Executive Compensation and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s

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Executive Compensation and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s

BENJAMIN ALARIE

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Until now the legal and regulatory measures that have been taken in the United States and Canada to combat excessive executive compensation have been largely ineffectual. The one possible exception is the tax deductibility cap of §162(m) of the US Internal Revenue Code, which was introduced in 1993. A similar but improved provision ought to be considered by Canadian policymakers. There are several lessons Canadian policymakers can take from the US experience with §162(m). First, policymakers should consider tightening, although not eliminating, the performance-based exemption. Second, policymakers should not anticipate a deductibility cap to raise a considerable amount of tax revenue or totally prevent CEOs from engaging in rent-seeking behaviour. Third, policymakers should strongly consider prohibiting executives from unravelling the incentives associated with performance-based compensation by entering into hedging transactions. Finally, Canadian policymakers would be wise to carefully consider the effects a deductibility cap would have on the competitive international environment in which Canada competes for corporate patronage.

Jusqu'à aujourd'hui, les mesures juridiques et réglementaires prises aux États-Unis et au Canada pour combattre des indemnisations excessives de dirigeants ont été inefficaces, généralement parlant. La seule exception possible est la déductibilité fiscale plafonnée à §162(m) du Code des taxes intérieures des É.-U. introduit en 1993. Une disposition similaire mais améliorée devrait normalement être envisagée par les
décideurs canadiens de politiques. Plusieurs leçons peuvent être tirées, par les décideurs canadiens, de l'expérience des É.-U. concernant ce plafond de §162(m). Premièrement, les décideurs de politiques devraient penser à rendre plus difficile, sans toutefois l'éliminer, l'exemption fondée sur la performance. Deuxièmement, les décideurs de politiques ne devraient pas anticiper que le plafond de la déductibilité engendrerait un montant considérable de revenus fiscaux, ou empêcherait totalement les chefs de direction d'adopter un comportement visant à rechercher une rémunération sous forme de retraite. Troisièmement, les décideurs de politiques devraient songer sérieusement à interdire aux dirigeants d'affaiblir les incitations liées à des rémunérations fondées sur la performance en faisant des opérations de couverture. En dernier lieu, les décideurs canadiens de politiques seraient bien avisés d’envisager avec attention les effets qu’un plafond de déductibilité aurait sur un environnement international concurrentiel dans lequel le Canada recherche le mécénat d’entreprise.

I

INTRODUCTION AND BACKGROUND

In the late 1980s and early 1990s, public concern over high rates of executive compensation led to a pledge by the Democratic Presidential Candidate, Bill Clinton, to curb excessive compensation practices should he be elected President.¹ The concerns of the polity surrounding executive compensation had been aroused by mass media furor that, in turn, had been fed by the public disclosure of compensation information. Although the mandatory disclosure of executive compensation has long been a fixture of US securities law, the rapidly rising levels of compensation for the most highly remunerated CEOs was alarming to many.²

Following his successful presidential campaign on August 19, 1993, President Clinton signed into law the Omnibus Budget Reconciliation Act of 1993,³ which enacted, inter alia, §162(m) of the Internal Revenue Code.⁴ In loose terms, §162(m) eliminates

¹ For a discussion of the public dismay regarding executive compensation levels in the late 1980s and early 1990s, see Richard Syron, “An Overview of the Revolt Against Executive Compensation” (1992) 45:1 Rutgers L. Rev. 121. In the presidential campaign of 1992 that led ultimately to his election, Bill Clinton remarked that “[i]t’s wrong for executives to do what so many did in the 1980s. The biggest companies raised their [CEOs] pay by four times the percentage of their workers’ pay went up and three times the percentage their profits went up.” It’s wrong to drive a company into the ground and have the chief executive bail out with a golden parachute to a cushy life. For America to be competitive, there must be a stronger link between pay and performance. An important part of this link is making management more accountable to shareholders.” See “Presidential Candidates Divide on Executive Compensation Caps” (23 October 1992) 24:42 Securities Regulation and Law Report 1634, cited in Mark Salky, “The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?” (1995) 49 U. Miami L. Rev. 795 at 826.


⁴ I.R.C. §162(m).
the tax deductibility of all executive compensation paid by public corporations to senior executives in excess of one million dollars per year, provided that the compensation does not qualify for a performance-based exemption.

