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Capital

A Reasoned Approach To Executive Compensation

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Since the onset of the financial crisis there has been a huge hue and cry about executive compensation, particularly compensation on Wall Street. It isn't hard to understand why, and it would not have been unexpected to see financial reform legislation that took a heavy-handed approach to "reforming" compensation practices. Early on in the crisis there were proposals to impose an 80% tax on bonuses and proposals to cap compensation in absolute terms. Last week members of the Angelides commission, charged with investigating the causes of the financial crisis, pummeled former Citi executives Charles Prince and Robert Rubin for getting generous compensation while the firm essentially collapsed around them.

We saw much of the same reaction in the 1930s. There was a huge public outcry over the compensation of Eugene Grace, the president of Bethlehem Steel, when it was revealed that he received a base salary of $12,000 and a bonus of more than $1.6 million in 1929. That amounts to $150,000 salary in 2010 dollars with a nearly $20 million bonus.

Similarly, the Pecora hearings in 1933 established that Charles Mitchell, president of National City Bank (today's Citibank), earned well over $1 million in salary and management-fund bonus in 1929, and that he had paid no income tax that year because of a capital loss incurred when he sold his bank stock to his wife in an improper sale.

In 1933 Congress demanded that every corporate income tax return include a list of salaries for top executives. When those lists were made public the following year, there was a huge outcry. "For the captains of industry to be drawing down large salaries is unconscionable and unpatriotic," declared Sen. Burton Wheeler, D-Mont. "The practice must be curbed by legislation, through taxation and publicity." But although there were proposals to cap compensation and to impose punitive (80%) taxes on compensation above a certain level, nothing much came of it.

There are two reasons for this. The first is the extraordinary deference the courts have paid to the prerogatives of corporate governance. Although the U.S. Supreme Court established in *Rodger v. Hill* (1933) the right to intervene in matters of compensation deemed excessive, courts since then have been reluctant to overrule decisions made by corporate boards. The overriding consideration is what is known as the business judgment rule. This holds that directors of public companies cannot be held liable for or overruled on decisions, good or bad, that are based on their best business judgment.

The second is contract law. The ability to write and enforce contracts without being subjected to arbitrary notions about fairness is one of the bulwarks of our system. It is a critical element of markets for human capital. Any attempts to interfere with employment contracts are not likely to survive legal challenges.

There is ample empirical evidence that business matters involving informed partners tend to seek resolution in courts that have very clear and not arbitrary legal precedents. That is why a preponderance of corporate governance matters are resolved in Delaware courts and why so many contracts disputes are resolved in New York Courts.

For these reasons, in spite of periodic expressions of outrage, efforts to "reign in" executive compensation have so far been relatively muted. The major pending legislation--Sen. Dodd's "Restoring American

Financial Stability Act of 2009"--makes some very cautious but important recommendations about compensation. There are four that are notable.

Say on Pay: The Dodd legislation would require that shareholders be offered the opportunity to make their views known on the compensation of executives. These ideas have been around for a while and are not particularly radical. They would require that proxies include a resolution subject to shareholder vote to approve the compensation of executives. Shareholders would also be empowered to make their own compensation proposals. None of this would be binding and would not overrule decisions by the board of directors.

The Structure of Compensation Committees: The Bill would require compensation committees to be composed of only independent directors with very strict requirements for independence. It would also empower them to hire independent compensation consultants and legal counsel. But the most significant language in the legislation are the rules of construction that essentially reaffirm the business judgment rule. Specifically the bill says: "Rule of Construction--This paragraph may not be construed (i) to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation consultant (or legal counsel); or (ii) to affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee."

Clawbacks: The Dodd bill would require firms to attempt recovery of erroneously awarded incentive-based compensation. No listing would be allowed for companies unless they have a policy on clawbacks and recovery from any compensation awarded within the past three years based on an accounting restatement, with or without fraudulent intent.

Hedging Strategies: Finally--and perhaps most importantly--the bill would require by rule that each public company "disclose in the annual proxy statement whether the employees of the issuer are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted to employees by the issuer as part of an employee compensation." The value of this requirement is that it provides an additional degree of transparency about the relationship between pay and performance. That is because the best way to align the interests of shareholders and managers is to have a fraction of managers annual pay take the form of deferred compensation the value of which is tied to the firm's performance--for example, restricted stock grants. To the extent that managers can and do hedge the risk in those holdings it undermines that incentive alignment.

The Dodd bill suggests some important improvements to corporate governance issues involving compensation. At the same time it shows a lot of respect for the current legal realities. Courts have been reluctant to undermine the business judgment rule or the sanctity of contracts for human capital and for good reason. Increased transparency, good guidelines, and frequent oversight are to be applauded, but more direct intervention in compensation is both unlikely and unwise.

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