising reality that the level of CEO pay often lacks any correlation to the company's overall performance.<sup>26</sup> "The American

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corporation frequently nominates these directors. See Bogus, *supra* note 7, at 34. Thus, the directors may feel obligated to "pay back" the CEO with a hefty compensation package. In fact, the CEO and the directors who set his pay might even be friends. Fierman, *supra*, at 58 ("Yet another, oh-so-subtle factor that impinges on the objectivity of many corporate paymasters: They have the tricky task of setting salaries for their peers, who, more often than not, are their friends."). In addition, corporate directors are often top executives of other companies. Therefore, they may have an incentive to increase the market value of CEO labor. In fact, some executives sit on each other's compensation committee. *Id.* at 58 ("Committee members gauge the reasonableness of a CEO's salary against their own.") (quoting professor Charles O'Reilly, an organizational psychologist at the University of California at Berkeley). Furthermore, corporate directorships have become very lucrative positions as directors typically are paid more than \$32,000 annually. Bogus, *supra* note 7, at 35. Consequently, these potential conflicts raise obvious concerns about the fairness of the process for determining executive pay and about the ability of directors to fulfill their fiduciary duties to shareholders. For an in depth analysis of corporate law solutions to "excessive" compensation, see *infra* part II.B.

22. Yablon, *supra* note 15, at 1872. Professor Yablon further explains what is meant by "arm's length" bargaining:

The point of such arguments is to show that the price was arrived at under circumstances *approaching* perfect competition, a blessed state involving, among other things, perfect information, large numbers of buyers and sellers, and product homogeneity. In such a market no individual buyer or seller has any power to influence price.

*Id.* at 1872 n.11 (citation omitted).

23. 138 CONG. REC. S14866 (daily ed. Sept. 24, 1992) (statement of Sen. Bentsen).

24. See generally CRYSTAL, *supra* note 2. Professor Yablon addresses the role of the corporate lawyer and how this role renders ineffective the existing compensation limitations. Yablon, *supra* note 15, at 1867, 1883-84.

25. *Id.* at 1874.

26. See, e.g., Graef S. Crystal, *The Wacky, Wacky World of CEO Pay*, FORTUNE, June 6, 1988, 68; Bok, *supra* note 5, at 106-08. But see Brownstein & Panner, *supra* note 1, at 31

public is tired of seeing executives make many, many millions of dollars a year when the stock price goes down, the dividends are cut, and the book value is reduced' . . . and 'the only one who gets the short end of the stick is the shareholder.'"<sup>27</sup> According to a study of 200 corporations, executive compensation rose 9.4 percent while the median stock price of the same corporations actually fell 7.7 percent.<sup>28</sup> Professors Michael Jensen and Kevin Murphy assert that the lack of correlation between the performance of the company and the CEO's pay is a result of the reluctance of the board of directors to link a CEO's pay to performance. This risk aversion, Jensen and Murphy argue, results from "uninvited but influential guests at the managerial bargaining table (the business press, labor unions, political figures)" who protest the level of CEO compensation, not the manner in which CEOs are paid.<sup>29</sup> There is something blatantly immoral about a company whose performance has declined, but yet continues to shower its top management with considerable pay raises.<sup>30</sup>

The problem of "excessive" compensation has become such an enormous problem that it appears no one knows the appropriate mechanism for its ultimate control. In the past, the only check on the level of executive compensation was the shareholders who could bring a derivative suit against the corporation under the corporate waste doctrine, lobby the board of directors to lower executive pay, or simply sell their

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("Taken out of context, any pay plan will appear nonsensical and unfair. But when viewed in the proper business context, the relationship between pay and performance reemerges.").

27. John A. Byrne, *Executive Pay*, BUS. WK., Mar. 30, 1992, at 52 (quoting Stanley C. Gault, chairman of Goodyear Tire & Rubber Co.).

28. Graef S. Crystal, *How Much CEOs Really Make*, FORTUNE, June 17, 1991, at 73. Some commentators assert, however, that while salaries have increased dramatically over the past several years, the rise in executive compensation results from a desire in the 1980s to pay executives for their performance through stock-based compensation plans. Brownstein & Panner, *supra* note 1, at 31.

29. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 139. Jensen and Murphy also argue that if CEO pay were more directly linked to corporate performance, average CEO compensation would rise. *Id.*

30. During the presidential election race of 1992, President Bill Clinton (then Governor Clinton) stated:

It's wrong for executives to do what so many did in the 1980s. The biggest companies raised their (CEOs) pay by four times the percentage their workers' pay went up and three times the percentage their profits went up. It's wrong to drive a company into the ground and have the chief executive bail out with a golden parachute to a cushy life. For America to be competitive, there must be a stronger link between pay and their performance. An important part of this link is making management more accountable to shareholders.

*Presidential Candidates Divide on Executive Compensation Caps*, 24 SEC. REG. & L. REP. (BNA) No. 42, at 1634 (Oct. 23, 1992).



stock.<sup>31</sup> In recent years, this heightened concern over executive pay inequities has prompted numerous legislative, regulatory, and judicial efforts at governing compensation determinations. Moreover, shareholder groups such as the United Shareholder's Association and large institutional investors such as the California Public Employees' Retirement System (CalPERS) have become involved in the struggle to tame corporate pay abuses. In addition, the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the Internal Revenue Service (IRS) have also joined the battle. The evidence shows that these efforts have begun to influence compensation decisions in the corporate boardrooms.<sup>32</sup>

The ultimate purpose of this Comment is to compare and contrast the effectiveness of the two regulatory regimes for controlling executive pay: (1) the enhanced disclosure requirements of the SEC and FASB along with improved shareholder participation in compensation decisions, and (2) sanctions against the corporation through the use of the federal income tax code. Part II of this Comment briefly discusses the availability of market restraints on compensation as well as the different corporate law restraints that exist for controlling unreasonable compensation for corporate executives including the corporate waste doctrine and the business judgment rule. Part III introduces the different regulatory schemes currently in place, including the new disclosure rules of the SEC and the proposed rules of the FASB, as well as the newly enacted limitation on the tax deductibility of "excessive" executive compensation in the Internal Revenue Code. Part IV provides additional commentary on the new regulatory schemes in the form of a comparative analysis to determine whether both, either, or neither schemes are necessary. Moreover, Part IV emphasizes the comparison between an informational approach to the executive compensation problem and a penalty-oriented approach. Finally, Part V concludes that even with the existing systems which attempt to place some type of limitation on over-compensation, in fact, any well-advised corporate compensation decisionmaker can easily circumvent the existing compensation restraints and pay excessive compensation.

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31. See *infra* part II.B.

32. See Byrne, *supra* note 11, at 56.

It may finally be happening: The mounting controversy over the growing paychecks of America's CEOs—not to mention the finger-pointing at complacent directors—seems to be goading many boards into action. Directors are devoting more time to the issue of compensation, often challenging the assumptions that lie behind the pay packages, demanding that they be linked to performance, and . . . hiring outside consultants. Some boards, consultants say, have even eliminated stock-option grants this year, while many others have cut the size of such awards.

*Id.*

## II. EXISTING STATE CORPORATE LAW RESTRAINTS ON EXECUTIVE PAY

Before detailing the recent legislative and regulatory attempts at improving corporate compensation decisions, this Comment discusses other existing restraints shareholders may rely upon to control the "excess." First, this Part explains the underlying reason that market forces alone do not suffice as adequate restraints on compensation. Next, this Part provides an overview of the state corporate law mechanisms for handling executive pay practices and discusses the increasing role of large shareholder groups in reforming corporate governance.

### A. "Free" Labor Market

Like all other contracts, wages should be left to the fair and free competition of the market and should never be controlled by the interference of the legislature.<sup>33</sup>

This statement reflects the expectation that in a free-market economy, individuals would negotiate their labor's worth based upon what the market could afford to pay.<sup>34</sup> Professor Derek Bok took a utopian view while reflecting upon the way in which corporations would set CEO pay in an idealistic society:

In the perfectly competitive world so dear to classical economists, all chief executives would receive amounts approximating what they added to the net profits of their company. Firms that could benefit the most from inspired leadership would pay the most money to the CEO of their choice. Because everyone in this world is perfectly informed, such companies would proceed unerringly to identify the best chief executives and offer them more than they were currently earning. The latter, being motivated primarily by love of money, would happily agree to serve. In this way, the greatest talent would move automatically to the firms in which it could do the most good, resources would be utilized more productively, and everyone would benefit as a result.<sup>35</sup>

This idealistic scenario, though, does not exist. Professors Berle and Means recognized that the market can not adequately safeguard against the inherent conflict between ownership and management within a pub-

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33. Byrne, *supra* note 27, at 53 (quoting David Ricardo, 1817).

