Executive Compensation: The Law and Incentives

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EXECUTIVE COMPENSATION: THE LAW AND INCENTIVES

By Stas Getmanenko

SSRN Abstract:

Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures. Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers. Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders’ right to benefit from the corporation’s wealth. Shareholders’ dividend is directly reduced by the company’s expenses, one of which executive compensation. For most of today’s public companies the executive compensation expense is often negligible when considered in light of mammoth balance sheets. However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders. In the most unfortunate scenario, executives’ personal interests can tumble a corporation and send ripples of pain elsewhere. To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for the executives. And when recently these committees have proved to be imperfect, additional legislative efforts have been introduced. As it unfolds, this paper attempts to answer the following three questions:

Question 1: Against the backdrop of a recent real estate bubble and the associated financial crisis, the populist outcry against excessive executive compensation is gaining
momentum. Some argue that the executive compensation – more specifically the misaligned incentives on executive pay – were among the chief factors contributing to the over-inflation and the bust of the real estate bubble. Those who support this view often place the blame on the executives and the compensation schemes at such companies as Washington Mutual (“WaMu”) and American International Group (“AIG”). They argue, inter alia, that WaMu was among the foremost facilitators of bad mortgage debt who “built [an] empire on shaky loans.” Meanwhile, AIG exacerbated the problem by “insuring” the repackaged mortgage debt in the secondary market. How meritorious is the claim that misaligned incentives on executive pay can trigger a world-wide financial turmoil?

Question 2: Business Roundtable is an American policy association comprised of chief executive officers of major U.S. companies. The group’s membership controls over $5 trillion in annual revenues and more than 12 million employees. The group claims a third of the total value of the U.S. stock markets and pays more than 60 percent of all corporate income taxes. On average, the group pays $167 billion in dividends and gives away another $7 billion in charitable donations. As justification for its existence, Business Roundtable routinely issues position statements on relevant economic and societal matters. In 2007, the organization published a white paper entitled “Executive Compensation: Principles and Commentary.” The first principle of the white paper states: “Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect
upside potential and downside risk.” How consistent is this guiding principle with the reality of executive compensation in today’s corporate America?

Question 3: In the recent months, as the bottom has dropped out of the economy and the unemployment rate has surpassed 10 percent, excessive executive compensation has generated a significant public firestorm. “Bonus” payments at companies receiving government funds have seized the national center-stage on several occasions. In 2008, the Wall Street banks paid themselves some $20 billion in bonuses amidst a year of dismal returns (more accurately “a year of colossal losses”). President Obama called the payouts “shameful.” Moreover, his sentiment is likely shared by most Americans who were not numbered amongst the bonus recipients. Whether the bonuses were “right” or “wrong,” deserved or undeserved, they gave rise to numerous attempts to “rein in Wall Street pay.” Among other proposals, a legislative response appears more likely than ever. What would be the scope and the efficacy of any proposed legislative check on executive compensation?

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Part I: Introduction

Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures. Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers. Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders’ right to benefit from the corporation’s wealth. For example, shareholders’ dividend is directly reduced by the company’s expenses, which include executive compensation. For most of today’s public companies the executive compensation expense is often negligible when considered in light of mammoth balance sheets. However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders. In the most unfortunate scenario, executives’ personal interests can tumble a corporation and send ripples of pain

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1 This paper examines executive compensation as it applies to publicly-traded companies. The analysis could differ significantly for private companies.
elsewhere. To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for the executives. Recently, when these committees have proven to be imperfect, additional legislative efforts have been introduced. As it unfolds, this paper attempts to answer the following three questions:

**Question 1**

Against the backdrop of a recent real estate bubble and the associated financial crisis, the populist outcry against excessive executive compensation is gaining momentum. Some argue that the executive compensation – more specifically the misaligned incentives on executive pay – were among the chief factors contributing to the over-inflation and the bust of the real estate bubble. Those who support this view often place the blame on the executives and the compensation schemes at such companies as Washington Mutual (“WaMu”) and American International Group (“AIG”). They argue, *inter alia*, that WaMu was among the foremost facilitators of bad mortgage debt who “built [an] empire on shaky loans.” Meanwhile, AIG exacerbated the problem by insuring the repackaged mortgage debt in the secondary market. *How meritorious is the claim that misaligned incentives on executive pay can trigger world-wide financial turmoil?*

