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Removing a Splinter by Amputating the Limb: How the SEC Misses the Mark (Again) on Executive Compensation with the Pay Ratio Disclosure Rule

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REMOVING A SPLINTER BY AMPUTATING THE LIMB: HOW THE SEC MISSES THE MARK (AGAIN) ON EXECUTIVE COMPENSATION WITH THE PAY RATIO DISCLOSURE RULE

I. INTRODUCTION

In 2013, the typical Walmart employee made less in the entire year than Michael Duke, Walmart's then-chief executive officer ("CEO"), made on January 1st alone.[1] In fact, Duke earned more than the typical Walmart employee's yearly salary by *lunchtime.*[2] The Economic Policy Institute ("EPI") conducts a study each year determining how much the average CEO makes compared to the typical employee.[3] In 2000, the ratio of CEO compensation-to-median employee pay reached an all-time high of 376-to-1.[4] In other words, the average CEO earned as much in one day as the typical employee of their company earned in 376 days. In 2016, that ratio dropped to a mere 271-to-1, which is a definite improvement.[5] However, when the ratio in the United States is nearly twice as large as those in Switzerland and Germany, and Japanese CEOs make roughly fifty-eight times what their employees make, 271-to-1 looks very bad.[6]

The annual compensation, or "overcompensation" as some would call it, of American CEOs is not going unnoticed by the American public. A study from Stanford University's Graduate School of Business in 2016 found that seventy-four percent of Americans believe that CEOs are being paid more than they should in relation to their average employee's salary.[7] Leading up to the 2016

1. Philip Bump, *The CEO of Your Company has Probably Already Earned Your 2016 Salary this Year*, WASH. POST (Jan. 5, 2016), https://www.washingtonpost.com/news/the-fix/wp/2016/01/05/the-ceo-of-your-company-has-probably-already-earned-your-2016-salary-this-year/?utm_term=.572114b35d1b [https://perma.cc/7H58-UE7Y].

2. *Id.*

3. Lawrence Mishel & Jessica Schieder, *CEO Pay Remains High Relative to the Pay of Typical Workers and High-Wage Earners*, ECON. POLICY INST. (July 20, 2017), http://www.epi.org/publication/ceo-pay-remains-high-relative-to-the-pay-of-typical-workers-and-high-wage-earners/ [https://perma.cc/5VMF-3UC2].

4. *Id.*

5. *Id.*

6. Anders Melin, *Executive Pay*, BLOOMBERG (Jan. 22, 2018, 11:12 PM), https://www.bloomberg.com/quicktake/executive-pay [https://perma.cc/R9UG-GRNT].

7. DAVID F. LARCKER, NICHOLAS DONATIELLO & BRIAN TAYAN, STANFORD GRADUATE SCH. OF BUS., AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION 3 (2016), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2016-americans-ceo-pay.pdf [https://perma.cc/ZSY7-Q3HC].

Presidential election, candidates from both sides of the aisle addressed the issue, and then-candidate Donald Trump called the current executive compensation environment "a total and complete joke."[8] However, the massive inequality between executive pay and typical employee pay has not always been an element of the American business landscape. In the thirty years between 1985 and 2015, the CEO-to-typical employee pay ratio increased from 46-to-1 to 276-to-1.[9] American lawmakers have explored numerous avenues attempting to curb this executive compensation issue. The latest iteration comes in the form of a mandatory disclosure required by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and Item 402 of Regulation S-K.[10] Under the "SEC Pay Ratio Disclosure Rule," which came into effect for fiscal years beginning on or after January 1, 2017, the Securities and Exchange Commission ("SEC") requires public companies to disclose the ratio of the compensation of their CEOs to the median compensation of their employees in their yearly proxy statement.[11]

Due to this Rule's likely inefficacy and the unreasonable burden it will put on reporting companies caused by inexactitude and a lack of direction from the SEC, the Pay Ratio Disclosure Rule will likely cause more harm than good.[12] If the American government truly wants to rein in executive compensation, it should look to two separate sources for a blueprint to success: the German government and American history books. A combination of executive and board regulations inspired by the German government and employee-centric social influences that had success in America's past could curb executive compensation and allow for both employees and shareholders to offer their input in more efficient and effective fashions.

Part I of this article will address the historical context behind executive compensation in the United States and why it has become such a topic for concern. In addition, Part I will discuss how American society has approached the issue of executive compensation, both in the courts and in boardrooms. Part II will discuss the three avenues American government has previously taken to

8. Jacob Goldstein, *Why Did America's CEOs Get Such a Big Raise?*, NPR PLANET MONEY (Feb. 18, 2016, 4:25 PM), https://www.npr.org/2016/02/18/467253394/why-did-americas-ceos-get-such-a-big-raise [https://perma.cc/L829-RXY5].

9. Roger Lowenstein, *CEO Pay Is Out of Control. Here's How to Rein It In*, FORTUNE (Apr. 19, 2017), http://fortune.com/2017/04/19/executive-compensation-ceo-pay/ [https://perma.cc/9PH6-25FW].

10. Press Release, U.S. SEC. & EXCH. COMM'N, *SEC Adopts Rule for Pay Ratio Disclosure* (Aug. 5, 2015), https://www.sec.gov/news/pressrelease/2015-160.html [https://perma.cc/TDB3-ZUB7].

11. *Id.*

12. IKE BRANNON, CTR. FOR CAPITAL MKTS. COMPETITIVENESS, THE EGREGIOUS COSTS OF THE SEC'S PAY-RATIO DISCLOSURE REGULATION 2 (2014), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf [https://perma.cc/5W44-6BH2].

address executive compensation: taxation, "say-on-pay" proposals, and mandatory disclosure requirements. Part III of this article will discuss the government's latest attempt at curbing executive compensation: the SEC Pay Ratio Disclosure Rule. This section will discuss the requirements of the rule itself, the public reaction to the rule, the application of the rule, and its likely results. Part IV of this article will discuss how the German government has handled the issue of executive compensation and will suggest that the American government, drawing inspiration from its German counterpart, implement employee representation on compensation committees through non-binding recommendations.

II. A HISTORY OF EXECUTIVE (OVER)COMPENSATION

A historical overview of executive compensation begins with the rise of the position to be compensated: the executive. In general, the position of "executive" exists simply as a medium through which passive owner-shareholders manage large corporations.[13] Until the turn of the twentieth century, executives did not exist, for the most part, because there was no need for them.[14] Organizations were run by individuals who received their compensation mostly from direct ownership.[15] The rise of salaried middle managers began with railroads, which were too expansive and complex as companies to be run by individuals.[16] Then, the "Great Merger Movement" of the early twentieth century led to dispersed ownership as smaller companies came together to form industrial conglomerates.[17] As companies grew in size, majority owners handed off their senior management positions to non-owner executives tasked with running the company in a way that would satisfy shareholders.[18]

During the era leading up to World War I, executives were compensated no differently than other employees.[19] The predecessor to executive compensation came in the form of executive bonus plans, and one of the first executive bonus plans arose at Bethlehem Steel, headed at the time by Charles Schwab.[20] Under that bonus plan, executives were paid a share of the company's net profits, and these bonuses grew nearly to the level of shareholder dividends by the late 1920s.[21] Executive bonus plans became increasingly popular as a method to

13. Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 695 (2010).

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* at 696.

18. Wells, *supra* note 13, at 696.

19. *Id.* at 697.

20. *Id.* at 699.

21. *Id.*

align executive incentives with those of the shareholders.[22] Owners reaped the benefits of increased shareholder value and, consequently, rewarded executives with bonuses to incentivize the growth of company profits.[23]

The first widely-heard objections to executive compensation policies coincided with the fall of the American economy during the Great Depression. With the economy failing, the American public became fixated on the idea that corporations awarding executive compensation exceeding $1,000,000, like the salaries brought home by the top executives at Bethlehem Steel, American Tobacco, and National City Bank at the end of the 1920s, should have been contributing some of that compensation to lower employees in hopes of stimulating the economy.[24] However, public outrage against executive compensation was not merely a coincidental byproduct of a failing economy. The public may have spoken out about these executive salaries before the fall of their economy, but they did not understand to what extent executives were being compensated. In fact, the amounts paid to executives as compensation were, for the most part, unknown to those in the public sphere until they were released to the public as a result of lawsuits that were often unrelated to compensation.[25]

Although public disclosure of executive salaries is commonplace today, the first compelled compensation disclosures did not come until the 1930s.[26] New Deal-era politicians, with the help of the Interstate Commerce Commission, implemented the country's first pay disclosure requirements,[27] the first of which required railroads to identify those executives whose compensation exceeded $10,000 a year.[28] In 1934, the SEC was created pursuant to the Securities Exchange Act of 1934.[29] Later that year, the SEC released rules requiring that publicly owned companies release the compensation, including the various components, of their top three executives.[30]

While executive compensation continued to rise relative to inflation through the 1930s, the 1940s brought a drop in executive compensation that has not been

22. *Id.* at 701.