34. In fact, supporters of the current high level of executive pay defend these levels as simply "being . . . the equilibrium reached by the operation of 'the market.'" Detlev Vagts, *Challenges to Executive Compensation: For the Market or the Courts?*, 8 J. CORP. L. 231, 234 (1983). Professor Vagts asserts that the executive labor market consists of three related markets: the labor, product, and capital markets. *Id.* at 234-40.

35. Bok, *supra* note 5, at 96.

lic corporation.<sup>36</sup> Consequently, management's desire for more compensation, along with its influence in compensation-related decision making, raises the need for some restraints on the "free" market.

The reluctance of the courts to find executive compensation unreasonable or excessive, however, might reflect a general acceptance of the market's ability to avoid compensation excesses.<sup>37</sup> Nevertheless, despite assertions that "the market works well enough over time and that nothing is so amiss that further legislation or regulation is needed,"<sup>38</sup> both the federal and state governments, responding to "populist" sentiment, have acted and enacted so that this "free" labor market economy for top corporate executives does not exist. The remainder of this Comment examines the various mechanisms for controlling executive compensation that have rid the United States' executive labor market of its "freedom" to contract through unhindered negotiation.

### B. *Corporate Governance, the Rise of Institutional Investors, and the Role of the Courts*

Defects in the compensation decision process generally result from management's participation in preparing its own compensation packages.<sup>39</sup> Typically, with the assistance of an outside compensation expert, CEOs formulate compensation packages to be submitted to the compensation committee that will, based upon artfully compiled (pro-management) market data, satisfy almost everyone.<sup>40</sup> According to most

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36. Berle and Means enunciated the need for separating ownership and control not only with regard to compensation decisions, but for others as well. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

Professor Vagts attempted to explain the conflict between management's goals (perhaps to increase compensation) and the owners' goals (to increase shareholder wealth). Vagts, *supra* note 34, at 235 ("The separation of ownership and management 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.").

37. For a discussion of courts unwillingness to criticize compensation decisions, see *infra* part II.B.

38. Bevis Longstreth & Nancy Kane, *Shareholders' Growing Role in Executive Compensation [Part I]*, N.Y.L.J., Feb. 20, 1992, at 5.

39. CRYSTAL, *supra* note 2, at 42-50.

40. *Id.* Professor Crystal attempts to explain the absurdity of the process:

A lot of rationalization goes on, and a lot of high-priced talent is retained to prove a conclusion that the CEO has already made. The compensation committee, because it meets so infrequently and has no independent counsel, becomes a willing accomplice. And everybody wins. The CEO gets a raise, the compensation consultant gets his bills paid, and the compensation committee goes home feeling good that it is paying for performance or keeping good people or both. Or almost everybody wins. Everybody but the shareholders.

*Id.* at 50.

state corporation laws, a committee consisting of the board of directors<sup>41</sup> establishes the compensation of senior executives,<sup>42</sup> keeping in mind the best interests of the corporation and its shareholders.<sup>43</sup> Based upon the traditional separation of ownership and management theory of corporate law,<sup>44</sup> shareholders generally may not participate in ordinary business decisions of a public corporation, including executive compensation determinations.<sup>45</sup>

Nonetheless, shareholders of large public corporations have several alternative means, both internal and external, to regulate "excessive" executive compensation. Perhaps the most effective internal control over compensation policies is the ability to elect independent directors.<sup>46</sup>

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41. One author notes that "[t]oday about 90% of public companies have compensation committees, and most face a structural dilemma. The CEO, whose pay the committee sets, sits on both sides of the table. That's because 76% of board chairmen are also CEOs." Fierman, *supra* note 21, at 66.

42. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1993) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); see also *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (compensation decisions are within the decisionmaking authority of the board of directors); Bevis Longstreth & Nancy Kane, *Shareholders' Growing Role in Executive Compensation [Part II]*, N.Y.L.J., Feb. 27, 1992, at 5.

Because the board of directors is generally responsible for the management of the corporation, the Delaware General Corporation Law appears to provide the board with the authority to set executive pay. See DEL. CODE ANN. tit. 8, § 122(5) (1993) (The corporation may "[a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation."); DEL. CODE ANN. tit. 8, § 122(15) (1993) (providing that the corporation may authorize certain benefit plans).

Unless otherwise stated, references to state law in this comment will cite Delaware law because virtually all consider Delaware the harbinger of corporate law development.

43. A director owes a fiduciary duty to the corporation and its stockholders and may not divert business opportunities to himself that are intended for the corporation. See *Loft, Inc. v. Guth*, 2 A.2d 225 (Del.Ch. 1938), *aff'd*, 5 A.2d 503 (Del. Super. 1939).

44. See generally BERLE & MEANS, *supra* note 36.

45. Longstreth & Kane, *supra* note 38, at 5 ("Executive compensation decisions traditionally have been viewed as ordinary business decisions, and as such, absent special charter or by-law provisions to the contrary, have been placed by state law solely under the authority of the board of directors. Thus, shareholders have no authority to set executive compensation directly."); see also *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934). But see Longstreth & Kane, *supra* note 42, at 5, noting that New York Business Corporation Law § 505(d) requires that "the issue of rights and options to purchase shares to directors, officers or employees of the corporation or of a subsidiary or affiliate, as an incentive to service or continued service must be authorized by the shareholders or pursuant to a plan authorized by the shareholders."

46. In fact, the most widely accepted reform mechanism involves the "facilitat[ion of] the election of directors thought to be both sufficiently independent and creative to implement rational and efficient compensation plans." Longstreth & Kane, *supra* note 38, at 5.

However, there are several obstacles to shareholder action in combating excessive pay. First, it is generally cheaper and more efficient to sell stock in the corporation than to reform the corporate pay practices (otherwise known as the "Wall Street Rule"). Bogus, *supra* note 7, at 41. In addition, because of the widely dispersed nature of corporate ownership, shareholder involvement in internal corporate reform through concerted shareholder voting power is almost impossible. *Id.* Finally, because compensation inequities are "nothing more than the proverbial

Moreover, shareholders may potentially influence executive compensation decisions by amending the corporation's by-laws<sup>47</sup> so long as the function of the board of directors is not "sterilized."<sup>48</sup> The emergence of large institutional investors, particularly large pension funds, as well as the rise of active shareholder movements, such as the United Shareholders Association, has had a significant impact upon directors' executive compensation decisions.<sup>49</sup> For example, the California Public Employees Retirement System, a pension fund which owns approximately one percent of each publicly traded major corporation in the United States,<sup>50</sup> caused both W.R. Grace & Company and ITT Corporation to adopt by-law amendments calling for the creation of internal compensation committees.<sup>51</sup>

In addition to the internal corporate solutions, a few successful challenges to executive self-dealing<sup>52</sup> have been external—through the

flea on the elephant's back" in large public corporations, there is no incentive for shareholders to act. *Id.*

47. See, e.g., DEL. CODE ANN. tit. 8, § 109(a) (1993). For an more intensive look at the state corporate law and federal securities law issues arising with regard to shareholders affecting "ordinary business decisions" by amending the corporation's by-laws, see Longstreth & Kane, *supra* note 42, at 6.

48. *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918); see also *Long Park Inc. v. Trenton-New Brunswick Theatres Co.*, 77 N.E.2d 633, 635 (N.Y. 1948).