**Question 2**

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trillion in annual revenues and more than 12 million employees.\textsuperscript{5} The group claims a third of the total value of the U.S. stock market and pays more than 60 percent of all corporate income taxes. On average, the group pays $167 billion in dividends and gives away another $7 billion in charitable donations. As justification for its existence, Business Roundtable routinely issues position statements on relevant economic and societal matters. In 2007, the organization published a white paper titled “Executive Compensation: Principles and Commentary.”\textsuperscript{6} The first principle of the white paper states: “Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.”\textsuperscript{7} How consistent is this guiding principle with the reality of executive compensation in today’s corporate America?

\textbf{Question 3}

In the recent months, as the bottom has dropped out of the economy and the unemployment rate has surpassed 10 percent, excessive executive compensation has generated a significant public firestorm.\textsuperscript{8} “Bonus” payments at companies receiving government funds have seized the national center-stage on several occasions. In 2008, the Wall Street banks paid themselves some $20 billion in bonuses amidst a year of dismal returns (more accurately “a year of colossal losses”).\textsuperscript{9} President Obama called the

\textsuperscript{5} See Business Roundtable, \textit{About Us}, http://www.businessroundtable.org/about.
\textsuperscript{7} Id. at 1.
\textsuperscript{9} See id.
payouts “shameful.” Moreover, his sentiment is likely shared by most Americans who were not numbered amongst the bonus recipients. Whether the bonuses were “right” or “wrong,” deserved or undeserved, they gave rise to numerous attempts to “rein in Wall Street pay.” Among other proposals, a legislative response appears more likely than ever. What would be the scope and the efficacy of any proposed legislative check on executive compensation?

**Part II: Executive Pay and Misaligned Incentives**

*How meritorious is the claim that misaligned incentives on executive pay can trigger world-wide financial turmoil?*

**A. The Biggest Bank Failure in U.S. History**

In 2007, WaMu held assets valued at $327.9 billion, and in 2008, WaMu was the biggest bank failure in U.S. history. Over the last decade, and prior to its failure, WaMu was synonymous with easy lending. And for a time it worked for WaMu. In 1990, Mr. Kerry K. Killinger became WaMu’s chief executive. He led the bank to an incredible expansion: During Mr. Killinger’s tenure, WaMu made some thirty banking acquisitions; it became the fifth largest American bank; and its stock price and the number of branches more than doubled. In 1999, WaMu made a key acquisition of Long Beach Financial, a California lender specializing in subprime mortgages. From that time onward, WaMu positioned its subprime lending business at the core of its offering. Mr. Killinger was the primary engineer behind WaMu’s easy lending philosophy. According

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10 Id.
to the Corporate Library, a research firm, Mr. Killinger’s compensation from 2001 to 2007 totalled $88 million.

Mr. Killinger’s compensation levels were set similar to the compensation of any other chief executive officer of a company traded on the New York Stock Exchange. Specifically, WaMu’s corporate filings disclosed that in addition to a predetermined annual salary, Mr. Killinger’s total compensation was significantly tied to WaMu’s performance. In fact, 94 percent of Mr. Killinger’s total direct compensation for 2007 was considered “at risk,” meaning it was tied to specific performance measures, and 71 percent of Mr. Killinger’s total direct compensation was tied to long-term performance measures.

Consider the following language from WaMu’s independent Compensation Committee:

For 2008 we have structured our long-term equity incentive and annual incentive bonus programs for named executives to align with our objective to improve Company performance in 2008 and beyond. We continue to provide at least 50% of total direct compensation to executives (over 70% for the CEO) in the form of long-term equity incentive compensation which is directly linked to stock price and total shareholder return . . . . Our 2008 annual incentive bonus plan is designed to align executive bonus compensation with the achievement of four objective performance measures that are core to the success of our business: (i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty.