23. Wells, *supra* note 13, at 701.

24. Steven A. Bank, Brian R. Cheffins & Harwell Wells, *Executive Pay: What Worked?*, 42 J. CORP. L. 59, 64 (2016).

25. Kevin J. Murphy, *Executive Compensation: Where We are, and How We Got There*, *in* HANDBOOK OF THE ECON. OF FIN. 44 (George Constantinides et al. eds., Elsevier/North-Holland, 2013).

26. *Id.*

27. *Id.*

28. *Id.*; *Railroad Salary Report: I.C.C. Asks Class 1 Roads About Jobs Paying More Than $10,000 a Year*, WALL ST. J., Apr. 28, 1932, at 2.

29. U.S. SEC. & EXCH. COMM'N, *The Laws that Govern the Securities Industry*, https://www.sec.gov/about/laws/sea34.pdf [https://perma.cc/C9KF-BXEW] (last visited Nov. 12, 2018).

30. Murphy, *supra* note 25, at 45.

seen in the years since.[31] With World War II tightening labor markets and increasing both union strength and government market intervention, the wartime atmosphere was only one of a number of factors that contributed to the drop in executive pay.[32] A 2011 study by Carola Frydman and Raven Molloy determined that the drop in relative executive pay, defined as "the ratio of executive pay to average industry earnings," is largely related to a drop in the return to firm size and a growing negative correlation between compensation and industry unionization.[33]

The war overseas during that period was the center of attention, and firms on the home-front struggled because of it. Executive pay rose much less than that of the typical worker during the 1940s, and the return to firm size fell from 1940 until 1942 and remained persistently low until 1949.[34] Frydman and Molloy attribute this correlative drop to a change in corporate governance practices and shifting social norms.[35] During the war, the idea of the "equality of sacrifice" rang throughout the media as people in America gave up their wealth for the success of their soldiers fighting in foreign lands.[36] Then-President Roosevelt's fireside chats repeated ideals of sacrificing for the good of others most likely filtered into the business world, and these ideals may have altered public perceptions of fairness regarding executives' egregious paychecks and the possibility of monopolizing firms taking advantage of the American public.[37]

Wartime also meant that unions on the home-front had an opportunity to grow in power. With the war-time economy boosting many unionized industries, employers were less opposed to union activity.[38] Additionally, the government took action during wartime to minimize labor disputes so that the country could focus on producing materiel for the fight overseas.[39] Union membership grew drastically during the war and continued to stay high until the end of the decade.[40] With greater support, unions were able to voice their opposition to

31. Carola Frydman & Raven Molloy, *Pay Cuts for the Boss: Executive Compensation in the 1940s* 1 (Nat'l Bureau of Econ. Res., Working Paper No. 17303, 2011).

32. *Id.*

33. *Id.* at 4–5.

34. *Id.* at 24–25.

35. *Id.*

36. David M. Kennedy, *The Nation: On the Home Front; What Is Patriotism Without Sacrifice?*, N. Y. TIMES (Feb. 16, 2003), http://www.nytimes.com/2003/02/16/weekinreview/the-nation-on-the-home-front-what-is-patriotism-without-sacrifice.html [https://perma.cc/43BK-NNPT].

37. Frydman & Molloy, *supra* note 31, at 25.

38. *Id.* at 18.

39. *Id.*

40. *Id*.

excessive executive salaries more effectively, and executives had no choice but to listen or run the risk of losing their workforce.[41]

After the drop in executive pay in the 1940s, executive compensation stagnated relative to the average worker's salary from the 1950s and into the late 1970s.[42] This is most likely due to the fact that top Federal Income Tax rates during that period remained above seventy percent, temporarily deterring executives from taking higher salaries.[43] From 1950 to 1975, average executive compensation grew by only 0.8% annually after adjusting for inflation.[44] Due to the phenomenon now referred to as the "Great Compression," the increase in post-WWII demand for less-educated workers combined with the consistently rising minimum wage to create a smaller wage gap among employees.[45] With more employees to pay, and a higher minimum wage to pay those employees, executives had no choice but to distribute compensation out of a smaller pot than they had become accustomed to in the 1920s.[46] As taxes rose for executives and other top earners during the 1950s, companies transitioned to paying their executives using tax-favored deferred compensation schemes.[47] The Revenue Act of 1950 allowed companies to grant executives "restricted stock options" which, in effect, gave executives an ascension to wealth in the form of ownership of the company while not being subject to the risk of typical stocks.[48] The "restricted stock options" of the Revenue Act of 1950 became "qualified stock options" in the Revenue Act of 1964.[49] "Qualified stock options" gave executives the benefit of holding stock in their company while receiving much more favorable tax treatment than typical stocks.[50] However, this transition to deferred compensation options did not have a substantial effect on overall executive compensation into the 1970s.[51]

The squeeze on executive pay lasted almost thirty years, but tides turned in the latter half of the 1970s. From 1973 to 1979, median cash compensation for CEOs in the Forbes 800 rose more than 12.2% annually while the annual inflation rate was 8.5%.[52] For the first time since before WWII, executive pay

41. *Id.*

42. Bank, Cheffins & Wells, *supra* note 24, at 93 n.261.

43. *History of Federal Income Tax Rates: 1913 – 2017*, BRADFORD TAX INSTITUTE, https://bradfordtaxinstitute.com/Free_Resources/Federal-Income-Tax-Rates.aspx [https://perma.cc/ZTJ3-UXJU] (last visited Aug. 17, 2018).

44. Bank, Cheffins & Wells, *supra* note 24, at 65.

45. Claudia Goldin & Robert A. Margo, *The Great Compression: The Wage Structure in the United State at Mid-Century*, 107 Q. J. ECON. 1, 32 (1992)

46. *Id.*

47. Bank, Cheffins & Wells, *supra* note 24, at 78.

48. Revenue Act of 1950, Pub. L. No. 81-814, § 218, 64 Stat. 906, 942 (1950).

49. Revenue Act of 1964, Pub. L. No. 88-272, § 221, 78 Stat. 19, 64–66 (1964).

50. *Id.*

51. Bank, Cheffins & Wells, *supra* note 24, at 65–66.

52. *Id.* at 66.

had experienced a sustained growth relative to the inflation rate, and it was only getting started.[53] According to an article in *Newsweek* from 1991, "CEO pay rose dramatically all through the 1980s—212 percent . . . —four times faster than pay for ordinary workers."[54]

Executive compensation continued to climb at an astronomical rate through the 1990s. The median compensation of an S&P 500 CEO was $2.2 million in 1992.[55] By 2001, that number had grown to $7.2 million, more than a 200% increase.[56] The early twenty-first century was the pinnacle for American executive compensation, and executive compensation has been declining slowly ever since.[57] However, CEO compensation is still extremely high in relation to the average employee's salary, and the American public is asking: How did this happen? What does it mean? And how will it change?

Outrage against excessive executive compensation became a major societal concern in the 1980s when a takeover boom arose fueled by the junk bond market, which facilitated the financing of large takeovers.[58] As executives in the country's biggest companies feared losing their positions of power due to hostile takeovers from shareholders, many large firms implemented so-called "golden parachutes" to provide ousted executives with cash payouts and other benefits to ease their transition into unemployment.[59] While an abundance of takeovers in the 1980s cost mid-level workers their jobs and their livelihoods, executives received notice of their dismissal alongside lucrative severance payments.[60] Naturally, the vast majority of Americans who did not receive millions of dollars upon their termination were furious with the executives who did. It did not help that American executives in the early 1990s were making roughly three times their counterparts in Britain, four times their counterparts in Germany, and six times their counterparts in Japan.[61] This discrepancy is likely related to the shift toward performance-oriented pay for American executives in the early 1990s.[62]

The issue with the rise of performance-oriented pay is that the correlation between the performance of a company and the executives' pay has never been

53. *Id.*

54. *The Pay Police*, NEWSWEEK (June 16, 1991, 8:00 PM), http://www.newsweek.com/pay-police-204464 [https://perma.cc/AV7Y-HYEB].