49. See John A. Byrne, *The Flap Over Executive Pay*, BUS. WK., May 6, 1991, at 95.

50. See Longstreth & Kane, *supra* note 38, at 5. Another example of institutional shareholder influence upon corporate governance involved the New York City pensions funds. These funds sponsored shareholder resolutions at Bally Manufacturing, W.R. Grace, Polaroid, and USF&G, calling for compensation committees consisting solely of independent, outside directors with access to their own outside compensation consultants. *Linking Pay To Performance Without the Fuss*, BUS. WK., June 7, 1993, at 7 (letter from Elizabeth Holtzman, Comptroller for the City of New York); see also Richard A. Melcher, *Yankee-Style Activists Strike Boardroom Terror Abroad*, BUS. WK., Mar. 15, 1993, at 74.

51. See Longstreth & Kane, *supra* note 42, at 6.

52. Shareholder charges of self-dealing occur when an executive has significant power within a corporation to strongly influence, or simply approve, his own compensation package. See BERLE & MEANS, *supra* note 36, at 122-24, 345-55. Other types of self-interested transactions involving the corporation and a director include negotiating and forming contracts with interested directors and corporate opportunities. See generally Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997 (1988). The Berle-Means tension between ownership and management is most apparent when the parties' financial interests are in opposition. Management's primary interest is maximizing its own wealth through attractive compensation packages, while the shareholders' main concern is maximizing shareholder wealth through either stock appreciation or dividend income. See, e.g., Paul Starobin, *Feeding at Capitalism's Trough*, 23 NAT'L J., June 8, 1991, at 1369.

Professor Robert Clark maintains that in order to satisfy the disinterested director requirement, the CEO should not only decline to vote on his own compensation package, but should simply not attend the meeting. ROBERT C. CLARK, *CORPORATE LAW* § 6.1, at 194 (1986).

Professor Bogus noted that Berle and Means would disapprove of present day corporate pay practices:

They would find that the driving force among those responsible for the nation's largest corporations is avarice, not social responsibility. They would find that

courts. Where charges of self-dealing exist, courts are more likely to sustain executive compensation plans where (1) the interested executive makes full disclosure of the plan and either a committee of disinterested directors<sup>53</sup> or the shareholders approve the compensation, and (2) the plan is fair to the corporation.<sup>54</sup> As long as these requirements are met, a court's examination of whether the directors have complied with the duties of loyalty and care will be subject to the pro-management business judgment rule.<sup>55</sup>

Even if disinterested directors approve or the shareholders ratify a particular compensation plan, courts may still strike it down as violating the corporate waste doctrine. In 1933, the Supreme Court decided *Rogers v. Hill*,<sup>56</sup> the landmark case for shareholder challenges to excessive compensation plans. The *Rogers* Court held that even though the shareholders apparently supported the compensation scheme by allowing it to continue for several years, the shareholder approval "cannot, against the protest of a shareholder, be used to justify payments of sums as salaries so large as in substance and effect to amount to spoilation or waste of corporate property."<sup>57</sup> But courts are generally unwilling to find a com-

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shareholders behave more like casino gamblers than business owners; that directors are given large fees and perks to keep them quiescent; and that managers live more like princes than Berle and Means ever dreamed was possible. They would tell us that, by making them rich, we have perverted the values of corporate managers.

Bogus, *supra* note 7, at 4 (citation omitted).

53. For a discussion of some of the assumptions that must be made when characterizing a director as "disinterested," see sources cited *supra* note 20.

54. See Eisenberg, *supra* note 52, at 997-98. Professor Eisenberg believes such self-interested compensation decisions are treated differently and often more leniently than other self-interested transactions because of the difficulty in ascertaining a market value for executive labor and because such transactions are unavoidable. *Id.* at 1006.

55. *Id.*; see, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812-13 (Del. 1984); *Beard v. Elster*, 160 A.2d 731, 738 (Del. 1960); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983).

According to the American Law Institute:

A director or officer who makes a business judgment in good faith fulfills his duty [of care] if:

- (1) he is not interested in the subject of his business judgment;
- (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
- (3) he rationally believes that his business judgment is in the best interests of the corporation.

PRINCIPLES OF CORP. GOVERNANCE § 4.01(c) (ALI) (Tentative Draft No. 4, 1985), *reprinted in* WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS* 488 (6th ed. 1988).

56. 289 U.S. 582 (1933). *Rogers* involved a suit by a shareholder seeking restitution against the American Tobacco Company, asserting that the compensation paid to some of its top six executives was unreasonable. The compensation plan in question was ratified by the shareholders and involved an incentive pay system whereby the executives earned a percentage of the corporation's profits above a certain figure. Over the years, the shareholder never modified the compensation scheme, and, as a result, as corporate profits rose, so did the executives' bonus. *Id.* at 590-91.

57. *Id.* at 591. The Court stated that "[i]f a bonus payment has no relation to the value of

pensation scheme unreasonable because of the lack of appropriate guidelines to judge whether an executive's remuneration results in corporate "waste."

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 this 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 no reason for eschewing it. . . . It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints 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.<sup>58</sup>

Consequently, reliance upon internal corporate procedures, particularly shareholder influence, as well as executive-market restraints, is the only sensible corporate law control on excessive compensation.

### III. REGULATORY AND LEGISLATIVE RESTRAINTS ON COMPENSATION

The recent uproar over "excessive" pay has probably caused many to feel that neither the executive market, internal corporate procedures, nor the courts were effective mechanisms, by themselves, for controlling executive compensation. Regulatory bodies such as the SEC, FASB, and the IRS were the obvious choices for reforming compensation practices in large publicly traded corporations. As a result of the recent commotion, two regulatory regimes have emerged: (1) enhanced disclosure, and (2) increased sanctions.

Although both evolved out of the same "populist" outrage, the rationale behind the two regulatory approaches is quite different. The purpose of the improved disclosure rules is "to furnish shareholders with a more understandable presentation of the nature and extent of executive

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services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority." *Id.* at 591-92.

58. *Heller v. Boylan*, 29 N.Y.S.2d 653, 679 (N.Y. Sup. Ct. 1941), *aff'd*, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941). The court further stated that "[c]ourts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province. Courts are concerned that corporations be honestly and fairly operated by its directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders." *Id.* at 680.

compensation.”<sup>59</sup> Conversely, under the sanctions approach, the IRS imposes a penalty upon the corporation for the compensation decisions of its board that do not comply or conform to a statutorily created level of frugality. Even though the two regimes take separate approaches to curbing executive pay abuses, only the enhanced disclosure approach has received more than a modest level of support. Under this approach, authority shifts to the shareholders, not the government, to control corporate executive compensation decisions. Part IV of this Comment further compares and contrasts the effectiveness of the coexisting regulatory regimes.

#### A. *Disclosure Reform—SEC and FASB*

Responding to criticism of excessive corporate executive pay practices, Securities and Exchange Commission Chairman Richard Breeden established a “three-part SEC initiative on executive compensation” in February of 1992.<sup>60</sup> The first part of the SEC’s plan required corporations to include in their proxy materials shareholder advisory proposals on executive compensation questions which were previously excludable as “ordinary business operations” of the company.<sup>61</sup> Breeden stated that the purpose of this modification of proxy policy would “bring a market solution to a market problem, by allowing the affected private sector groups—management, directors and shareholders—to resolve the compensation questions in each company . . . without government regulation.”<sup>62</sup> Secondly, Chairman Breeden announced a plan to enhance the disclosure requirements of the corporation’s executive’s compensation in order to make it easier for shareholders to determine exactly what an executive earns and why he earned it.<sup>63</sup> Finally, the SEC began a study of the sufficiency of the accounting standards for reporting stock-option grants.<sup>64</sup> In October of 1992, the SEC ultimately adopted two sets of rule changes: (1) facilitating shareholder communication about corporate voting matters;<sup>65</sup> and (2) giving shareholders unambiguous disclosure about the compensation of their top executives.<sup>66</sup>

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59. 57 Fed. Reg. 48,126 (1992).

60. *Breeden Announces SEC Initiative on Executive Compensation Issues*, 24 Sec. Reg. & L. Rep. (BNA) No. 8, at 223 (Feb. 21, 1992) [hereinafter *Breeden Announcement*].

61. Longstreth & Kane, *supra* note 42, at 7; see also *Breeden Announcement*, *supra* note 60, at 223.

62. *Id.*

63. *Id.* This change was necessary, Breeden said, because the old disclosure of executive compensation was an “impenetrable, legalistic narrative.” *SEC Adopts Proxy Reforms After Long Study, Debate*, 61 U.S.L.W. 2234 (BNA) (Oct. 27, 1992).