In theory and on paper, this compensation scheme would likely pass the scrutiny of most vigilant shareholders who demand the highest dividend possible, especially in the long-term. In reality, however, WaMu did not make it through the end of 2008.

16 Id.
The demise of WaMu was brought on by subprime mortgages. In 2007, WaMu recorded a $67 million dollar loss in its subprime lending unit and shut it down. In total, by 2007 WaMu has accumulated $180 billion in mortgage-related loans. Intriguingly, prior to the burst of the housing bubble, it was this enormous mortgage portfolio that inflated WaMu’s stock price and created value out of thin air (or out of empty IOUs). With the increase in stock price, the level of Mr. Killinger’s compensation also increased. Consistent with the formulas drawn out by the compensation committee, Mr. Killinger’s compensation was directly related to the growth in the mortgage portfolio. This growth, however, was achieved through reckless lending, and a day of reckoning was still several years away.

In 2007, when WaMu’s shareholders’ wealth was essentially wiped out entirely, the calculation of Mr. Killinger’s bonus still excluded the losses from mortgage securities, thus igniting shareholders’ rage and rightfully positing the question: Whose interests were the executives advancing after all? Despite seemingly infallible language and the intent of the Compensation Committee, the reality proved that the executives’ incentives were entirely misaligned with the long-term interests of the shareholders.

Even worse for the rest of us, WaMu’s resale of mortgage securities in the secondary market spread the pain elsewhere. Contrary to the well-known colloquialism, this is one case where spreading the manure around did not do much good.

B. “Business Acumen” in AIG’s “Shop”

18 See id.
19 Hardly we can expect the compensation committee to have a greater foresight into the company’s core business than the company’s CEO. Nevertheless, it is the compensation committee that is charged with defining long-term incentives for the company’s executives. Herein lies one of the paradoxes.
When these “shaky” WaMu loans were resold in the secondary market, they were sliced up, bundled, and repackaged into sophisticated derivatives that intended to minimize the risk of default. AIG then insured these instruments.20 This novel type of insurance was pioneered by one Joseph Cassano with the help from a handful of people in AIG’s London-based banking unit.21 While the entire unit employed only 377 of AIG’s 116,000 employees, it was the primary cause of AIG’s downward spiral, posting $25 billion in losses two quarters into 2008.22 These losses translated into direct and immediate cash outflows for AIG. Suddenly, a company with a trillion dollar balance sheet was lining up with an outstretched hand for the largest corporate “bailout” in history.

Prior to all the trouble, the compensation in Mr. Cassano’s unit averaged $1 million a year for the 377 people employed there; Mr. Cassano personally received $280 million in the eight years prior to his resignation in 2008.23 The incentives at AIG were clear: Write more insurance, get more money. Unfortunately, when the dust settled, the American taxpayers were the ones who ultimately paid for the salaries of these London-based bankers.24

C. Executive Compensation as the Cause? Likely Not, But a Trigger?

21 These instruments are known in the Wall Street jargon as CDOs or collateralized debt obligations, where the ownership of the mortgages has been sold to individual investors and the repayments of principal and interest are separated into maturity streams, known as tranches. See MOLES et al., THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS, at 361 (defining “mortgage-backed security”), and 560 (defining “tranche”).
22 See id.
24 The American taxpayers also paid for the large insurance sums that AIG owed to many foreign-owned banks, pursuant to insurance written by Cassano.
So, how meritorious is the claim that misaligned incentives on executive pay can trigger world-wide financial turmoil?

Mr. Killinger and Mr. Cassano hardly knew that they were operating in tandem when they were writing and insuring risky mortgages. Their expectations for the future were based on their knowledge of the past. Killinger and Cassano both had the same incentives based on one assumption: The incentives were to increase revenue and thereby to increase their compensation; the assumption was a reflection in the rearview mirror showing “constantly rising housing prices and inflated appraisals, conditions that could not possibly last.”