55. Bank, Cheffins & Wells, *supra* note 24, at 67.

56. *Id.*

57. Mishel & Schieder, *supra* note 3.

58. Peer Fiss, *A Short History of Golden Parachutes*, HARV. BUS. REV., (Oct. 3, 2016), https://hbr.org/2016/10/a-short-history-of-golden-parachutes [https://perma.cc/6VUG-NVVA].

59. *Id.*

60. Bank, Cheffins & Wells, *supra* note 24, at 67.

61. Peter Passell, *Economic Watch; Those Big Executive Salaries May Mask a Bigger Problem*, N.Y. TIMES (Apr. 20, 1992), http://www.nytimes.com/1992/04/20/business/economic-watch-those-big-executive-salaries-may-mask-a-bigger-problem.html?pagewanted=all [https://perma.cc/J5P2-QKSP].

62. Bank, Cheffins & Wells, *supra* note 24, at 67–68.

clear.[63] Graef Crystal, a professor from the University of California at Berkeley and an expert on executive pay, conducted a survey in the early 1990s that found that ninety-six percent of CEO pay "has nothing, absolutely nothing, to do with the company's performance."[64] Crystal compared the executive compensation at 450 corporations to the total return received by those corporations' shareholders and found that only five percent of the statistical variation could be explained by the company's performance that year.[65] Crystal concluded that, "[t]he most common reference used by compensation committees must be a table of random numbers."[66]

Boards of directors typically determined executive pay leading up to the 1990s, but a trend arose that decade where CEOs recruited directors who might have been more likely to reward greater executive compensation in return for their position as director.[67] Crystal's study uncovered an interesting observation in the 1990s: "the higher the directors' fees, the higher the CEO's pay."[68] This suggests that CEOs were buying directors' loyalty with high directors' fees and accepting the directors' thanks in the form of higher compensation.[69]

Another issue that arose from performance-oriented pay is the "ratchet effect" (also called the "Lake Wobegon" effect after the fictional lake in a Garrison Keillor novel where "all the children are above average").[70] As boards of directors meet to set their executives' compensations, they typically bring in an outside consultant to determine an appropriate amount.[71] Those consultants usually compare peer companies and provide the boards with what would equate to an average executive compensation.[72] However, afraid to admit that their executives are simply "average," the board of directors will set their executives' compensation at a level that would equate to the sixtieth or seventieth percentile, "ratcheting up" the average executive compensation with each "above-average" determination.[73]

The rapid growth of executive compensation came to a halt in the early 2000s due to the "dot-com" bubble burst and corporate governance scandals such as what lead to the collapse of Enron.[74] As the economy sank and the

63. *See The Pay Police*, *supra* note 54.

64. *See id. See also* Passell, *supra* note 61.

65. *See* Passell, *supra* note 61.

66. *Id.*

67. *See The Pay Police*, *supra* note 52.

68. *Id.*

69. *Id.*

70. DANIEL JUROW ET AL., EXECUTIVE COMPENSATION: HOW DOES PAY INFLUENCE DECISIONS AND GOVERNANCE? 7, https://www8.gsb.columbia.edu/leadership/sites/leadership/files/bernstein-exec-comp-whitepaper.pdf [https://perma.cc/2WFQ-84EN].

71. *The Pay Police*, *supra* note 52.

72. *Id.*

73. JUROW ET AL., *supra* note 70, at 7.

74. Bank, Cheffins & Wells , *supra* note 24, at 68.

American people had tangible evidence of executives extorting their power, executives lost bargaining power and were forced to give up some of their questionably-earned pay.[75] The financial crisis in 2008 led to another slight drop in executive pay, but executive pay in America still vastly eclipses the pay of the average employee.[76]

The ratio of executive pay to average employee pay in America has practical implications beyond public perception and international comparison. Studies have shown that there is a significant relationship between pay equity among different levels of employees and the resulting product quality.[77] It is the author's opinion that product quality can be a crucial determinant of customer satisfaction and business profitability. The perception of unfairness created by vast pay inequity, as is becoming prominent in America today, can lead to a decreasing sense of worth from lower-level employees and, ultimately, lost profits.[78]

III. THREE REGULATORY APPROACHES TO CURBING EXECUTIVE COMPENSATION

Instead of sitting back while executives continually drive their compensation higher than the levels enjoyed by their employees, American regulators have attempted to curb excessive executive compensation in three different fashions: tax implementation, shareholder-powered "say on pay" proposals, and compelled disclosure.[79]

A. Taxation of Executive Compensation

In August of 1993, on the recommendation of then-President Bill Clinton, Congress enacted legislation—the Revenue Recollection Act of 1993 and section 162(m) of the Internal Revenue Code—that removed the ability of corporations to deduct executive compensation in excess of one million dollars that was not performance-based.[80] In addition, the Revenue Recollection Act imposed a special surtax on incomes exceeding $250,000.00 per year.[81] The Congressional theory was that exorbitant executive salaries would be too costly from a tax standpoint to negotiate and to provide.[82] Writing shortly after the

75. *Id.*

76. *Id.*

77. Douglas M. Cowherd & David I. Levine, *Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory*, 37 ADMIN. SCI. Q. 302, 314, 316 (1992).

78. *Id.* at 307.

79. JUROW ET AL., *supra* note 70, at 8–9.

80. Charles M. Elson, *Executive Overcompensation – A Board-Based Solution*, 34 B.C. L. REV. 937, 940 (1993).

81. *Id.*

82. *Id.* at 957.

release of the Revenue Recollection Act, Charles M. Elson of Stetson University said that, "[t]his response is akin to removing a splinter by amputating the limb. The splinter is gone, but at an enormous cost."[83] He theorized then that the attempt to place a cap on executive compensation would limit the productivity of executives who were incentivized by higher salaries.[84] When he opined that the "tax-based 'cure' may result in more harm to the patient than the initial problem," he was correct that it would result in more harm, but the cause of the harm was not what he expected.[85]

The initial response to the $1,000,000 cap was to inspire companies whose CEOs earned less than that amount to increase their executive salaries.[86] Instead of becoming a mark that companies should avoid, the million dollar mark became a "standard" for executive salary and a bargaining point for those CEOs who thought they were not being compensated enough.[87] In the first year after the tax was imposed, executive pay increased at a rate twenty-nine percent faster than it had in the fourteen years before the tax came into effect.[88] Section 162(m) made it much more difficult for shareholders to challenge the reasonableness of any executive salary under one million dollars, and, while one million dollars might be pocket change for some executives in large corporations, it could be entirely unreasonable for executives with smaller roles in smaller organizations.[89]

In light of the shareholders' inability to challenge salaries under one million dollars, it must be mentioned that courts have a history of being particularly hesitant to interfere in executive compensation practices when shareholders attempt to challenge compensation through derivative actions.[90] Because executive compensation decisions are protected by the business judgment rule, the court applies an assumption that the board of directors made the correct decision in allocating assets so long as there is no self-dealing and so long as there is not a waste of corporate assets.[91] The doctrine of waste, established by the Supreme Court in *Rogers v. Hill*, indicates that companies cannot "justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property."[92] However, applying the doctrine of

83. *Id.* at 958.

84. *Id.*

85. Elson, *supra* note 80, at 958.

86. Joy S. Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 522–23 (2009).

87. JUROW ET AL., *supra* note 70, at 8.

88. Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 89 (1998).

89. *Id.* at 96–97.

90. Elson, *supra* note 80, at 959–60.

91. *Id.*

92. 289 U.S. 582, 591 (1933).

waste has been notoriously difficult to accomplish as explained by the *Heller v. Boylan* case from the New York State Supreme Court:

> Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuringrod? 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?[93]

In the infamous Walt Disney case where Michael Ovitz received $140 million dollars in a severance package after only fourteen months of employment, the court reiterated the difficult burden of proving waste by saying "waste is a rare, unconscionable case[] where directors irrationally squander or give away corporate assets."[94]

In addition to mystifying the amount of executive compensation that would qualify as reasonable, Section 162(m) also allowed for unlimited deductions on executive compensation over one million dollars attributed to performance-based pay.[95] Treasury regulations provide an exceedingly low bar for performance based pay: "[a] performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses."[96]

Section 162(m) was not the only failed attempt at curbing executive compensation through taxation. Sections 280G and 4999, signed before Section 162(m), similarly missed their mark.[97] Section 280G, intended to decrease implementation of golden parachutes, disallowed tax deductions for golden parachute payments exceeding the amount 2.99 times greater than annual compensation.[98] However, like the cap on executive compensation, this led to the standardized golden parachute payment being at least 2.99 times annual compensation.[99] Section 4999 imposed a tax equal to twenty percent the amount of any payment in excess of the golden parachute limit set in Section 280G.[100] Companies responded with "gross ups," or increases in payment, to cover the twenty percent tax imposed on their golden parachute agreements.[101] This resulted in corporate monies being used to both inflate executive compensation and to pay off the taxes resulting from the inflated compensation.