64. *Breeden Announcement*, *supra* note 60, at 223.

65. See 57 Fed. Reg. 48,276 (1992).

66. *SEC Adopts Proxy Reforms After Long Study, Debate*, *supra* note 63, at 2235. For the



The "shareholder communication" changes to the SEC proxy rules allow easier communication among shareholders and thus provide more opportunity for concerted action by shareholders by providing that certain matters submitted for shareholder vote are exempt from some proxy solicitation requirements.<sup>67</sup> In addition, the changes facilitate shareholder ability to vote for independent directors who ultimately make the compensation decisions.<sup>68</sup> Also, the rules require companies seeking proxies to "unbundle" propositions set for a shareholder vote, whereas, prior rules forced shareholders to vote for a bundle of propositions, some of which they opposed.<sup>69</sup> Thus, the "shareholder communication" changes were promulgated in an attempt to make the directors who set executive compensation more accountable to shareholders.

In addition to the changes in the SEC's proxy rules regarding shareholder communication, the SEC issued changes in its executive compensation disclosure requirements in order to improve shareholders comprehension of executive compensation plans. The SEC's reform in this area was prompted by the desire for better information. "Most proxies don't give a clear picture of exactly what the CEO stands to gain or what goals he must meet to earn his bonus. Corporate lawyers have turned proxy obfuscation into an art, keeping shareholders and the competition in the dark. The SEC should demand better."<sup>70</sup>

The SEC responded to this problem with radical disclosure reform. Some experts feel the reforms are actually working.<sup>71</sup> The executive compensation disclosure rules consist of five principal components: (1) a "Summary Compensation Table" providing an overview of compensation paid to the CEO and the four highest paid officers; (2) a report by the compensation committee of the board of directors explaining the corporate performance factors relied on in making compensation decisions; (3) several tables delineating the details and values of long-term incen-

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amended executive compensation disclosure rules, see 17 C.F.R. pts. 228, 229, 240, 249 amended (1995).

67. 57 Fed. Reg. 48,276 (1992).

68. *SEC Adopts Proxy Reforms After Long Study, Debate*, *supra* note 63, at 2234.

69. 57 Fed. Reg. 48,276; *SEC Adopts Proxy Reforms After Long Study, Debate*, *supra* note 63, at 2234.

70. Fierman, *supra* note 21, at 66. The Coca-Cola Company is a good example of this "obfuscation." In 1992, the company awarded Chairman Roberto C. Goizueta \$80 million worth of restricted stock: "To uncover that generosity, however, shareholders had to search through dense prose in the proxy statement. Only then would they stumble upon a mention of the award—with the amount written out in words rather than numbers, making it even harder to find." John A. Byrne, *You Can't Bury CEO Treasure Chests Anymore*, *Bus. Wk.*, Apr. 26, 1993, at 62.

71. Peter T. Chingos of KPMG Peat Marwick, for example, stated: "If the objective was to curb abuses in the marketplace, executive-pay disclosure is working. . . . I am seeing a level of scrutiny and attention to detail I have not seen in my 22 years of consulting." Byrne, *supra* note 11, at 56.

tives such as stock options and stock appreciation rights; (4) a Performance Graph comparing the corporation's total shareholder return to various indices; and (5) disclosure of information regarding relationships between compensation committee members and the registrant or other entities that may result in potential conflicts of interest.<sup>72</sup> By providing improved information and disclosure of executive compensation decisions, the SEC intends that shareholder who disagrees with the compensation committee may "remedy" the situation by "vot[ing] against reelection of committee members as directors, not [by] litigat[ing] in the courts."<sup>73</sup>

In addition to the SEC's actions, the Financial Accounting Standards Board ("FASB"), the organization that establishes and improves financial accounting and reporting standards, has begun to review the possibility of reforming the way stock options are disclosed on corporate financial statements. One of the primary problems with existing compensation reporting standards is that corporations may pay executives in stock options without having to report the options as a charge against earnings on financial statements.<sup>74</sup>

The sad truth is that accounting rules make options as free as those tinted dollars in the Parker Brothers game. It's funny money. Everyone agrees that a stock option has real value, yet companies are not required to charge them against earnings. Because option awards are essentially free, they're "never measured, never managed."<sup>75</sup>

During the 1980s, the FASB considered whether corporations should treat the cost of stock options as an expense and deduct the cost from company profits during the period in which the options were granted. Because of the inability of FASB to come up with an appropriate method for valuing stock options, FASB never adopted the proposal.

Because of the intensity of the debate over extravagant executive salaries, the concern over modifying accounting standards for stock options has resurfaced.<sup>76</sup> Senator Carl Levin, an outspoken critic of excessive executive compensation, expressed his concern that a corpora-

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72. 57 Fed. Reg. 48,126-28.

73. *Id.* at 48,127.

74. Senator Carl Levin referred to stock options as "stealth compensation" because "these options never appear on the company books as an expense." Executives get the benefit of rises in stock price and the corporation gets the benefit of not having to show the compensation as an expense on the books. *Hearings on Executive Compensation*, *supra* note 9 (statement of Sen. Levin).

75. Byrne, *supra* note 27, at 54 (quoting Raymond C. Lauver, a former member of FASB). Another problem with stock options is the misunderstanding that executives who receive stock options are being paid for their performance when, in fact, the increase in stock price may be the result of a general upswing in the market or inflation. *Id.*

76. See Brownstein & Panner, *supra* note 1, at 34.

tion who grants its executives stock options “ ‘ought to show [that the executive’s] wealth came out of the company’s coffers at shareholder’s expense.’ ”<sup>77</sup> The FASB proposal would force companies to carry estimates of the present value of their outstanding options on their financial statements as a charge against current earnings.<sup>78</sup>

The FASB’s stock option proposal faces staunch opposition from many organizations—particularly small high-tech companies.<sup>79</sup> George H. Sollman, President and Chief Executive Officer of Centigram Communications Corporation, opposed such treatment of stock options in testimony before the Senate Finance Committee’s Subcommittee on Taxation, and argued that stock options were very important to high-tech companies.<sup>80</sup> Startup companies and high-tech firms rely on stock options as a significant component in their compensation packages in order to attract the innovative employees who might not otherwise come.<sup>81</sup> These smaller companies typically offer stock options to all employees, not just top executives. Forcing them to reflect the value of stock options as an expense would deter these companies from granting options to most of their employees.

In sum, both the SEC and FASB rely on the concept of providing a true and accurate depiction of the executive compensation scheme. Therefore, shareholders may rely on the full disclosure of all material information when utilizing the internal corporate procedures for affecting corporate pay decisions. Reform in this area should “make compensation disclosure clearer and more concise, and more useful to shareholders.”<sup>82</sup> Full disclosure of compensation information will assist shareholders in electing and reelecting the ultimate in fair corporate policy makers—an independent, outside board of directors.

### B. *Sanction Approach—IRS*

Because of the inherent difficulties with allowing corporations to solve the excessive compensation problem through internal procedures, some legislators believe that the appropriate means for dealing with

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77. John A. Byrne, *Clinton Starts a Stampede*, BUS. WK., Dec. 14, 1992, at 38.

78. John A. Byrne, *‘Hands Off’ My Stock Pile*, BUS. WK., Apr. 12, 1993, at 28.

79. *Hearings on Executive Compensation*, *supra* note 9.

80. Mr. Sollman listed four explanations for the importance of stock options to startup companies: “One, employees stock options allow young, cash-strapped firms to compete against more established companies for scarce technical talent. Two, stock options merge the interests of employees and the investors. Three, stock options enhance productivity, innovation, and shareholder value. And four, stock options stretch the very scarce, venture-capital dollars.” *Hearings on Executive Compensation*, *supra* note 9.