Of course, it would be at large an overstatement to place the responsibility for a world-wide financial collapse squarely on the shoulders of these two men. After all, they are not the ones delinquent on their mortgage payments; they did not erase margin requirements or make easy lending a reality through lax monetary policies and low interest rates.

They have, however, proved to be far less insightful than they held themselves out to be. In 2007, a year prior to AIG’s embarrassing demise, Mr. Cassano said:

We're sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places . . . . The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?

The irony of the situation is blatant. Fortunately for Killinger and Cassano, they emerged largely unscathed, stripped only of their egos. The author argues that the

compensation schemes at WaMu and AIG were not the least of the reasons that brought on the recent financial turmoil. And the independent compensation committees at these companies were as near-sighted as Mr. Cassano and Mr. Killinger themselves.

D. Conclusion

Without a doubt, Mr. Killinger and Mr. Cassano were motivated by their paychecks. Today, with the benefit of hindsight, many accuse this duo of engineering world-wide financial turmoil. But the accusers rarely link compensation with the men’s behavior. The author believes this omission to be material. What people do at work is motivated by a paycheck, otherwise they would not be collecting one. If a person is given an opportunity to increase the amount of his pay, he will most likely pursue that opportunity. It must be mentioned that neither Cassano’s nor Killinger’s contract had a “clawback” provision. Therefore, both men expected to keep their money once they received it.

On paper, WaMu did everything right, and yet it failed. The compensation incentives spoke of long-term value for the shareholders, but the reality proved the opposite. Cassano and Killinger most likely did not foresee the mayhem or caused it intentionally: After all, they were considered the all-stars of their trade. If that’s the case, this underscores the difficulty of determining the company’s long-term interests and deriving therefrom meaningful incentives for executive pay.

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27 See discussion infra Part III.
Part III: The Difficulty of Allocating Incentives on Executive Compensation: The Paradoxical American Reality

How consistent with reality is Business Roundtable’s maxim on executive compensation?

A. Introduction

This section examines the structure and role of compensation committees and reviews practical constraints affecting the committees’ work. Specifically, this section considers the independence of committee members, the role of compensation consultants, and the difficulty of formulating effective long-term incentives.

B. Compensation Committee on Paper

For the majority of U.S. public companies, the compensation of top executives is determined by a compensation committee, and the favorite task of any compensation committee is benchmarking – that is comparing one company’s executive pay to that of its peers. As a result, in 2007, an average S&P 500 CEO made 344 times the pay of an average American worker, 724 times the pay of a minimum-wage worker, and about $10.5 million more than 15 million unemployed Americans. These “populist” figures aside, the compensation committee is meant to ensure integrity in corporate compensation schemes. It embodies the principles of corporate law commonly known as duties of loyalty, care, and good faith; it prevents the potential conflicts of interest and ensures the greatest possible return for the shareholders.

Organizations such as Business Roundtable, consisting exclusively of top-tier CEOs who are accustomed to frictions with shareholders over executive pay, recognize the importance of compensation committees. Because the “oversized” executive pay packages originate from these committees and not from the executives themselves, compensation committees serve as a deflection from scrutiny. A compensation committee also serves a tax purpose. The IRS requires such a committee before a company can claim the $1 million limit on salary deductibility.32

Therefore, Business Roundtable wisely allots a central role for compensation committees. Business Roundtable’s principles on executive pay include the following provisions, among others: (1) long-term interests of the shareholders; (2) executive pay where a large portion of the compensation is tied to long-term performance and is represented by executives’ equity investment in the company; (3) existence and operation of an independent and well-educated compensation committee that determines the pay and the incentives; (4) complete, accurate, understandable, and timely disclosure of compensation schemes to the shareholders.33

It is difficult to argue against the soundness of these principles. But how consistent are they with reality?