93. 29 N.Y.S.2d 653, 679 (N.Y. Sup. Ct. 1941).
94. In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (alteration in original).
95. Mullane, *supra* note 86, at 524.
96. 26 C.F.R. § 1.162-27(e)(2)(i) (2018).
97. JUROW ET AL., *supra* note 70, at 8.
98. 26 U.S.C. § 280G (2000).
99. JUROW ET AL., *supra* note 70, at 8.
100. 26 U.S.C. § 4999 (2000).
101. JUROW ET AL., *supra* note 70, at 8.

B. Shareholder "Say-on-Pay" Proposals

Shareholders had voiced their opinions about executive compensation for many years before they were given the authority to weigh in and the means to do so.[102] The origin of the "say-on-pay" proposal, as it is now known, is an expansion to SEC Rule 14a-8 in 1992 to include executive compensation among the issues shareholder proxy proposals were able to address.[103] Previously disallowed under the "ordinary business" exclusion preventing shareholders from submitting proposals having to do with the ordinary business of a company's management,[104] political unrest with the issue of executive compensation in the early 1990s inspired the SEC to place a renewed emphasis on that issue.[105]

Starting in 1992, shareholders had the power to offer their opinion on the paychecks executives were cashing. However, "say-on-pay" votes in the United States are merely advisory: even if the shareholders responded to a proposal with a resounding "yes" or "no" vote, the company has the ability to completely ignore the proposal.[106] Additionally, "say-on-pay" proposals were not initially required until the United States mandated their inclusion under the Dodd-Frank Act.[107] The current iteration of Rule 14A requires that companies submit a "say-on-pay" proposal to their shareholders in the annual proxy at least once every three years.[108] Even so, the "say-on-pay" proposal is merely an advisory vote, as the vote "shall not be binding on the issuer or the board of directors of an issuer."[109]

So far, the advisory "say-on-pay" proposals have produced mixed results in the United States. A 2017 study in the Multinational Finance Journal cited studies that have found that "shareholders generally support managers' pay packages unless the firm performs poorly and has excessive executive pay, low shareholder returns, and negative proxy voting recommendations."[110] Another study cited found that "fewer than 3% of firms fail to pass their say-on-pay proposals, but shareholder dissent is higher in firms with high CEO

102. Stephani A. Mason, Ann F. Medinets & Dan Palmon, *Say-on-Pay: Is Anybody Listening?*, 20 MULTINAT'L FIN. J. 273, 285 (2016).

103. *Id.* at 285–86.

104. 17 C.F.R. § 240.14a-8 (1963).

105. Mason, Medinets & Palmon, *supra* note 102, at 285.

106. *Id.* at 286.

107. Press Release, U.S. SEC. & EXCH. COMM'N, *SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act*, (Jan. 25, 2011), https://www.sec.gov/news/press/2011/2011-25.htm [https://perma.cc/EA84-TRTT].

108. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010–11 (Jan. 25, 2011) (codified at 17 C.F.R. pts. 229, 240).

109. 15 U.S.C. § 78n-1(c) (2012).

110. Mason, Medinets & Palmon, *supra* note 102, at 292.

compensation or poor performance."[111] In other words, advisory "say-on-pay" proposals are extremely unlikely to pass, even when shareholders are upset with executive compensation or the company's performance.

The argument for the ineffectiveness of advisory "say-on-pay" votes is two-fold: shareholders do not want to put in the effort necessary to make a meaningful vote, and shareholders have a more powerful ability than advisory voting.[112] For those shareholders with minimal holdings in the company, "the opportunity cost to become informed is high" due to the elaborate nature of compensation plans.[113] Shareholders with more expansive, non-controlling holdings are unlikely to vote against executive compensation because there is a high chance their own executive compensation is arguably excessive as well.[114] The shareholders' greater power, however, is the power to sell their shares.[115] If shareholders are not happy with a company's executive compensation plans, they can sell their shares and move on to a different investment. Those with short-term investments have little to no incentive to vote, and those with long-term investments are shown to be very likely to vote in favor of the company's compensation plan.[116]

C. Disclosure of Executive Compensation

The "say-on-pay" initiative was not the only effort the SEC took in the early 1990s to curb executive compensation. Coinciding with the expansion of shareholder proposals to include executive compensation, the SEC increased requirements for the disclosure of executive compensation.[117] As already mentioned, compensation disclosure became mandatory in the 1930s.[118] The goal then was to "shame" executives into taking smaller compensation packages following the Great Depression.[119] In 1938, the disclosure requirement expanded to include full descriptions of compensation plans, and in 1942 those compensation arrangements were required to be presented in tables for each director or officer making more than $20,000 a year.[120] Ten years later, the SEC mandated disclosure for each director and for the "top 3" executives, as well as demanding that deferred compensation, in the forms of pension or retirement plans, had to be disclosed separately.[121]

111. *Id.*
112. *Id.* at 308.
113. *Id.*
114. *Id.*
115. Mason, Medinets & Palmon, *supra* note 102, at 308.
116. *Id.*
117. Bank, Cheffins & Wells, *supra* note 24, at 92.
118. *Id.* at 90.
119. *Id.*
120. *Id.*
121. *Id.* at 91.

In 1978, the SEC again increased disclosure requirements by mandating that companies make their compensation disclosures closer to the beginning of disclosure documents, attempting to prevent those disclosures from being buried within the documentation.[122] As addressed previously, the heightened scrutiny on disclosures in the early 1990s coincided with an incredible boom in executive compensation.[123] Reflecting on the reform of the 1990s, Graef Crystal, who had been an advisor to the SEC for the purposes of developing the reform, said, "I absolutely thought it would cause comp[ensation] to go down because the disclosures would be so embarrassing. But it turned out that when somebody is hauling in $200 million, he's not embarrassable."[124]

While the goal of increased disclosure was to shame executives into taking lower salaries, more than seventy years of disclosure has only led to increased salaries. A 2006 *New York Times* article summarizes the various attempts to curb executive compensation and how they have failed.[125] The article points out that increased disclosure has only lead to an increased awareness of what other executives are making and how they are making it.[126] The author states: "history suggests that whenever [an executive] discover[s] a fellow C.E.O. is getting something they don't have, they make a grab for it."[127]

In the same article, then-SEC Chairman Christopher Cox said that "[i]t is not the role of the S.E.C. to determine the level of compensation. It is the role of directors and shareholders."[128] This would seem to be backwards as the SEC continues to enact stricter regulations on compensation disclosure, while directors only have incentives to increase compensation and shareholder "say-on-pay" proposals lack the necessary power or participation to have a legitimate effect.

The current state of executive compensation has scholars perplexed. At the end of the 2006 article, author Joseph Nocera left this note:

> So how would you fix the executive pay problem? Send me your ideas at tsnocera@nytimes.com. If I get enough good ones, I'll revisit the subject. And if not, I'll just keep wringing my hands, like everyone else.

Nocera left the Times in 2015.[129] He never released a solution to the issue of executive compensation.

122. Bank, Cheffins & Wells, *supra* note 24, at 91.

123. *Id.* at 92.

124. Joseph Nocera, *Disclosure Won't Tame C.E.O. Pay*, N. Y. TIMES (Jan. 14, 2006), http://www.nytimes.com/2006/01/14/business/disclosure-wont-tame-ceo-pay.html [https://perma.cc/LVF9-SMUY].

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Joe Nocera*, N.Y. TIMES, https://www.nytimes.com/by/joe-nocera [https://perma.cc/MX6Y-LGJ4].