81. *Id.*

82. 58 Fed. Reg. 48,126 (1992).

excessive executive pay is the Internal Revenue Code.<sup>83</sup> Following the SEC's disclosure reforms, some felt that further reform through the tax code was unnecessary.<sup>84</sup> Nevertheless, prior to the enactment of the new \$1 million cap on the deductibility of executive remuneration,<sup>85</sup> Congress debated several compensation-related tax bills that aimed at curbing the abuses of overcompensation. For instance, Representative Martin Sabo sponsored legislation, entitled the Income Disparities Act of 1991, that would have denied tax deductions for executive compensation in excess of twenty-five times the lowest compensation paid to any employee.<sup>86</sup> Similarly, Senator Tom Harkin introduced legislation which would have fixed the limit of reasonable compensation<sup>87</sup> to include only the first \$500,000.<sup>88</sup> In June 1992, the House of Representatives passed the Unemployment Compensation Amendments of 1992, which established a \$1 million limitation on the deductibility of executive compensation similar to the provision that eventually became law.<sup>89</sup> A version of the \$1 million limitation was ultimately part of a bill that President Bush vetoed.<sup>90</sup> Furthermore, Senator DeConcini proposed an amendment to the provision that was vetoed by President Bush which would have allowed a deduction of only 75% of executive compensation in excess of \$1 million.<sup>91</sup> Finally, as part the Omnibus Budget Reconcil-

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83. This, of course, is not the first time that commentators have suggested using the Internal Revenue Code to regulate executive pay. Professor Crystal noted that "[a]s recently as 1963, an executive who earned taxable income of over \$400,000 per year (the equivalent figure today, after correcting for cost of living changes since 1963, would be around \$1.7 million) would have been subjected to a marginal tax rate . . . as high as 91%." CRYSTAL, *supra* note 2, at 25.

Legislative action in other areas of the law have also attempt to curb excessive compensation practices. For example, the FDIC Improvement Act of 1991 requires that federal banking agencies prescribe standards for compensation, fees, and benefits paid by banks and savings and loan institutions, and to define what constitutes excessive levels, the payment of which will be deemed an "unsafe and unsound practice." See Longstreth & Kane, *supra* note 38, at 7.

84. See, e.g., Howard Gleckman, *Executive Pay: Clinton's Curbs Are Out Of Touch—And Out Of Bounds*, BUS. WK., Mar. 22, 1993, at 33 ("The President may be trying to fix a problem that's already being solved.").

85. 26 U.S.C. § 162(m) (Supp. V 1993).

86. H.R. 3056, 102d Cong., 1st Sess. (1991). For a look at the problem that Rep. Sabo wished to address, see *supra* note 17 and accompanying text.

87. Individuals and corporations may take as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a *reasonable allowance for salaries or other compensation* for personal services actually rendered . . . ." 26 U.S.C. § 162(a)(1) (1988) (emphasis added).

88. S. 2329, 102d Cong., 1st Sess. (1992). Senator Thomas Daschle proposed a similar bill which would include cost-of-living adjustments to the \$500,000. S. 2261, 102d Cong., 1st Sess. (1992).

89. H.R. 5260, 102d Cong., 1st Sess. (1992).

90. H.R. 4210, 102d Cong., 1st Sess. (1992).

91. 138 CONG. REC. S14866 (daily ed. Sept. 24, 1992).

iation Act of 1993,<sup>92</sup> President Clinton signed into law an amendment to section 162 that caps the deductibility of certain corporate executive compensation at \$1 million.<sup>93</sup>

The public policy argument for the enactment of a cap on the deductibility of "excessive" compensation is simple. As mentioned in Part I, the increasing gap between the pay of corporate executives and the average factory worker concerned many, including those in Congress. In addition, Congress felt that taxpayers should not have to subsidize corporations paying senior management huge compensation packages through a tax deduction for such compensation. Therefore, Congress placed sanctions on those corporations who could not comply with an arbitrarily determined "reasonable" level of compensation.<sup>94</sup>

While the underlying rationale for attempting to control excessive compensation is commendable, the enacted provisions are filled with loopholes so that the impact of this legislation is sure to be minimal. Not only will the new tax code provision be an ineffective means of lowering executive pay and raising tax revenues, but it will also be more expensive for shareholders. By disallowing a tax subsidy for excessive compensation expenses, the government is ultimately shifting the costs to the shareholders. "By imposing what is, in effect, an excise tax on executive salaries, Congress may satisfy populist political demands. But it will hardly improve the economy or respond to the interests of shareholders."<sup>95</sup>

#### 1. THE "OLD" REASONABLE COMPENSATION STANDARD

Some argue that the new limitation on executive remuneration is not necessary because "excessive" compensation is already not deductible under the reasonable compensation standard.<sup>96</sup> Notwithstanding that section 162(m) of the Internal Revenue Code places a limitation on the deductibility of applicable employee compensation of \$1 million, to be deductible, the compensation must still be an ordinary and necessary trade or business expense, and be "a reasonable allowance . . . for personal services actually rendered."<sup>97</sup> Therefore, by enacting section

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92. More specifically, § 13211 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 469, added § 162(m) to the Internal Revenue Code.

93. 26 U.S.C. § 162(m) (Supp. V 1993).

94. The remainder of this section will demonstrate the numerous loopholes to section 162(m) so that only ill-advised executive compensation decision makers will actually be penalized for breaching the \$1 million level.

95. Brownstein & Panner, *supra* note 1, at 33-34.

96. For a discussion of the reasonable compensation standard, see David E. Hoffman, *Heeding Significant Factors Improves the Odds for "Reasonable" Compensation*, 50 J. TAX'N 150, 155 (1979).

97. 26 U.S.C. § 162(a)(1) (1988).

162(m), Congress did not intend to set a figure which is per se reasonable. Instead, Congress simply determined a figure above which it would no longer subsidize as an ordinary and necessary business expense.

The IRS and the courts have typically applied a case-by-case determination of whether compensation is "reasonable."<sup>98</sup> Generally, the courts consider the following factors:

- (1) employee qualifications;
- (2) the nature, extent and scope of the work;
- (3) the size and complexity of the business;
- (4) prevailing general economic conditions;
- (5) compensation as a percentage of gross and net income;
- (6) compensation compared to distributions to shareholders;
- (7) compensation compared to non-shareholder employees and to prior years; and
- (8) prevailing rates of compensation for comparable positions in comparable concerns.<sup>99</sup>

Thus, even if an executive's compensation is less than the statutory \$1 million limitation, a corporation may not be allowed to deduct the entire amount of the compensation if it is not "reasonable" according to the aforementioned criteria. However, the "reasonable" standard has mainly been used to limit payments by closely-held companies where non-deductible dividends are disguised as deductible compensation.<sup>100</sup>

## 2. THE NEW LIMITATION ON DEDUCTIBILITY OF EXECUTIVE REMUNERATION

In response to the public outcry over excessive compensation, Congress enacted section 162(m) as a measure to reduce such compensation.<sup>101</sup> Section 162(m)<sup>102</sup> establishes a general rule that for purposes of

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98. *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5th Cir. 1987).

99. *RTS Inv. Corp. v. Commissioner*, 877 F.2d 647, 651 (8th Cir. 1989); *see also* *Rutter v. Commissioner*, 853 F.2d 1267, 1271 (5th Cir. 1988); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d at 1323.

100. *Omnibus Budget Reconciliation Act of 1993 (S.1134)*, U.S. Tax Rep. (RIA) No. 26, at 69 (June 24, 1993).

101. *Id.*

102. (m) CERTAIN EXCESSIVE EMPLOYEE REMUNERATION—

(1) IN GENERAL.—In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.

(2) PUBLICLY HELD CORPORATION.—For purposes of this subsection, the term "publicly held corporation" means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.

(3) COVERED EMPLOYEE.— For purposes of this subsection, the term “covered employee” means any employee of the taxpayer if—

(A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or

(B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

(4) APPLICABLE EMPLOYEE REMUNERATION.—For purposes of this subsection—

(A) IN GENERAL.— Except as otherwise provided in this paragraph, the term “applicable employee remuneration” means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year (determined without regard to this subsection) for remuneration for services performed by such employee (whether or not during the taxable year).

(B) EXCEPTION FOR REMUNERATION PAYABLE ON COMMISSION BASIS.— The term “applicable employee remuneration” shall not include any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual to whom such remuneration is payable.