C. Practical Hurdles of a Typical Compensation Committee

1. Independence of Directors
Jiang Jianqing, chairman of the world’s largest bank, made just $234,700 in 2008.34 The Industrial and Commercial Bank of China is one of three Chinese banks in

32 See IRC §162(m).
the world’s top five, and each of Mr. Jiang’s Chinese fellow CEO colleagues made roughly the same sum last year.\(^{35}\) HSBC, England’s largest and the world's third-largest bank, paid its CEO Michael Geoghegan $2.8 million in 2008.\(^{36}\) In contrast, America’s JPMorgan Chase, the world’s fourth-largest bank, rewarded its CEO, Jamie Dimon, with a hefty $19.6 million for the same time period. As it turns out, in 2008, the Chinese bankers made less than 2 percent and Mr. Geoghegan made less than 15 percent of Mr. Dimon’s pay.

Skeptics link this disparity to the work of U.S. compensation committees. To fully ascertain the independence of compensation committees, it is first necessary to understand the general makeup of an average board of directors. A typical board consists of past and present CEOs of major U.S. companies, which are often from within the same industry.\(^{37}\) Independent board members are those who are not employed and without “strong ties” to the company on whose board they sit. Several independent board members then make-up a compensation committee.\(^{38}\) Most commonly, the committee also includes a compensation consultant.

When a committee convenes, it sets compensation for the company’s top executives. In doing so, the committees often use “benchmarking,” a process that includes creating peer groups of comparable companies and using those companies’ compensation figures as a standard for comparison.\(^{39}\) Thus, in reality, although CEOs do

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\(^{35}\) See id.

\(^{36}\) See id.


\(^{38}\) See JAMES F. REDA, ET AL., THE COMPENSATION COMMITTEE HANDBOOK 3 (2007)

\(^{39}\) See id. at 24.
not set their own compensation, their compensation is set by other “independent” CEOs who are comparing each other’s pay checks.  

The author believes this setup also explains the growing “pay gap at the top,” meaning the pay gap between the chief executives and their top subordinates. Over the last two decades the compensation of No. 3 executives has decreased from around 50 percent to about 25 percent of the CEO’s pay. Similar trends are also in effect for other top subordinates. Could it be because the number of CEOs on corporate boards exceeds the number of CFOs? Or could it be because the CEOs have joined a covert union?

Of course, the cynical view includes an entrenched committee “rubber-stamping increasingly lucrative pay programs with a wink and a nod.” Skeptics have good reasons to argue that an “independent” compensation committee is nothing more than a thinly-veiled self-serving “union”. They insist that benchmarking benefits even “independent” directors: These directors can set a high standard for their own companies to benchmark against.

For example, WaMu used the following companies in its peer group when determining Mr. Killinger’s compensation: Bank of America, Bank of New York, Capital One Financial Corp., Citigroup, Countrywide Financial, Fifth Third Bancorp, JPMorgan Chase & Co., KeyCorp, National City Corp., PNC Financial Services Group,

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40 See id.  
42 See id.  
45 The author must add that they insist quite convincingly. But compare id. (I tend to dismiss the cynical scenario . . . . Although there are undoubtedly exceptions, outside board members approach their jobs with diligence, intelligence, and integrity, regardless of whether they have social or business ties with the CEO. However, judgment calls tend systematically to favor the CEO. Faced with a range of market data on competitive pay levels, committees tend to error on the high side.).
Suntrust Bank, U.S. Bancorp, Wachovia, and Wells Fargo & Company.\textsuperscript{46} JPMorgan Chase, in 2009, used the following companies: American Express, Bank of America, Citi, Goldman Sachs, Morgan Stanley, and Wells Fargo.\textsuperscript{47} Note that neither bank included their Chinese or even European colleagues in the mix.

2. \textbf{A Short Aside}

A very interesting, although not directly related topic, is the spread of American compensation practices overseas. For example, when an American subsidiary conducts business in a third country, the American parent typically implements American executive compensation practices within the subsidiary. Such was the case for Mr. Cassano and AIG’s London-based banking unit. This practice forces additional pressure on foreign companies, who are beginning to benchmark against their American competitors, thus increasing executive compensation worldwide.\textsuperscript{48} With additional pressure on executive pay after the recent financial turmoil, the future undoubtedly holds intriguing developments in this area.