IV. THE SEC PAY RATIO DISCLOSURE RULE: MORE TROUBLE THAN IT'S WORTH

The latest regulatory attempt at curbing executive compensation is Section 953(b) of the Dodd Frank Wall Street Reform and Consumer Protection Act, which is more casually referred to as the "pay ratio directive" or the "SEC Pay Ratio Disclosure Rule" (the "Rule").[130] Originally proposed in 2010, the final Rule passed in August of 2015.[131] Author of the Rule, U.S. Senator Bob Menendez of New Jersey, celebrated the passage of the rule in saying that the Rule would "[restore] sanity to runaway executive pay."[132] Menendez insisted that "[t]his simple benchmark will help investors monitor both how a company treats [its] average workers and whether its executive pay is reasonable."[133]

The Rule was set to take effect in 2017, with initial disclosures coming in proxy statements during 2018.[134] This buffer period turned out to be advantageous as the Rule produced continuous debate lasting up until those affected were forced to turn their attention to implementing the rule.[135]

Initial supporters of the Rule, like N.Y. State Comptroller Thomas P. DiNapoli, opined that a great disparity between CEO pay and employee pay would lead to a drop in morale and productivity.[136] Laura Campos, the Director of Shareholder Activities for the Nathan Cummings Foundation, wrote a letter to the Secretary of the SEC, Elizabeth Murphy, illustrating that shareholders have a right to know information concerning executive pay because those exorbitant wages could be used to improve the company and the corresponding stock.[137] Even Hillary Clinton spoke out in support of the Rule, saying that "workers have a right to know whether executive pay at their company has gotten out of balance, and so does the public."[138]

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130. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953(b) (2010) (codified as amended at 15 U.S.C. § 78n).

131. Press Release, *Menendez Reacts to SEC Vote Approving CEO-to-Worker Pay Ratio Rule*, U.S. SENATOR BOB MENENDEZ (Aug. 5, 2015), https://www.menendez.senate.gov/news-and-events/press/menendez-reacts-to-sec-vote-approving-ceo-to-worker-pay-ratio-rule [https://perma.cc/D87X-5NHZ].

132. *Id.*

133. *Id.*

134. U.S. SEC. & EXCH. COMM'N, *supra* note 10.

135. *See* Press Release, Acting Chairman Michael S. Piwowar, U.S. SEC. & EXCH. COMM'N, *Reconsideration of Pay Ratio Rule Implementation*, (Feb. 6, 2017), https://www.sec.gov/news/statement/reconsideration-of-pay-ratio-rule-implementation.html [https://perma.cc/NBF8-NMLB].

136. Letter from Thomas P. DiNapoli, N.Y. State Comptroller, to Elizabeth M. Murphy, Sec'y, U.S. Sec. Exch. Comm'n (Nov. 27, 2013).

137. Letter from Laura Campos, Director of Shareholder Activities, The Nathan Cummings Foundation, to Elizabeth M. Murphy, Sec'y, U.S. Sec. Exch. Comm'n (Nov. 21, 2013).

138. Drew Harwell & Jena McGregor, *This New Rule Could Reveal the Huge Gap Between CEO Pay and Worker Pay*, WASH. POST (Aug. 4, 2015), https://www.washingtonpost.com/news/

The Rule's initial passage came as a result of a 3-2 vote from the SEC.[139] The two dissenting Commissioners, Daniel Gallagher and Michael Piwowar, responded to the passage with seething dissents.[140] In response to the SEC's reasoning that the Rule would "help inform investors in their oversight of executive compensation, including say-on-pay votes," Gallagher, stealing a line from Justice Scalia, said, "this is pure applesauce."[141] Gallagher argued that the Rule was far too broad, particularly the definition of "employee", and that implementation would cost an "astronomical" amount of money.[142] He found "no credible evidence in the record that a reasonable investor would find the pay ratio to be useful," and called the pay ratio information that would be disclosed "low-quality, non-comparable data of use only to certain investors who have idiosyncratic reasons for wanting it."[143] From Gallagher's point of view, the intent of the Rule was to "name and shame registrants into reducing CEO pay."[144] He closed out his comments by saying that the Rule "highlights the sad fact that, over five years after Dodd-Frank, the Commission is still wandering through the wilderness, and that the voice of one or two minority Commissioners crying out in that wilderness can do little to put us back on the right path."[145]

Piwowar had different concerns, stating that the Rule "pandered to politically-connected special interest groups and, independent of the [Dodd-Frank] Act, could not stand on its own merits."[146] He stated that the Dodd-Frank Act allows for investor testing of possible regulations, but the SEC did not take advantage of this testing in development of the Rule.[147] He also pointed out that the passage of the Rule was rushed, and the timing of the vote was intentional due to rising opposition in Congress and the convenient recesses in the House of Representatives and the Senate, allowing for passage with reduced

on-leadership/wp/2015/08/04/this-new-rule-could-reveal-the-huge-gap-between-ceo-pay-and-worker-pay/?noredirect=on&utm_term=.4202b4158c49 [https://perma.cc/5SVT-CKJS].

139. Peter Schroeder, *SEC Finalizes Contentious CEO Pay Ratio Rule*, THE HILL (Aug. 5, 2015, 12:37 PM), http://thehill.com/policy/finance/250317-sec-finalizes-contentious-ceo-pay-ratio-rules [https://perma.cc/2ZHJ-L3WK].

140. *Id.*

141. Daniel M. Gallagher, *Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule*, U.S. SEC. & EXCH. COMM'N (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html#_ednref4 [https://perma.cc/L4N7-J45U].

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

146. Michael S. Piwowar, *Dissenting Statement at an Open Meeting on Pay Ratio Disclosure*, U.S. SEC. & EXCH. COMM'N (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html [https://perma.cc/46TM-83HV].

147. *Id.*

opposition.[148] In Piwowar's words, the SEC's actions qualified as "bullying tactics," and according to Piwowar, "[a]cquiescing to bullies only gives them more ammunition and makes it worse."[149]

Continued opposition threatened the enactment of the Rule. As recently as February of 2017, then-Acting Chairman of the SEC Piwowar opened the Rule up to comment.[150] Not until September of 2017, three months before the Rule were to go into effect, did the SEC confirm that the Rule would be implemented.[151] At that point, some public companies required to disclose a ratio had yet to begin preparing for its calculation, leaving them with an extremely short amount of time to achieve compliance.[152]

The major points of opposition are that the Rule is excessively costly and provides no real benefit to investors.[153] The excessive costs come from the time and manpower needed to calculate the required ratio.[154] The Center for Capital Markets conducted a study comprised of 118 public companies that would be required to disclose their pay ratio and found that the average company expected to spend 952 hours per year calculating their ratio at an average labor cost of $185,600.[155] Applied to the entire population of public companies that are affected by the Rule, this equates to $710.9 million and 3.6 million hours applied to compliance with the Rule annually.[156]

The difficulty in complying with the Rule is a product of the language of the Rule itself.[157] The statute provides that an "employee" means "an individual employed by the registrant or any of its consolidated subsidiaries, whether as a full-time, part-time, seasonal, or temporary worker, as of a date chosen by the registrant within the last three months of the registrant's last completed fiscal year."[158] The proposed rule stated that public companies should determine their median employee from an employee base established on the last day of their fiscal year, but outside comments from public companies whose employee bases are heavily affected by seasonal hiring requested a more lenient standard.[159]

148. *Id.*

149. *Id.*

150. Piwowar, *supra* note 135.

151. Kelly Simoneaux & Hope Spencer, *CEO Pay Ratio Disclosure – Time to Prepare*, NAT'L LAW REVIEW (Sep. 15, 2017), https://www.natlawreview.com/article/ceo-pay-ratio-disclosure-time-to-prepare [https://perma.cc/NE3K-KK3L].

152. *Id.*

153. *See* Gallagher, *supra* note 141; Piwowar, *supra* note 146.

154. Steven A. Bank & George S. Georgiev, *Paying High for Low Performance*, 100 MINN. L. REV. HEADNOTES 14, 21–22 (2016).

155. BRANNON, *supra* note 12, at 6–7.

156. *Id.* at 7.

157. 17 C.F.R. § 229.402(u) (2017).