(C) OTHER PERFORMANCE-BASED COMPENSATION.— The term “applicable employee remuneration” shall not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if—

(i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors,

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

(D) EXCEPTION FOR EXISTING BINDING CONTRACTS.— The term “applicable employee remuneration” shall not include any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration is paid.

(E) REMUNERATION.— For purposes of this paragraph, the term “remuneration” includes any remuneration (including benefits) in any medium other than cash, but shall not include—

(i) any payment referred to in so much of section 3121(a)(5) as precedes subparagraph (E) thereof, and

(ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter.

For purposes of clause (i), section 3121(a)(5) shall be applied without regard to section 3121(v)(1).

(F) COORDINATION WITH DISALLOWED GOLDEN PARACHUTE PAYMENTS.— The dollar limitation contained in paragraph (1) shall be reduced (but not below zero) by the amount (if any) which would have been included in the applicable employee remuneration of the covered employee for the taxable year but for being disallowed under section 280G.

both the regular tax and alternative minimum tax. Unless an exception exists, no publicly held corporation can deduct more than \$1 million of a covered employee's total compensation package<sup>103</sup> as a section 162 ordinary and necessary trade or business expense.<sup>104</sup> Because of the ease with which well-advised compensation committees can get around this provision, coupled with the fact that fewer than 400 executives of companies earn more than \$1 million,<sup>105</sup> section 162(m) is an ineffective means of controlling executive pay. "[T]he Clinton plan will do little more than change the way a handful of high-priced execs are paid."<sup>106</sup>

a. Publicly-Held Corporation Requirement

The first characteristic that would exclude a corporation from section 162(m) treatment is that the corporation must be "publicly held."<sup>107</sup> Section 162(m) defines a "publicly held" corporation as one which has common equity securities that, on the last day of the taxable year, the SEC requires to be registered under section 12 of the Securities Exchange Act of 1934.<sup>108</sup> Consequently, a "privately held" corporation may deduct "excessive" executive compensation for income tax purposes,<sup>109</sup> whereas its "publicly held" equivalent may not. If registration of securities is merely voluntary, then the corporation is not considered to be "publicly held".<sup>110</sup> Moreover, the proposed regulations provide that the determination of whether the taxpayer is a publicly held corpo-

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103. For purposes of § 162(m), an executive's compensation package includes "any remuneration (including benefits)" in the form of cash, property, or services, except for remuneration in the form of (i) contributions to or payments from qualified retirement plans; (ii) fringe benefits which "at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income"; (iii) specified commissions; (iv) compensation based upon performance goals; and (v) income payable under a written binding contract that was in effect on Feb. 17, 1993. 26 U.S.C. § 162(m)(4).

Also note, the \$1 million limitation is reduced by the amount of any excess golden parachute payments (as defined in § 280G) which are not deductible by the corporation. *Id.* § 162(m)(4)(F).

104. *Id.* § 162(m)(1).

105. See Gleckman, *supra* note 84, at 33.

106. *Id.*

107. 26 U.S.C. § 162(m)(1).

108. *Id.* § 162(m)(2). A publicly-held corporation required to register under section 12 of the Securities Exchange Act of 1934 generally includes corporations (1) whose securities are listed on a national securities exchange or (2) that have \$5 million or more of assets and 500 or more shareholders. Fed. Tax Guide Rep. ¶ G-2360 (CCH) (Aug. 20, 1993).

109. Of course, compensation must still be "reasonable" within the meaning of § 162(a)(1).

110. Prop. Treas. Reg. § 1.162-27(c)(1)(i), 58 Fed. Reg. 66,314 (1993). The Internal Revenue Service issued proposed regulations on § 162(m) because of the taxpayers need for guidance in order to comply with the Jan. 1, 1994, effective date. The IRS maintains that these proposed regulations are not comprehensive, and to the extent the IRS did not cover a particular issue, the IRS mandates utilizing a "reasonable, good faith interpretation" of the statute. 58 Fed. Reg. 66,310 (1993).



ration is to be made on the last day of the taxable year.<sup>111</sup> Thus, the \$1 million limitation seemingly does not apply to a corporation that goes private on the last day of its taxable year. The regulations further provide that "publicly held corporation" includes corporations within an affiliated group even if they do not file a consolidated income tax return.<sup>112</sup>

#### b. Covered Employee Requirement

In addition to requiring that the corporation be "publicly held," the statute provides that the \$1 million limitation does not apply unless the employee qualifies as a "covered employee"<sup>113</sup> on the last day of the taxable year.<sup>114</sup> Section 162(m)(3) defines a "covered employee" as either (1) the chief executive officer or one acting in such capacity, or (2) the four highest compensated officers, other than the chief executive officer, whose "total compensation . . . is required to be reported to shareholders under the Securities Exchange Act of 1934."<sup>115</sup> Furthermore, the regulations provide that an employee who is not employed by the corporation on the last day of the taxable year does not qualify as a "covered employee."<sup>116</sup> Therefore, the amount of compensation, the executive compensation disclosure rules of the 1934 Act,<sup>117</sup> and the employment status of the executive on the last day of the taxable year determine whether the individual is a "covered employee."<sup>118</sup> Unless characterized as a covered employee, that employee's compensation is exempt from the \$1 million limitation.

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111. Prop. Treas. Reg. § 1.167-27(c)(1)(i), 66,314, 58 Fed. Reg. 66,314 (1993).

112. *Id.* § 1.167-27(c)(1)(ii), 58 Fed. Reg. 66,314. Section 1504 of the Internal Revenue Code defines an affiliated group.

113. 26 U.S.C. § 162(m)(1).

114. Prop. Treas. Reg. § 1.167-27(c)(2), 58 Fed. Reg. 66,314.

115. 26 U.S.C. § 162(m)(3). Thus, if corporations are required to disclose the compensation of fewer than four executives, only those for whom disclosure is required are covered employees. *Omnibus Budget Reconciliation Act of 1993 (S.1134)*, *supra* note 100, at 70.

116. Prop. Treas. Regs. § 1.162-27(c)(2)(i), 58 Fed. Reg. 66,314.

117. The reference in I.R.C. § 162(m)(3)(B) to compensation "required to be reported to shareholder under [the 1934 Act]" pertains to the SEC's disclosure rules, which require disclosure in a corporation's proxy statements of the compensation of its CEO and its four highest compensated officers. 17 C.F.R. § 240.14a-101 (1995); 17 C.F.R. § 229.402(a)(3) (1995). For a discussion of the SEC's executive compensation disclosure rules, see *supra* part III.A.

118. There was considerable debate in Congress over why the excessive compensation rules would only apply to corporate executives and not other highly paid individuals such as athletes and entertainers. For example, Rep. Gerald Solomon of New York noted an article published in the *Wall Street Journal*, entitled "The FOB Loophole," which discussed the inequities in the new amendment (FOB stands for "Friend of Bill Clinton"). Rep. Solomon noted that Barbara Streisand, who made \$20 million in two days of work for MGM, would be taxed at a considerably lower rate than an executive at MGM making the same amount for the entire year. 139 CONG. REC. E2460 (daily ed. Oct. 15, 1993) (statement of Rep. Solomon) (quoting *The FOB Loophole*, WALL ST. J., Oct. 14, 1993).

c. Compensation-in-the-Form-of-Commissions<sup>119</sup> Exception

In order to determine the amount of "applicable employee remuneration" for purposes of computing "excessive" compensation of a "covered employee," a corporation must exclude "any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual."<sup>120</sup> Employee compensation does not fail this test simply because the individual has the use of support services such as secretarial or research services.<sup>121</sup> Moreover, commissions based upon income generated by a "business unit" within the corporation do not qualify under this exception.<sup>122</sup> Certainly, the main problem here is determining at what point one can attribute income directly to efforts of an individual employee as opposed to an entire business unit.

d. Performance-Based Compensation Exception

Probably the most complex and burdensome exceptions to the deduction limitation within section 162(m) is compensation paid on account of "one or more performance goals"<sup>123</sup>—performance-based compensation. The theory behind excluding such compensation reflects the criticism by many that the yearly pay of CEO's in the past had no significant correlation to the company's overall performance.<sup>124</sup> In fact, while corporate profits decreased by 7% in 1990, CEO pay increased by 7%.<sup>125</sup> Presenting corporations with an incentive to better equate CEO compensation with the firm's overall performance is one means by which Congress sought to remedy the overcompensation problem.