3. \textbf{Independence of Compensation Consultants}

In 2008, ninety-two of the top-100 U.S. companies disclosed the retention of a compensation consultant.\textsuperscript{49} The compensation consultant also participates in determination of executive pay. The present disclosure rules require the company to disclose the role played by compensation consultants in determining or recommending

\textsuperscript{46} See WaMu Annual Report for 2007 on Form 10-K/A at 84, available at \url{http://www.sec.gov/Archives/edgar/data/933136/000104746908006870/a2185889z10-ka.htm}.
\textsuperscript{47} JPMorgan Chase, 2009 Proxy statement, available at \url{http://files.shareholder.com/downloads/ONE/785360220x0x283556/c5104551-d652-4e86-a894-852a4f97265a/2009_Proxy_PDF_format.pdf}.
\textsuperscript{48} Fortunately for the American companies, this likely makes their foreign counterparts less competitive. For further discussion, see Goodman, supra note 2.
\textsuperscript{49} See Shearman and Sterling, 2009 Trends in Corporate Governance of the Largest US Public Companies, at 13, \url{http://info-shearman.com/vfl/7430r9691V7164G68k} (registration required).
executive pay. However, presently, disclosure of the consultant’s independence is not required, neither is the employment of an independent consultant.

An issue with independence of compensation consultants arises when the consultant, in addition to providing compensation consulting, also provides other consulting services to the company. Compensation consulting usually represents only a small fraction of the total consulting bill. Therefore, non-compensation consulting, which is contractually secured by the management, represents the consultant’s livelihood. The consultant thus has few incentives to be the shareholders’ watchdog on the compensation committee.

For the 2009 proxy season, fifty-four of the U.S. Top-100 companies voluntarily disclosed that their compensation consultant was independent and twenty-nine acknowledged that their compensation consultant provided other services to the company. In light of the growing concern over independence of compensation consultants, additional disclosure rules have been proposed. They are discussed infra.

4. The Difficulty of Formulating Meaningful Long-term Incentives
The premise that corporations exist to create shareholder wealth is rarely questioned, and the creation of this wealth typically results from payment of dividends and appreciation of company’s stock. Theoretically, there could be nothing easier than to tie these objectives to executive compensation. In practice, however, determination of meaningful long-term incentives requires profound knowledge of the company’s core business.

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50 See id.
51 See id.
52 See id at 13.
For instance, in the previously discussed WaMu example, WaMu’s compensation committee connected the following objectives to the level of executive pay: “(i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty.” These objectives stated nothing about “upside potential” or “downside risk,” the two maxims at the center of the Business Roundtable’s principles. In fact, within just a few months, WaMu crashed into the downside territory under the risk which its management flagrantly ignored. On the other hand, risky lending indisputably increased WaMu’s net operating profit, banking fees, and customer loyalty—at least in the short run. Mr. Killinger himself, assumingly the best CEO WaMu could find and afford at the time, did not foresee this risk. The only people who foresaw the imminent burst of the bubble were marginalized economists that now stand in line for the Nobel Prize. Unfortunately for WaMu, none of them were sitting on WaMu’s compensation committee.

Herein lies the extreme difficulty of determining meaningful long-term incentives. The task is particularly complicated in the financial world, where banking and finance companies engage, *inter alia*, in highly sophisticated derivative trading. Consider, for example, the sheer size of the components of the derivative trading industry: Credit default swaps now account for $45 trillion dollars; interest rate derivatives stack up at $500 trillion. Faulty and near-sighted incentives laid out by inadequate compensation committees can be the first causal “trigger” of the next meltdown. Therefore, if

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shareholders are serious about creating long-term value, they must insist that executives’ incentives are thoroughly analyzed and determined by highly competent and truly independent compensation committees.

D. Conclusion

So, how consistent with reality are the Business Roundtable’s maxims on executive compensation? Again, Business Roundtable calls for executive compensation that is “closely aligned with the long-term interests of shareholders and with corporate goals and strategies.” Executive compensation “should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.” Compensation should be determined “entirely by independent directors” who understand all of its aspects and who oversee compensation consultants to ensure their independence.