This article proceeds in six parts. In Part II, I provide motivation for the article by briefly outlining some *prima facie* evidence that the prevailing rates of executive compensation in North America may reasonably be regarded as excessive. In Part III, I briefly outline agency theory and use it to describe the two stylized competing conceptions of corporate governance. In Part IV, I canvass three current legal approaches to controlling excessive executive compensation. These approaches include (1) mandatory disclosure laws, (2) the common law rule regarding 'reasonable compensation,' and (3) the deductibility cap of §162(m) of the Internal Revenue Code. In Part V, I identify and describe four issues that Canadian policymakers should address in the design of a tax policy instrument similar to §162(m). Part VI concludes.

## II BACKGROUND AND MOTIVATION

The rate at which CEOs are compensated at large American corporations has been increasing at a rapid pace over the past thirty years. In 1992, Linda Barris reported that the compensation of CEOs at Fortune 500 companies rose by 30 per cent over the course of the 1970s and 212 per cent over the course of the 1980s. And according to *Business Week*, CEOs at a sample of 730 large American public companies took home an average of 550 per cent more in 2000 than their 1990 counterparts. On average, these CEOs pocketed $13.1 million in 2000. Approximately 80 per cent of this compensation constituted gains realized on stock options. Obviously, the value of these stock options was driven higher by the strong US equity markets of the late 1990s and early 2000. Even still, with flagging US markets in 2001, the average CEO managed to take home approximately $11 million.

Examining these figures carefully reveals some alarming trends. Average executive compensation at large US public companies is growing at an increasing rate.

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9 The figure of $11 million is biased upward by the record $706 million take by Oracle’s Lawrence Ellison. If Ellison’s compensation is removed from the sample of 730 CEOs, average compensation would be $9.1 million. See Levelle et al., *supra* note 6.
Compensation of CEOs rose by 30 percent over the 1970s, 212 percent over the 1980s and by a remarkable 550 percent over the course of the 1990s. This second-order trend in executive compensation growth is striking and, much like the gains of the manic dot-com stock market of the late 1990s, it cannot reasonably be sustained in the medium to long-term. Although average CEO compensation in 2001 decreased by 16 per cent, this decline was primarily due to weaknesses in US equity markets and not to any identifiable fundamental changes in approaches to CEO compensation at large public companies. Once the bear market subsides, it will be no surprise if we quickly witness new highs in average compensation among CEOs at large US public companies.

Some perspective can be gained on just how dramatically the pay of CEOs has increased in the US by making comparisons with other groups over the 1970-2000 period, such as Major League Baseball (MLB) players, frontline employees and foreign CEOs. The average MLB player’s salary has increased almost as dramatically (though in a qualitatively different manner) over the course of the past 30 years as has the average compensation of CEOs at large public corporations. In 1970, the average MLB player’s salary was approximately $29,000, but had increased five-fold to $144,000 by 1980. By 1990, the average MLB salary totaled $598,000. In the year 2000, the average baseball player’s salary amounted to approximately $1.895 million. These figures represent increases of 397 per cent over the course of the 1970s, 315 per cent over the course of the 1980s and 217 per cent over the 1990s. Therefore, whereas in the executive compensation context the growth rate in average remuneration has been increasing, the decade by decade growth rate of baseball salaries has been declining.

There is little doubt that baseball players have been very successful at bargaining for higher wages over the past three decades; however, that success appears to be tailing off. The empirical evidence for CEOs, on the other hand, suggests that executives are reaping greater compensatory rewards decade-by-decade and that these rewards are growing at an increasing rate.

The sheer magnitude of the increases in average CEO remuneration over the past 30 years is brought into even greater relief by a comparison to the average wage of the frontline employees of large corporations that these executives manage. In 1980, CEOs of large public corporations in the United States made approximately 42 times that of what their average employee took home. By the year 2000, this figure had increased by nearly a factor of 10 to approximately 419 times average frontline employee remuneration.

The absolute amount of CEO remuneration and also the relative earnings of CEOs vis-à-vis their frontline staff lends intuitive prima facie support to the comments of one observer that “anyone who makes that kind of money must be doing something either illegal or immoral.” While this conclusion is premature, it is tempting to endorse.

