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MORE INTRUSIVE FEDERAL RULES FOR EXECUTIVE COMPENSATION UNJUSTIFIED

by
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Executive compensation continues to receive close attention from activist investors, the media, courts, and politicians. Chairman of the House Financial Services Committee Barney Frank, for example, is pushing a bill (H.R.1257) to amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation. The Bill has been approved for floor debate by the Rules Committee. Under it, public companies would be required to hold an annual nonbinding shareholder vote on the executive compensation arrangements disclosed in the company's proxy statement and also would require a separate shareholder vote for any additional compensation that is tied to the sale or purchase of a company.

There is no question that executive compensation has grown significantly over the last two decades. House Report 110-088, which accompanies H.R.1257, notes that in FY 2005 the median CEO among 1,400 large companies "received $13.51 million in total compensation, up 16 percent over FY 2004." The Report also notes that "in 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500 to 1."

Yet, we live in an era in which many occupations carry such vast rewards. Lead actors routinely earn $20 million per film. The NBA's average salary is over $4 million per year. Top investment bankers can earn annual bonuses of $5 to $15 million. Unless one's objection to the amounts received by corporate executives is based solely on the size of those amounts, one must be able to distinguish corporate managers from these other highly paid occupations.

In their book, *Pay Without Performance* (Cambridge, MA: Harvard University Press, 2004), upon which House Report 110-088 heavily relies, law professors Lucian Bebchuk and Jesse Fried contend that actors and sports stars bargain at arms'-length with their employers, while managers essentially set their own compensation. As a result, they claim, even though managers are under a fiduciary duty to maximize shareholder wealth, executive compensation arrangements often fail to provide executives with proper incentives to do so and may even cause executive and shareholder interests to diverge. In other words, the executive compensation scandal is not the rapid growth of management pay in recent years, but rather the failure of compensation schemes to award high pay only for top performance.

Bebchuk and Fried's "managerial power" argument is premised on their claim that boards of directors have been pawns of management. As a result, they claim, executive pay greatly exceeds the levels that would prevail if directors loyal to shareholder interests actually bargained with managers at arms'-length.

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Since Bebchuk and Fried provide much of the intellectual framework for H.R.1257, it is worth noting that their claims have faced strong criticism. One review, for example, argues "that in many settings where 'managerial power' exists, observed contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally." John E. Core, Wayne R. Guay, & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay without Performance?* 28 (Dec. 1, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=628742. Snyder argues that "most of the results that [Bebchuk and Fried] see as requiring us to postulate managerial dominance turn out to be consistent with a less sinister explanation." Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 132 (2003). Finally, and perhaps most importantly, Gabaix and Landier find that "the six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large U.S. companies." Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased so Much?* (May 8, 2006), available at http://ssrn.com/abstract=901826. In other words, CEOs got richer because their shareholders got richer.

In sum, the evidence simply does not support the managerial power model on which H.R. 1257 rests. To the contrary, executive pay turns out to be closely linked to performance. Put simply, H.R. 1257 is attacking a problem that does not exist.

Let us suppose, however, that the system of executive compensation in fact is broken. Should the purported problem be addressed at the federal level?

In our federal system, issues of corporate governance, including both executive compensation and the substance of shareholder voting rights, traditionally have been the province of state corporation law rather than federal securities law. As the Supreme Court has explained, "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." *CTS Corp. v. Dynamics Corp*., 481 U.S. 69, 89 (1987). Accordingly, it "is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares." *Id.* at 91.

Of particular relevance to H.R. 1257 is the Supreme Court's reminder that it is state law that determines the rights of shareholders, "including ... the voting rights of shareholders." *Id.* at 89. State law thus determines such questions as which matters may be authorized by the board of directors acting alone and which must be authorized by the shareholders. State law, for example, establishes the vote required to elect directors. State law determines whether shareholders have the right to cumulative voting in the election of directors, whether the corporation's directors may have staggered terms of office, and whether shareholders have the right to remove directors prior to the expiration of their term of office. H.R. 1257 thus would constitute a substantial federal intrusion into the state sphere and a substantial violation of the longstanding federalism principles in this area.

According to the *CTS* decision, the country as a whole benefits from assigning these matters to the states. This is so, in large part, because ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis pointed out many years ago, "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of country." *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion, but instead may lead to more efficient corporate law rules.

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