158. *Id.*

159. Recent Regulation, *Securities Regulation – Dodd-Frank Wall Street Reform and Consumer Protection Act — SEC Finalizes Regulations Requiring Companies to Disclose Pay*

While this may be helpful for public companies with seasonal employee populations that do not accurately represent the average employee population, it provides additional compliance costs for public companies who either (1) have tax and payroll systems that are not calculated until the last day of the fiscal year, or (2) go through the added work of calculating ratios determined by employee populations on numerous dates for the most favorable numbers.[160]

In additional guidance for applying the Rule, the SEC excluded from the definition of employee "workers who are employed, and whose compensation is determined, by an unaffiliated third party but who provide services to the registrant or its consolidated subsidiaries as independent contractors or 'leased' workers."[161] However, many public companies hire employees under the "independent contractor" title and determine those employees' compensation, which produces even more effort required for companies who employ both independent contractors whose compensation is determined by a third party, such as a contracting firm, and independent contractors on contracts with compensation determined by the company itself.[162] The law requires that the public company affected by the Rule "may identify the median employee using annual total compensation or any other compensation measure that is consistently applied to all employees included in the calculation."[163] Additionally, public companies are allowed to exclude certain employees from this calculation.[164] Up to five percent of non-U.S. employees are excludable, but the public company must exclude all the employees from any non-U.S. country if they choose to exclude any employee from that country.[165] Also, employees from countries where data privacy laws may conflict with the disclosure are also excludable.[166] Both of these exclusions may help public companies with large, multi-national employee populations, but executing the exclusions still requires an impressive amount of work to determine if the exclusions will save time or produce a more favorable ratio.[167]

By way of offering guidance for how to determine the components of "annual total compensation" necessitated by the Rule, the regulation provides

Ratio Between the CEO and Median Employee. — Pay Ratio Disclosure, 80 Fed. Reg. 50, 104, (Aug. 18, 2015) (To be codified at 17 C.F.R. Pts. 229, 240, 249), 129 HARV. L. REV. 1144, 1147 (2016) (hereinafter Recent Regulation).

160. *Id.* at 1151.

161. Cydney S. Posner, *SEC (Limited) Guidance on Pay-Ratio Disclosure*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Oct. 1, 2017), https://corpgov.law.harvard.edu/2017/10/01/sec-limited-guidance-on-pay-ratio-disclosure/ [https://perma.cc/T5WW-UXTN].

162. *Id.*

163. 17 C.F.R. § 229.402(u)(4)(ii)(B).

164. Recent Regulation, *supra* note 159, at 1146.

165. *Id.*

166. *Id.*

167. *See id.*

this definition: "Annual total compensation means total compensation for the registrant's last completed fiscal year."[168] The SEC allows the use of "reasonable estimates" in calculating annual total compensation,[169] but it offers no guidance regarding how benefits, allowances, insurance costs, et cetera should be included in the calculation.[170]

The flexibility allowed in determining the ratio required by the Rule "will likely render pay ratio comparability across companies—even those within the same industry—virtually unachievable."[171] Because each public company can determine compensation in its own manner and choose to exclude certain employees at their discretion, there is extensive potential for public companies to game the disclosure in deceptive ways.[172] Each public company's disclosure will be unique, but it is inevitable that activists will use the ratios to "name and shame" certain public companies with high pay ratios,[173] even if the differing pay ratios produce "no particular insight whether a CEO or the median employee is fairly compensated."[174]

As of January 2018, one pay ratio has been released from a reporting company.[175] Invivo Therapeutics Holdings Corp., a public company of sixteen employees, submitted this verbose disclosure in their proxy statement:

> PAY RATIO
>
> Following is a reasonable estimate, prepared under applicable SEC rules, of the ratio of the annual total compensation of our Chief Executive Officer to the median of the annual total compensation of our other employees. We determined our median employee based on base salary (annualized in the case of full- and part-time employees who joined the Company during 2017) of each of our 16 employees (excluding the Chief Executive Officer) as of December 1, 2017. Of the two potential median employees, we selected the employee without significant severance payments. The annual total compensation of our median employee (other than the Chief Executive Officer) for 2017 was $384,528. As disclosed in the Summary Compensation Table appearing on page 76, our former Chief Executive Officer's annual total compensation for 2017 was $2,471,333. Our former Chief Executive Officer served in this capacity from

168. 17 C.F.R. § 229.402(u)(2)(ii).

169. 17 C.F.R. § 229.402.

170. BRANNON, *supra* note 12, at 5–6.

171. Allan B. Afterman, *Pay Ratio Disclosure: A Final SEC Rule Laden with Controversy*, CPA JOURNAL (Apr. 2016), https://www.cpajournal.com/2016/04/14/pay-ratio-disclosure-final-sec-rule-laden-controversy/ [https://perma.cc/LH3G-6KJD].

172. Bank & Georgiev, *supra* note 154, at 22.

173. Afterman, *supra* note 171.

174. BRANNON, *supra* note 12, at 4.

175. Cydney S. Posner, *First Pay-Ratio Disclosure Sighted*, LEXOLOGY (Jan. 30, 2018), https://www.lexology.com/library/detail.aspx?g=b2dbb1d7-c68e-4a29-a1c7-58e5d84148e9 [https://perma.cc/M6K6-86C5].

> January 1, 2017 to December 18, 2017, which includes December 1, 2017, the date of determination for the median employee. As noted in the footnotes of the Summary Compensation Table, Mr. Perrin's salary in the Summary Compensation Table includes a payment of 10 days salary in conjunction with his resignation in lieu of the notice period in his Employment Agreement, so his annual total compensation includes salary for a full year. Based on the foregoing, our estimate of the ratio of the annual total compensation of our CEO to the median of the annual total compensation of all other employees was 6.4 to 1. Given the different methodologies that various public companies will use to determine an estimate of their pay ratio, the estimated ratio reported above should not be used as a basis for comparison between companies.[176]

Note that Invivo took the initiative to explicitly plead that the ratio disclosed should not be used to compare public companies. Also, note the variety of elements that went into determining the ratio in a public company with less than twenty employees. Imagine the time and effort it would take to apply this Rule in a public company of twenty *thousand* employees. Due to the flexibility of the Rule and the arbitrary nature of the results, early findings show that the Rule will cost a lot more than it is worth.

V. TAKING A TIP FROM GERMAN CORPORATE GOVERNANCE

After the global economic downtown at the end of the twenty-first century's first decade, global leaders met in Pittsburgh for the G20 Summit.[177] Political leaders from around the world agreed that extensive executive compensation reform was needed to prevent future economic crises.[178] In the U.S., the first attempt at comprehensive economic reform came in the form of the aforementioned Dodd-Frank Act.[179] On the date of the Act's passage, the *New York Times* wrote that "a number of the details have been left for regulators to work out, inevitably setting off complicated tangles down the road that could last for years."[180] The Times was correct in its prediction that implementing the Act would be arduous. As of the five-year anniversary of the Act's passage, almost thirty percent of the rulemaking deadlines set in the Act had passed without finalization of any rule.[181] A packet of all of the rules passed or proposed by that anniversary would contain more pages than thirty-four copies of Herman

176. Invivo Therapeutics Holdings Corp., Registration Statement (Form S-1) (Jan. 26, 2018).

177. Emilie Mathieu, *Beyond Wall Street: Germany, the United States, and Executive Compensation*, 38 BROOK. J. INT'L L. 579, 581 (2013).

178. *Id.*

179. *Id.* at 596.

180. *Id.*; Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES (July 21, 2010), http://www.nytimes.com/2010/07/22/business/22regulate.html [https://perma.cc/9LEP-5LSD].

181. DAVISPOLK, DODD-FRANK PROGRESS REPORT 2 (July 16, 2015), https://www.davispolk.com/files/2015-07-16_Dodd-Frank_Progress_Report_Five-Year_Anniversary.pdf [https://perma.cc/3V6G-U87S].

Melville's *Moby Dick*.[182] While U.S. regulators labored to implement economic reform post-recession, the powers-that-were in Germany made quick work in passing legislation that took almost as long to take effect as it does to pronounce.

In June of 2009, before the G20 Summit when global leaders were to discuss executive compensation reform, Germany passed the *Vorstandsvergiltungsangemessenheitsgesetz*, or "VorstAG" for short.[183] While the Dodd-Frank Act has taken years to be put into action, the VorstAG was entirely entered into force by the end of that summer.[184] The VorstAG was designed to reformat German executive compensation by increasing transparency and giving shareholders more insight into companies' compensation policies, both goals the Dodd-Frank Act intended to achieve.[185] It is important to note that, while executive compensation had been a contentious topic for decades in the U.S. by the time the 2009 G20 Summit came around, excessive executive compensation had been a non-issue in Germany until the turn of the century.[186] In 1997, the top German executives at Daimler-Chrysler, BMW, VEBA, and Siemens in Germany made from $1.5 to $2.5 million, while the top American executives at Daimler-Chrysler, GE, Intel, and Healthsouth made between $14 and $131 million (using a rough conversion from the now-defunct deutschmark).[187]

There are two reasons German executive compensation was so low for so long. First, the body that governs German public companies, the *Aktiengesetz*, did not allow companies to offer stock options as compensation until 1998.[188] Second, the driving historical forces for German and American corporate governance were very different. While the U.S. focused on "stock market" or "Anglo-American capitalism" that inspired companies to run primarily for the benefit of shareholders, German companies historically practiced "welfare capitalism," which places an emphasis on the concerns of the stakeholders, including employees and creditors.[189] In a welfare capitalism system, a company's executive compensation is tied to the interests of the employees and creditors of the company, and those interests lead to greater influence in setting compensation.[190] Whereas American companies were more concerned with growth, German companies, under the welfare capitalism system, were

182. DAVISPOLK, FIVE YEARS OF DODD-FRANK (2015), https://www.davispolk.com/files/dodd-frank_five-year_anniversary_infographic.pdf [https://perma.cc/FR2L-B7FW].