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10 Ibid.
The compensation of American CEOs also dwarfs that of CEOs in other developed countries. In April 2001, Business Week reported that the average Japanese CEO pockets between $300,000 and $500,000 annually—a considerable sum of money, but a far cry from the average compensation of comparable American CEOs. The average CEO at a large US public company, therefore, earns 25 times what their Japanese counterpart receives. Clearly, unless Japanese CEOs are woefully incompetent (in a relative sense) at managing their corporations, there is something either seriously deficient in the compensation of Japanese CEOs or there is something exorbitant about the remuneration of American CEOs. The CEOs of companies listed on the Toronto Stock Exchange (previously the TSE, now the TSX) appear to be remunerated at a rate situated at the midpoint between their American and Japanese counterparts. According to data compiled from proxy materials by Xianming Zhou, Canadian CEOs earned roughly 50 per cent of what their American counterparts earned over the 1991-1994 period. Although the Canadian problem with apparently excessive executive compensation is not as severe as it is in the US, the problem certainly has the potential to worsen. As NAFTA tightens our economic ties with our largest trading partner and Canadian companies are forced to compete with their American cousins for managerial talent, we may find Canadian executive compensation practices being drawn asymptotically closer to those prevailing south of the border.

Without baldly stating that there is necessarily something immoral or illegal about the prevailing levels of executive compensation in the US or Canada, there is some evidence to suggest that, in some cases, executives are being compensated at levels that are clearly excessive. For example, in 2001, Lawrence Ellison of Oracle Corp. received record compensation of $706 million. At one point in the the late 1990s, Michael Eisner (the CEO of Disney) received compensation totaling $575.6 million. Similarly, in 1999 Charles B. Wang (the CEO of Computer Associates International) received a total of $655 million in compensation. Canadian CEOs who have done extremely well include John Roth of Nortel, who earned $70.8 million in 2000 and Frank Stronach of Magna, who received $48.5 million for his efforts in the same year. As previously suggested, although these observations constitute anecdotal evidence and are taken from the high end of the compensation distribution, they suggest that there is something “excessive” about executive compensation in at least some corporations. This is especially so when the stories of Ellison, Eisner and Wang are read in conjunction with the evidence regarding MLB players, frontline workers and Japanese CEOs.

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15 Another potential justification is that Japanese economy has been in a state of depression since the early 1990s. The US economy, on the other hand, experienced its longest period of sustained growth ever.


17 See Leveille et al., supra note 6.


Before concluding that in aggregate (rather than anecdotaly) North American executive compensation practices are “excessive,” however, it may be useful to clarify what is meant by the term. The qualifying term ‘excessive’ refers to compensation that exceeds that which is required to elicit the optimal level of effort from an executive. In the language of economics, this means that the marginal benefit in terms of additional managerial output for one dollar in additional salary is equated to the value of one dollar paid in additional compensation. The intuition behind this idea was well expressed by Rep. Peter Hoagland as part of the debates in Congress leading up to the eventual reform of §162 of the Internal Revenue Code: “There is a point at which compensation goes beyond what we normally think of as the cost of doing business and moves into the range of executive greed and ego gratification.”

In Canada and the United States, corporations have historically been entitled to deduct from gross revenue (almost) all expenses incurred to generate that revenue to determine taxable income. These expenses include all wages, salaries and bonuses paid to staff—from frontline workers to the CEO. This practice reflects the notion that only the net receipts associated with productive activity ought to be taxable. The rationale underlying this notion can be traced back to at least the 1930s with the writings of Henry Simons. Although there is debate surrounding the deductibility of certain kinds of expenditures in the personal income tax context, there is little doubt that compensation paid to employees is an acceptable expense so long as corporate taxation is concerned. Not allowing a deduction for compensation paid to employees would unduly impose double taxation on funds that are spent with the sole purpose and effect (in other words, with no positive consumption externalities) of generating a surplus through productive activity.

In the context of executive compensation, this reasoning leads to the conclusion that all executive compensation ought to be tax deductible except to the extent that the compensation has been paid for reasons other than to generate net income by eliciting productive effort from executives. From the perspective of tax policy, the extent to which payments can be characterized as the misappropriation or “wasting” of shareholder wealth, they should not be deductible since they do not contribute to corporate production and thereby a strengthening of the bottom-line. In tax policy terms, therefore, the debate about the deductibility of executive compensation can be reduced to an issue surrounding the characterization of executive compensation. The foundational issue in the executive compensation context is thus whether a given level of remuneration is best understood as representing fair compensation for services performed on behalf of the corporation (in which case executive compensation should be tax deductible), or whether some portion of the pay is extortive or in some other way not related to generating corporate income (in which case at least some portion of the payments should not be tax deductible).