The author’s research and analysis reveals that for the most part the trends in executive compensation are consistent with the Business Roundtable principles. At the same time, the principles themselves reflect an imperfect system: independence and competence of directors and consultants can be reasonably questioned. Can the proposed legislative efforts provide a fix?

Part IV: Legislative Proposals on Executive Compensation

What would be the scope and the efficacy of any proposed legislative check on executive compensation?

A. Introduction

Since the passage of the Troubled Assets Relief Program (“TARP”), there have been several legislative proposals that could significantly impact US compensation
practices. The reality of a legislative intervention is more likely than ever. Of course, few management teams will welcome the new rules, which will abridge the management’s authority and potentially limit or reduce executive paychecks.

Moving in the same direction, but using a different mechanism, are the shareholders. Within the recent year alone, there was a total of 77 compensation related shareholder proposals at the top 100 U.S. companies. This section examines the convergence of two fundamentally different influences on corporate law: the external governmental intercession and the internal shareholder pressure.

B. Shareholder Initiatives

Shareholders’ authority is derived from their ownership of the corporation. It is only natural that shareholders would desire to do everything within their power to ensure efficient operation of the enterprise. This subsection reviews the following shareholder initiatives as they relate to executive pay: say-on-pay provisions, clawback provisions, and risk assessment.


Say-on-pay provisions allow shareholders to influence remuneration of executives. In a typical say-on-pay scenario, shareholders do not directly determine executive pay, rather they have an opportunity to vote on the numbers prepared by the compensation committee. The vote can be advisory, that is non-binding, or, alternatively, shareholders may insist on a binding vote. Those companies that have

56 For background on the compensation regulations under the TARP, see Treasury Releases Executive Compensation Regulations for TARP Recipients, available at www.shearman.com/treasuryreleases-executive-compensation-regulations-for-tarp-recipients.
57 Id. at 6.
adopted say-on-pay proposals most commonly give the shareholders a non-binding vote.\textsuperscript{59} The vote serves a purpose similar to compensation disclosure rules. In essence, the shareholders are timely informed on the issue of executive pay and, at minimum, are able to voice their support or opposition to the compensation figures.

Although, say-on-pay votes are most often advisory, they can, nevertheless, serve an important purpose. Compensation committees become more aware of the scrutiny given by the shareholders to the committee’s proposals. Timely disclosure and feedback process also allows for greater accountability. Caution, on the other hand, should be taken with binding shareholder votes. In certain scenarios, disagreements and standoffs are possible between shareholders and management. The current administration is a big proponent of say-on-pay provisions. The governmental efforts in this area are discussed \textit{infra}.

\textbf{2. Clawback Provisions}

Clawback provisions are after-the-fact confiscatory measures. Clawback provisions are not particularly novel. For example, Sarbanes Oxley Act of 2002 provides for recoupment of certain executive compensation in the event of material noncompliance with financial reporting.\textsuperscript{60} Similarly, shareholders may include clawback provisions that are triggered by certain threshold performance figures. Arguably, such provisions have some merit for a company with a very predictable business model where meaningful incentives can be set with certainty. However, clawback provisions will do very little to help compensation committees set incentives within sophisticated industries, such as, for example, the financial industry. In short, clawback provisions do not offer a remedy for a

\textsuperscript{59} See id.
\textsuperscript{60} See Sarbanes-Oxley Act of 2002, Section 304, Pub.L. 107-204.
lack of foresight, they merely offer token assurance that “bad-boy” executives will not collect a windfall at the expense of shareholders.

3. Risk Assessment

Risk assessment attempts to tackle head-on one of the recurring themes of this paper: the difficulty of setting meaningful long-term incentives for executives. Risk is the “new buzzword” in executive pay discussion. Relevant shareholder proposals call for thorough evaluation of all potentially detrimental risks and for their disclosure. Compensation incentives should then thoroughly discourage unnecessary risk taking. The author is skeptical of any potential effectiveness of broad language that discourages unnecessary risk-taking. At large, risk assessment analysis is nothing more than a reincarnation of age-old duty of loyalty: The management is not expected to take on excessive risks for personal benefit and at the detriment of the shareholders. Because risk assessment will most likely become the task of compensation committees, the entire issue is again reduced to the competence of the committees’ members and their knowledge of the company’s core business. As long as broad admonitions are not replaced with company-specific and truly beneficial long-term incentives, the new “buzzword” will be as effective as any previous broadly worded measures.