183. Mathieu, *supra* note 177, at 583.

184. *Id.* at 584–85.

185. *Id.*

186. *Id.* at 600.

187. *Id.* at 600 & n. 95.

188. Mathieu, *supra* note 177, at 600.

189. Trevor Buck & Azura Shahrim, *The Translation of Corporate Governance Changes Across National Cultures: The Case of Germany*, 36 J. INT'L BUS. STUD. 42, 43 (2005).

190. *Id.*

concerned with the economic stability that comes with satisfied employees and creditors.[191]

At the turn of the century, Anglo-American capitalism found its way across the pond and into German territory on the heels of the Daimler-Chrysler merger.[192] When the two companies came together, the *vice* chairman of the U.S. company made more than the top ten German employees *combined*.[193] With stock options available as an element of executive compensation post-1998, German executives began to follow the lead of their American counterparts and focus on the shareholders instead of the stakeholders.[194] German compensation rose over the opening decade of the twenty-first century, but it came nowhere close to where American compensation stands.[195] AFL-CIO information compiled in 2012 found that German CEOs were paid salaries 147 times as large as their average workers, but top-ranking American executives at S&P 500 companies made 354 times as much as their average workers during that year.[196]

The differences in how the U.S. and Germany treat executive compensation are amplified by the corporate governance systems in place in both countries. Due to German skepticism toward directors' ability to protect a company's interests while making decisions affecting other stakeholders, German stock companies are required to have a two-tiered board.[197] Such companies must have a management board to run the company and a supervisory board to ensure that the management board is doing their job.[198] Any member of the management board cannot also serve on the supervisory board, establishing a check on the powers of the management board and ensuring that the management board is acting in the best interests of the company.[199]

191. Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 501 (2001).

192. Mathieu, *supra* note 177, at 602–03; Edmund L. Andrews & Laura M. Holson, *Shaping a Global Giant: The Overview; Daimler-Benz Will Acquire Chrysler in $36 Billion Deal That Will Reshape Industry*, N.Y. TIMES (May 7, 1998), http://www.nytimes.com/1998/05/07/business/shaping-global-giant-overview-daimler-benz-will-acquire-chrysler-36-billion-deal.html [https://perma.cc/PS2L-SPAC].

193. *Daimler Chrysler Will Face Wide Gap in Executive Pay*, WARDSAUTO (June 1, 1998), http://wardsauto.com/news-analysis/daimlerchrysler-will-face-wide-gap-executive-pay [https://perma.cc/U4SG-CJ45].

194. Cheffins, *supra* note 191, at 510.

195. Mathieu, *supra* note 177, at 602–03.

196. *S&P 500 CEOs Make 354 Times More Than Their Average Workers: AFL-CIO*, HUFFINGTON POST (Apr. 15, 2013), https://www.huffingtonpost.com/2013/04/15/sp-500-ceos_n_3085601.html [https://perma.cc/C8EF-RQRS].

197. Franklin A. Gervutz, *Disney in a Comparative Light*, 55 AM. J. COMP. L. 453, 470 (2007).

198. Aktiengesetz [AktG][Stock Corporation Act], § 111(1), translation at https://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.html#p0591 [https://perma.cc/FCA8-DC5J] (Ger.).

199. Aktiengesetz [AktG][Stock Corporation Act], § 105(1), translation at https://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.html#p0591 [https://perma.cc/FCA8-DC5J] (Ger.).

Additionally, the supervisory board determines the compensation of the members of the management board.[200]

In contrast, the U.S. Code of Federal Regulations requires that the majority of directors at listed issuing companies be disinterested, but interested directors can serve on compensation committees or perform the function of determining compensation (so long as they do not vote on their own salaries, which would be challengeable by shareholders absent shareholder ratification).[201] Some corporations might attempt to mimic the formation of a supervisory board in the formation of compensation committees, but they are not required.[202] There are some requirements for the independence of compensation committee members among NYSE and NASDAQ-listed companies,[203] but the independence of these committee members does not produce the same company-centric concern that the German supervisory board does.

Part of the reason German supervisory boards are so concerned with the well-being of the company is the presence of employee representation on supervisory boards, a concept known as co-determination.[204] Under German law, companies with more than 2,000 employees must allow employees working in Germany to elect fifty percent of the supervisory board.[205] If there are supplementary committees to take on tasks such as determining executive compensation, they must follow the same ratio.[206] Those elected by the employee population will be much more likely to avoid approving excessive executive compensation for two reasons. First and foremost, those from the average employee population will be blown away by the numbers presented in multimillion dollar compensation packages.[207] A 2016 study from the Stanford Graduate School of Business found that the typical American believes a CEO at a Fortune 500 company earns $1.0 million in compensation.[208] The median reported compensation for Fortune 500 CEOs in 2016 was $10.3 million, ten times the estimate of the typical citizen.[209] The other reason employee

200. Aktiengesetz [AktG][Stock Corporation Act], § 112, translation at https://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.html#p0591 [https://perma.cc/FCA8-DC5J] (Ger.).

201. 17 C.F.R. § 229.407.

202. Gervutz, *supra* note 197, at 471.

203. Order Approving NYSE Proposed Rule Changes Relating to Compensation Committees, Exchange Act Release No. 34-68639, 78 Fed. Reg. 4570 (Jan. 11, 2013); Order Approving NASDAQ's Proposed Rule Changes Relating to Compensation Committees, Exchange Act Release No. 34-68640, 78 Fed. Reg. 4554 (Jan. 11, 2013). *See also* Jesse M. Brill, *Compensation Committee and Advisor Independence Standards: Actions to Take Now*, 27 CORP. EXEC. 1, 1 (2013).

204. Gervutz, *supra* note 197, at 474.

205. Mitbestimmungsgesetz [Co-determination Act], §§ 1, 7, 27, 29 (Ger.).

206. Gervutz, *supra* note 197, at 474.

207. *Id.* at 476.

208. LARCKER, DONATIELLO & TAYAN, *supra* note 7, at 4.

209. *Id.*

representatives tend to shy away from gratuitous executive compensation is selfish, but rightfully so. Employee representatives are much more concerned with direct executive-to-employee compensation comparisons than independent committee members would be, as they might be on the wrong end of the equation if they think their CEO is making money that should be going home with the average worker instead.[210]

The other aspect of German corporate governance that affects treatment of executive compensation is the fact that the sections of the German Corporate Governance Code ("GCGC") are not technically binding, but merely recommendations.[211] The GCGC operates on a "comply- or-explain" basis where publicly-traded companies are only required to disclose to what extent they have complied with GCGC recommendations and why they chose not to comply with any recommendations.[212] If the GCGC issues recommendations that do not produce satisfactory compliance, the German government has shown a willingness to turn those recommendations into binding law, just as it did with disclosure of individual compensation in the early 2000s.[213] The fact that the GCGC is not technically binding allows companies to interpret corporate governance recommendations in ways that suit the companies themselves, instead of relying on the legislature to enact binding laws which apply across the board for all types of businesses.[214] Instead of forcing companies to comply with inflexible regulations, the GCGC allows companies to find what is best suited for themselves and their stakeholders.[215] Additionally, this flexible corporate governance environment allows the market to be the ultimate arbitrator when it comes to approval of corporate actions.[216] Instead of relying on the government to enact stricter regulations that force suitable corporate compliance, German companies are inspired to act responsibly on their own merit or run the risk of their shareholders leaving for greener pastures in the form of companies with more appropriate corporate governance strategies.[217]

While the Dodd-Frank Act has been slow to implement and, arguably, ineffective, the German VorstAG represents the opposite end of the spectrum in terms of efficacy and efficiency. The VorstAG set out to (1) increase

210. Gervutz, *supra* note 197, at 476.

211. Mathieu, *supra* note 177, at 607–08.

212. *Id.*

213. *Id.* at 609.

214. *Id.* at 608.