In order to qualify as performance-based compensation, four requirements must be met.<sup>126</sup> First, qualified performance-based compensation must be attributable to the achievement "of one or more preestablished, objective performance goals."<sup>127</sup> Prior to the commence-

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119. Although commission-based compensation is generally based upon performance, I treat commissions separately because, for purposes of computing total compensation, publicly held corporations may exclude commissions without regard to the four part test to exclude "performance-based compensation." 26 U.S.C. § 162(m)(4)(B).

120. 26 U.S.C. § 162(m)(4)(B).

121. Prop. Treas. Reg. § 1.162-27(d), 58 Fed. Reg. 66,314-15.

122. *Id.*, 58 Fed. Reg. 66,315. Neither the actual provision nor the proposed regulations define "business unit," but it seems quite clear that a "business unit" refers to a group of more than one individuals.

123. 26 U.S.C. § 162(m)(4)(C).

124. For a more explicit discussion of the pay for performance problem, see notes 26-30 and accompanying text.

125. *Hearings on Executive Compensation*, supra note 9 (statement of Sen. Boren).

126. 26 U.S.C. § 162(m)(4)(C)(i)-(iii).

127. Prop. Treas. Reg. § 1.162-27(e)(2)(i), 58 Fed. Reg. 66,315.

ment of the services for which the compensation committee establishes particular performance goals and before the outcome of the performance goals is certain, the corporation's compensation committee must set forth, in writing, the particular performance goals.<sup>128</sup> Not only must the compensation committee preestablish the performance goals, but the goals must be objective. In other words, the performance goals must be such that "a third party having knowledge of the relevant facts could determine whether the goal is met."<sup>129</sup> Moreover, in order for a particular performance goal to be "objective," a third party with knowledge of the applicable performance results should be able to calculate the amount of compensation.<sup>130</sup> Although this objective standard requires the performance goals be fixed and the amount of compensation be non-discretionary, the proposed regulations allow the compensation committee the discretion to reduce, but not enlarge, the amount of compensation or other economic benefit even if the employee achieves the performance goals.<sup>131</sup>

Compensation committees may use one or more of the following business criteria to set performance goals: stock price, market share, sales volume, earnings per share, return on equity, or costs.<sup>132</sup> The compensation committee may, nonetheless, simply base performance determinations upon "maintaining the status quo or limiting economic losses."<sup>133</sup> As such, preestablished, objective performance goals do not necessarily mandate a showing of what one typically perceives as positive business results. The proposed regulations expressly prohibit, however, predicated performance pay solely upon "continued employment" of the corporate officer.<sup>134</sup>

Notwithstanding the three additional performance-based compensation requirements, the preestablished, objective performance requirement is, for the most part, illusory. Because of the broad definition of an

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128. *Id.*

129. *Id.*

130. *Id.* § 1.162-27(e)(2)(ii), 58 Fed. Reg. 66,315.

131. *Id.* § 1.162-27(e)(2)(iii), 58 Fed. Reg. 66,315.

The IRS and Treasury believe that the retention of 'negative' discretion to reduce compensation does not undercut the policies underlying the exception for performance-based compensation under section 162(m). Moreover, discussions with the staff of the Securities and Exchange Commission and suggestions received from taxpayers, shareholders, and other interested parties indicate that it is desirable for directors to retain this discretion in order to take into account other subjective factors and to preserve their flexibility to act in the best interest of the company and its shareholders.

58 Fed. Reg. 66,311.

132. Prop. Treas. Reg. § 1.162-27(e)(2)(i), 58 Fed. Reg. 66,315.

133. *Id.*

134. *Id.*

authorized "performance goal" and the relative ease with which crafty lawyers or compensation consultants can draft performance goals which are easy to achieve, section 162(m)(4)(c) creates a loophole. The rules and regulations are unclear as to whether a corporation can set pay based upon the attainment of an almost certain goal. For example, would it be an appropriate for the Walt Disney Company to base some or all of Michael Eisner's "performance-based" compensation upon the sale of 500 tickets to one of its many theme parks? Or, could Coca-Cola pay its CEO a large "performance-based" bonus upon keeping its stock price above \$10 per share for the year?<sup>135</sup> The regulations require a facts and circumstances analysis to determine whether the employee would receive all or part of the compensation, regardless of whether the employee attains the performance goal.<sup>136</sup> If so, the compensation does not qualify as "performance-based."<sup>137</sup> Therefore, if an executive's compensation is "nominally or partially contingent on attaining a performance goal,"<sup>138</sup> then none of the payment associated with that particular grant or award qualifies for this exception.

The second requirement of the performance-based compensation exception is that a compensation committee of the board of directors, comprised solely of two or more outside directors, must establish the performance goals.<sup>139</sup> A director is not "considered an outside director if the individual: (1) is a current employee of the corporation, (2) is a former employee . . . receiving compensation for prior services (other than benefits under a tax-qualified retirement or savings plan), (3) has been an officer of the corporation at any time, [or] (4) is receiving compensation in any capacity other than as a director."<sup>140</sup> In addition, the proposed regulations deem certain payments to entities in which a director has an ownership interest as paid to the director, subject to a de minimis payment rule.<sup>141</sup>

The third requirement necessary to qualify for the performance-based compensation exemption is that the material terms of the performance goal be fully disclosed to shareholders and approved by a majority shareholder vote before payment of such remuneration.<sup>142</sup> If the com-

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135. As of March, 1994, Coca-Cola stock was trading on the New York Stock exchange at around \$40 per share. WALL. ST. J., Mar. 12, 1994, at C3.

136. Prop. Treas. Reg. § 1.162-27(e)(2)(iv), 58 Fed. Reg. 66,315.

137. *Id.*

138. *Id.*

139. 26 U.S.C. § 162(m)(4)(C)(i).

140. 58 Fed. Reg. 66,312.

141. Prop. Treas. Reg. § 1.162-27(e)(3)(ii), 58 Fed. Reg. 66,317. For further discussion of the de minimis rule, see *Unofficial Transcript of IRS Hearing on Executive Compensation*, reprinted in 94 TAX NOTES TODAY 93-15 (1994), available in LEXIS, Fedtax Library, TNT file.

142. 26 U.S.C. § 162(m)(4)(C)(ii).

pensation would be paid regardless of whether the shareholders approve, the performance-based exception does not apply.<sup>143</sup> The material terms required to be disclosed include (1) the individuals eligible to receive compensation, (2) a description of the business criteria upon which the performance goals are based, and (3) either the maximum amount of the compensation to be paid or the formula used to calculate the amount of compensation if the performance goal is attained.<sup>144</sup> The proposed regulations also provide that to the extent that the regulations do not cover disclosure of the material terms of the performance goals, the disclosure rules of the SEC apply.<sup>145</sup> In the case of performance-based compensation other than stock options, the shareholder approval requirement is met if the shareholders approve the specific terms of the plan, as well as the class of executives to which it applies.<sup>146</sup> If the compensation plan involves stock options, "the shareholders generally must approve the specific terms of the option plan, the class of executives to which it applies, the option price or formula for setting the price, and the maximum number of shares subject to the option that can be awarded under the plan to any executive."<sup>147</sup> Also, unless a material change in a plan occurs, no further shareholder approval is required once a plan has been approved.<sup>148</sup>

Finally, the compensation committee must certify, in writing, that the executive has satisfied the performance goals and any other material terms before the corporation pays a covered employee his remuneration.<sup>149</sup> However, "[c]ertification by the compensation committee is not required for compensation that is attributable solely to the increase in the stock of the publicly held corporation."<sup>150</sup> Thus, in order to qualify for the performance-based compensation exception, a "covered employee" must meet the performance goal preestablished by a committee consisting of two or more outside directors, the material terms of which have been fully disclosed to and approved by shareholders, and the compensation committee must certify that the performance goal has been satisfied.

#### e. Grandfather Clause—Binding Contract Exception

The fifth and final exception to the excessive employee remunera-

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143. Prop. Treas. Reg. § 1.162-27(e)(4)(i), 58 Fed. Reg. 66,317.