C. Governmental Efforts

Unlike the shareholders, who derive their authority to influence corporate decisions from their ownership of the corporation, the government contends that it vicariously represents the host of other legitimately interested parties such as employees, labor unions, citizens, and consumers. The government is particularly watchful of

companies receiving federal aid. Following the recent bailout and in response to populist outrage, the Obama administration took several steps to limit executive compensation at these companies.

To a large extent, the administration’s efforts have paralleled those of the shareholders. Specifically, President Obama and his advisors have issued strong backing for say-on-pay provisions, risk assessment and disclosure, and clawback provisions. The Securities and Exchange Commission (“SEC”) is preparing a series of rules aimed at introducing these principles. At this time, the rules extend only to companies receiving government aid, but the administration has not been apologetic about the possibility of these rules applying to a broader mix of companies. Predictably, such propositions are likely to cause near-hysteria in certain corporate circles.

In addition to the present TARP and SEC rules, Congress is working on the Corporate and Financial Institution Compensation Fairness Act of 2009. This Act would codify non-binding say-on-pay shareholder votes, require the SEC to develop an additional set of executive pay regulations, and introduce “sound risk management” within executive pay.

In the interim, the administration has appointed a well-known Washington lawyer, Kenneth Feinberg, to the position frequently dubbed as “Pay Czar.” This development is entirely unique and unprecedented. Mr. Feinberg wields wide discretion, and he has

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64 See id.
66 See id.
not been afraid to use it. As of October 2009, he has cut total compensation by about 50 percent for the top 25 earners at seven companies that receive “exceptional help.”68 Most recently, he has left Kenneth Lewis of Bank of America without salary and bonus for 2009.69

Unfortunately, Mr. Feinberg’s efforts are likely to be as effective as clawback provisions: They provide a measure of consolation but do not reverse the past or create shareholder value for the future. Arguably, Feinberg’s efforts may even have an opposite effect – that of discouraging top executives from working at already struggling “bailed out” companies.70 Moreover, if Mr. Feinberg alone determines future incentives for executives at a broad range of industries and does so without appropriate knowledge or expertise, he may repeat the mistakes of WaMu’s and AIG’s compensation committees.

D. Conclusion

So, what is the scope and efficacy of any proposed legislative check on executive compensation? The proposed scope of governmental action is largely parallel to already existing internal initiatives of the shareholders, and legislation will only make mandatory what many companies have adopted voluntarily. Of course, if any legislation codifies or extends the position of the “pay czar,” it may not be long before American executives are “benchmarking” against their Chinese counterparts. As to the efficacy of the proposed rules, it will be marginal at best. Voluntary compliance has stolen much of legislators’ “thunder,” and none of the proposals are revolutionary or particularly innovative. The legislation does, however, send an important signal to the corporate world: The

government is not afraid to challenge the existing *status quo* in executive pay and beyond. If the present administration continues until 2016, the country will undoubtedly face additional changes.

**Part V: Afterword**

This paper was meant to be a short legal survey of today’s state of executive compensation. Presently, this field is evolving at a rapid pace, and many of the overarching issues within this debate are truly interdisciplinary and of significant societal import. The author believes the scrutiny awarded to this subject by the general public, the press, and the academic community is fully justified. Our joint discussion elicits recurrent, critical, and indispensable themes of just societal construction. Many of the questions presented by this dialogue – wealth, its generation and distribution within a society, incentives and their effect on human behavior, efficiency and the formative power of law – are all long-stranding and recurring human concerns. Hopefully, our efforts will foster a realization that maximum overlap of seemingly diverging interests is possible. However, that is a subject of a different intellectual journey.