215. *Id.*

216. Dr. Gerhard Cromme, Chairman of the Gov't Comm'n on the German Corporate Governance Code, Address at the Press Conference Following the Handing over of the German Corporate Governance Code (Feb. 26, 2002), https://www.dcgk.de/en/kommission-33/die-kommission-im-dialog/details/remarks-by-dr-gerhard-cromme.html [https://perma.cc/JC84-EVQ4].

217. *Id.*

transparency, (2) increase sustainability among compensation structures, and (3) emphasize long-term company success and stability instead of immediate profits in structuring compensation.[218] A study of the first three years of the VorstAG's implementation found that transparency increased dramatically with longer, clearer, and more in-depth compensation discussions being released to shareholders.[219] Early returns on sustainability and a shift in focus toward extended success are inconclusive over such a short time period as they are both long-term goals by nature.[220] However, the biggest mark of success is not a quantitative figure. It is the fact that the public concern for executive compensation in Germany has subsided.[221] The German government has moved past executive compensation to other corporate governance issues, and German newspapers rarely discuss executive compensation anymore, something that cannot be said of their American counterparts.[222]

Even without the immediate statistics to back up the success of the VorstAG, the decrease in public concern suggests that the German government's quick and effective approach to tackling the issue of executive compensation through increased transparency and a shift toward sustainability at the interest of the companies themselves, and not the government that regulates them, achieved what it set out to accomplish. While the U.S. struggles to implement corporate governance guidelines a decade after the G20 Summit where executive compensation was a main focus, the German government proposed and implemented a successful plan in a few months' time by giving German companies guideposts to success instead of highly-regulated avenues to compliance. What happened in Germany is evidence that more government regulation might not be the ideal pathway to addressing corporate governance issues. If the American government were to take a few pointers from their old rivals across the Atlantic and implement something similar to the VorstAG, they might be able to see if a system based on long-term success and sustainability, instead of increased compliance, would lead to empowered companies and shareholders being able to address their executives' compensation on their own terms. After years of failures as a result of stricter regulations, maybe the U.S. could benefit from letting companies have a looser leash for once.

One of the goals of the SEC Pay Ratio disclosure is to tighten the wage gap between the employees and employers, but it will most likely result only in employee dissatisfaction, which will lead to lower worker morale and poor performance.[223] This paper has illustrated that external influences such as

218. Mathieu, *supra* note 177, at 636.
219. *Id.* at 636–38.
220. *Id.* at 637–38.
221. *Id.* at 652.
222. *Id.*
223. Cowherd & Levine, *supra* note 77, at 316.

increased disclosure, shareholder proposals, and stricter tax regulations have done little to help dispel the outrage surrounding executive compensation. In fact, increased disclosure and stricter tax regulations have provided benchmarks for executive compensation and produced great increases in executive pay. Former-SEC Chairman Cox said that it is not the SEC's job to decrease executive compensation, and he is correct.[224] Considering how the increased disclosure that goes along with the SEC Pay Ratio might cause more harm than good, this begs the question: What is the point of placing stricter regulations on companies if we already know they will not help?

The SEC Pay Ratio is supposed to guide shareholders in "say-on-pay" proposals, but, even in the brief history of "say-on-pay", it is evident that (1) the advisory votes have little effect on executive compensation, and (2) shareholders have little incentive to vote against executive compensation when they are better suited selling their shares and walking away.

Shareholders have the ability to sell their stock at will, so they are naturally less inclined to be involved in the governance of a corporation. The same can be said of shareholders in Germany as it can in the U.S. However, German executive compensation culture differentiates itself because employees are much more tied to the organization than are the shareholders.

While shareholders are primarily concerned with stock price and the changes in executive compensation that coincide with the market's view of the organization, employees are naturally inclined to be much more interested in the allocation of the organization's funds and the long-term health of the organization as a product of their position. Shareholders have the option of selling stock and pursuing greener pastures if corporate governance is not suitable. If employees are unhappy about corporate governance in their current organization, they are in a more difficult situation than unhappy shareholders. Leaving one organization for a position in another is arguably more burdensome than selling stock, particularly without a guarantee that the new position will be in an organization any more favorable than the last.

It is suggested that the issue of executive compensation starts and ends with those who determine it: the board of directors. However, as previously illustrated, there is little to no incentive for those whose compensation is determined by the company's highest executives to decrease the pay of those executives.[225]

The lowest executive-to-average worker compensation rates in U.S. history came during the 1940s, but the likely causes—increased union power and heavy influence from social norms—cannot be replicated by external forces.[226] If the U.S. is interested in solving its issue with executive compensation, I suggest that

224. *See* Nocera, *supra* note 124.

225. JUROW ET AL., *supra* note 70, at 7.

226. Bank, Cheffins & Wells, *supra* note 24, at 106–07.

the U.S. take a hint from their German counterparts and recommend employee representation on compensation committees.

This would provide for greater influence from a body of stakeholders that has inherent interest in the long-term wellbeing of the company and the transparency of company-wide compensation. It has been shown that increased transparency in compensation policies leads to increased firm performance.[227] A quick way to increase transparency would be to have an employee representative sitting at the table where compensation is determined, so that representative can report the reasoning behind this determination to the employees they represent. If employees are unhappy or compensation policies are not disclosed in a transparent fashion, the employee representative acts as a direct link between an employee population and those determining the compensation. Additionally, this representative can act as both a simulation of the union pressure union leaders held over executives in unionized industries in the 1940s and as a liaison for the social factors that helped compress executive compensation in the past but are now most likely ignored by directors whose primary concern is their own paycheck.

Admittedly, one employee representative may not initially carry much weight in compensation determinations. However, the point is not to give employee representatives power that challenges that of shareholder representatives as the supervisory boards in Germany do.[228] The point is to give employees a seat at the bargaining table. Even if the shareholder representatives initially ignore the employee representative, the fact that the employee representative is present creates a direct line to the employee population. If the shareholder representatives give no merit to the concerns of the employee population, work production will suffer, and employees will feel inspired to pack up their bags and look for a company where the shareholders care about employee input.

In the end, an employee representative on the compensation committee has the potential to increase transparency between executives and employees, which has the potential to increase performance, increase stock price, and satisfy shareholders. In order to satisfy disgruntled employees and increase company performance, executives will have more incentive to take annual salary cuts in favor of deferred compensation plans that relate to the company's success. Because deferred compensation plans receive favorable tax treatment, executives might be able to take home the same amount of money after-tax while not facing the pressure from employees due to the disgustingly large numbers popping out of the proxy disclosures.

227. Ethan Rouen, *Rethinking Measurement of Pay Disparity and Its Relation to Firm Performance* 38 (Harv. Bus. Sch., Working Paper 18-007, 2017).

228. Gervutz, *supra* note 197, at 474.

Taking inspiration from the German VorstAG, the U.S. implementation of employee representation on compensation committees should be a recommendation, and not a binding requirement. The GCGC's non-binding nature allows companies to decide what is best for them and for their shareholders.[229] The institution of two-tiered boards in Germany in combination with mandatory employee representation gives companies greater power to supervise their directors and decreases the need for costly external regulation. American corporations are currently governed in such a way that the supervision of directors is limited to regulation from the SEC or shareholder activism, which is most often and most effectively exercised in the buying and selling of shares. The open-ended recommendations from the GCGC and heightened involvement from internal representatives through co-determination allow for a more individualized form of governance that might produce lasting effects on corporations that changing stock prices would not.

An article from the Brooklyn Journal of International Law compares the GCGC's approach at providing guideposts to corporate governance to the SEC's method of strictly limiting every avenue possible in saying that the SEC "precisely defining every word removes space for innovation and the opportunity to let companies (and ultimately the market) decide what works well."[230] The author continues in saying that the "open-ended reform" offered in Germany

> is critical for triggering the self-reflection needed to determine how to best translate these general principles into practical measures. This kind of self-reflection, in turn, is in and of itself vital. For if, as companies say, the one-size-fits-all solution is too constraining, then they are in the best situation to determine which solutions work best for them.[231]

My suggestion is for the U.S. to explore the effects of employee representation on compensation committees through corporate governance recommendations. I think it would be beneficial for the American government to take a detour from the typical highly-regulated SEC requirements and urge public companies to handle the issues with executive compensation on their own terms. The presence of an employee representative among compensation committee members may not have a direct effect on the level of executive

229. Mathieu, *supra* note 177, at 608.
230. *Id.* at 650.
231. *Id.*

compensation, but giving employees a seat at the bargaining table will lessen the disconnect between executives and employees the SEC set out to solve with the Pay Ratio Disclosure Rule and open up discussion for more internal solutions for compensation issues.

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