144. *Id.*

145. Prop. Treas. Reg. § 1.162-27(e)(4)(v), 58 Fed. Reg. 66,318.

146. Fed. Tax Guide Rep. ¶ G-2360 (CCH) (Aug. 20, 1993).

147. *Id.*

148. *Id.*

149. 26 U.S.C. § 162(m)(4)(C)(iii).

150. Prop. Treas. Reg. § 1.162-27(e)(5), 58 Fed. Reg. 66,318-19.

tion rules is for binding employment contracts that were in effect on or before February 17, 1993, and that were not modified in any material respect before such remuneration was paid.<sup>151</sup> This exception does not apply unless, under the applicable state law, "the corporation is obligated to pay the compensation if the employee performs services."<sup>152</sup> Furthermore, a contract that is either renewed after February 17, 1993, or terminable by the corporation after February 17, 1993, is not treated as a binding contract as of that date.<sup>153</sup>

The \$1 million cap on a corporation's ability to deduct executive compensation as an ordinary and necessary business expense is thus overflowing with easily attainable exceptions. The statute is not a useful mechanism for controlling excessive executive compensation as it does not prohibit companies from paying whatever they consider appropriate. It only limits the deductible amount to \$1 million per covered executive.<sup>154</sup> The only effect, if any, that the provision will have is to effectively shift the cost of executives' salaries from the corporation to the shareholders.<sup>155</sup> However, in that respect, it provides incentive for shareholders to ensure that compensation levels remain "reasonable" and below the \$1 million cap and also removes the burden from taxpayers who have been subsidizing "excessive" compensation. If shareholders feel that an executive is worth millions, then they have every right to pay it. "Shareholders are going to hold the company more accountable than the taxpayers are. . . . In terms of general tax fairness, and who is bearing the brunt of the costs and who is receiving the benefits, it seems appropriate." <sup>156</sup>

Companies are still going to have to pay what the market requires, but they will hire compensation consultants and crafty attorneys to design compensation packages that are not effected by the deduction limitation. Because few corporations will actually be subject to this provision, and those who are subject will likely pay compensation consultants a nice fee to find ways around this tax penalty, the effectiveness of this amendment is surely in question.

#### IV. DISCLOSURE REGIME VS. TAX PENALTY REGIME

While the SEC's approach to monitoring executive pay by increas-

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151. 26 U.S.C. § 162(m)(4)(D).

152. Prop. Treas. Reg. § 1.162-27(h)(1)(i), 58 Fed. Reg. 66,319.

153. *Id.*

154. See Allison L. Cowan, *A Corporate-Tax Approach To Curbing Executives' Pay*, N.Y. TIMES, June 11, 1992, at D1.

155. *Id.* at D7.

156. *Id.* (quoting Issac Shapiro, a senior research analyst for the Center on Budget and Policy Priorities, a Washington research center that supports the provision).

ing the clarity of executive compensation disclosure has received applause from virtually every affected party, the IRS's imposition of a tax penalty for excessive compensation has not been so fortunate. Advocates for the disclosure regime note the benefits of shifting more corporate control to the shareholder through increased availability of information regarding executive compensation. With the help of large institutional investors and shareholder activist groups, shareholders will now have a more powerful role in corporate decisionmaking, and consequently will be in a better position to protect their investment from corporate "waste." By allowing these disclosure reforms, the SEC has effectively encouraged greater accountability of the board of directors in fulfilling their fiduciary duties to shareholders.

The IRS approach, on the other hand, is not to protect shareholder interests by providing shareholders the ability to make more prudent investment decisions. (In fact, public access to the corporation's tax return is not allowed without the consent of the taxpayer. Therefore, without the SEC's executive compensation disclosure rules, the investing public would have no protection against investing in corporations with excessive pay practices.) The IRS approach's main thrust is the imposition of a tax penalty for compensation above \$1 million so that taxpayers no longer subsidize large executive salaries.<sup>157</sup> Even though parts of the new tax provision rely on the SEC's disclosure requirements, the IRS approach is effectively a modest increase in revenue at the expense of ill-advised corporate compensation committees.

The IRS provision does not force a company to reconsider the amount of money it pays its executives, just how it pays them. With the enactment of the cap on the deductibility of executive compensation, compensation committees who wish to pay their executive's million-dollar salaries will simply have to hire compensation consultants to design compensation plans that qualify for one of the applicable exceptions—particularly the performance-based compensation exception. Although this might influence compensation committees to link an executive's pay to the corporation's performance, it does not require it.

In contrast, the SEC's comprehensive disclosure allows for increased shareholder scrutiny of both the amount and type of pay. Although the SEC modified the rules to allow shareholders to have an advisory role in "ordinary" compensation decisions, increased disclosure will force the board of directors to justify their compensation decisions to the shareholders and thus facilitate arm's-length bargaining between executives and the board of directors.

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157. Of course, one of the primary purposes of many tax provisions is to raise revenue for governmental spending.

Who decided that \$1 million was a "reasonable" amount of executive compensation? The \$1 million cap amount is simply an arbitrary figure for determining "excessive" compensation.

The appropriate level of compensation of corporate officers depends on the specific circumstances of each particular company in a particular time period. Compensation that might seem excessive in one company, could be inadequate in another. And what is deemed appropriate must be constantly adjusted to reflect the circumstances of the company at the most recent times.<sup>158</sup>

For example, a successful CEO sought after by several competing corporations who wish to pay him millions of dollars is very different from a CEO who takes advantage of his influential position to urge directors that he's worth several million dollars. The SEC's disclosure regime specifically addresses this situation by allowing shareholders to participate in a "reasonableness" determination.

It is quite difficult to imagine how a \$1 million limitation on the tax deductibility of executive compensation can be an effective means of controlling executive pay, much less a viable means for raising revenues. Section 162(m) provides several alternative means by which a compensation committee can get around the limitation amount so that the shareholders will not have to absorb the cost of a disallowed deduction. On the other hand, the SEC disclosure approach, standing alone, has already impacted several board's compensation decisions.<sup>159</sup> In addition, with the potential reform of the FASB accounting standards for valuing stock options, shareholders will have access to significant amounts of compensation information with which to evaluate investment opportunities. Therefore, while the SEC approach of improving shareholder's position in corporate governance is beneficial, the IRS approach of "limiting" the deduction for excessive compensation at \$1 million is entirely unnecessary and ineffective.

## V. CONCLUSION

Years of abusive corporate pay practices by top executives and boards of directors have culminated in a full-throttled attempt by governmental bodies to intervene in corporate governance. From one point of view, the SEC's disclosure and proxy reform shifts some of the balance of power away from senior management and back to the owners. In addition, one might expect new accounting standards for valuing stock options in order to better inform shareholders of executives' "true"

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158. *Hearing on Executive Compensation*, *supra* note 9 (statement of SEC Chairman Richard C. Breiden).

159. *See supra* notes 32 & 71 and accompanying text.



compensation. As a result, shareholders will be able to more easily ascertain exactly what an executive earns and to adjust future compensation decisions accordingly.

Limiting executive pay through the income tax code, however, is an entirely different situation. Shareholders will not benefit from the new provision unless the compensation committee chooses to tie the executive's compensation more closely to the corporation's overall performance. In fact, those few corporations actually affected by the \$1 million limitation who wish to continue paying more than \$1 million to its executives will simply be shifting the tax burden to shareholders. Thus, the only worthwhile reason for this provision is to encourage corporations to tie highly-paid executives' compensation to the company's performance.

It is unclear whether any of the existing restraints on "excessive" compensation will actually have significant impact on executive compensation in the future. Perhaps compensation consultants will find new ways not only to avoid the income tax penalty for certain compensation above \$1 million, but also to satisfy shareholders that individual compensation packages are in fact what the particular executive is worth in the executive labor market. CEOs atop successful corporations will likely have more bargaining power with shareholders in compensation decisions than CEOs in less successful corporations. Certainly, a successful CEO can always accept a similar position at a competing corporation willing to pay what the CEO wishes. However, any regulatory regime that can somehow grant shareholders more power over compensation decisions than they have had in the past is a positive step toward improving the inherent problems with existing compensation practices.

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