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20 Congressional Record H2170 (29 April 1993).
22 The debate is less settled on the “net receipts” concept in the personal income tax area, where various opinions on how to treat medical costs, educational costs, and child care expenses are important areas in which there is no broad consensus.
III AGENCY THEORY AND TWO COMPETING APPROACHES TO GOVERNANCE

Michael Jensen and William Meckling pioneered the formalized application of principal-agent theory to corporate governance in 1976, although they were not the first to recognize the incentive problems implicit in the corporate organizational structure. Berle and Means were acutely aware of the issue in 1932, although they were also latecomers to the principal-agent theory scene in historical terms. Awareness of the principal-agent problem in the corporate context dates back at least two hundred years earlier with Adam Smith's *Wealth of Nations*. The key insight espoused by Smith is that managers who do not own the entire equity of the firm they manage do not have the incentive to exercise prudence in its management so as to maximize its value. Instead, managers have an incentive to exact excessive compensation from the firm, consume perquisites, appropriate business opportunities, engage in self-dealing, and engage in insider trading at the expense of the shareholders.

The fact that diversionary incentives exist, however, would not be as problematic if shareholders could costlessly and effortlessly monitor the behavior and decisions of the CEO. With costless monitoring, the CEO would not be able to easily capitalize on any of the incentives associated with self-dealing, insider trading, shirking, consuming perquisites, or extracting supra-normal remuneration, since these abuses would

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24 See Adolf Berle & Gardiner Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1933). Berle and Means remark, "When the owner was in control of his enterprise he could operate it in his own interest and the philosophy surrounding the institution of private property assumed that he would do so. This assumption has been carried over to present conditions and it is still expected that enterprise will be operated in the interests of the owners. But have we any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners? The answer to this question will depend on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions" at 121.

25 In *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith remarks that "The directors of such [joint-stock] companies, however, being the managers rather of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private coartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* [1776] (New York: Modern Library, 1937) at 700.

26 Even costless monitoring would not necessarily result in zero agency costs, although the costs would be lower than they would be with imperfect monitoring. See William D. White, "Information and the Control of Agents" (1992) 18 Journal of Economic Behaviour and Organization 111. White remarks that, "Eliminating informational asymmetries between employers and agents typically eliminates agency problems. However, circumstances exist in which even the ability to costlessly monitor an agent in a timely fashion is not sufficient to control moral hazard at zero cost."
immediately be detected by shareholders. As a consequence, the CEO could be held accountable directly for any significant abuses as and when they occurred. Agency costs arise because monitoring is imperfect and costly. Economic theory predicts that shareholders (the principals) will invest resources in monitoring only to the extent at which the marginal cost of monitoring equals the marginal benefit of reduced diversion by managers (their agents).

There is an additional wrinkle in the context of widely-held corporations, as Berle and Means deftly pointed out in 1932. Each individual shareholder internalizes the entire cost of the resources devoted to monitoring management and the board of directors, whereas the benefits of the monitoring are shared proportionally among shareholders according to their ownership interests. In the language of law and economics, this state of affairs constitutes a collective action problem that further exacerbates the imperfect nature of shareholder monitoring.

The agency problem is compounded in the context of executive compensation by the fact that there are two agency relationships implicit in the setting of compensation contracts. First, shareholders elect members of boards of directors. Consequently, board members act (at least theoretically) as representatives and agents of shareholders. Boards of directors, however, are just as much principals as they are agents. A board of directors is collectively responsible, in general terms, for overseeing the management of the corporation. In practice, boards delegate this responsibility to the CEO and other senior executives, who they are responsible for monitoring. In the received model of corporate governance, the CEO and other senior executives are theoretically the agents of the board of directors and only indirectly the agents of shareholders.

The principal-agent problem constitutes the backdrop of the debate involving executive compensation in North America. The debate about whether or not executive compensation is excessive and ought to be curtailed really surrounds which of two stylized versions of corporate governance proponents favour as being more realistic. The two competing procedural views—the ‘optimal contracting’ view on the one hand, and the ‘rent extraction’ or ‘managerial power’ view on the other, differ primarily in their assessment of how effectively principal-agent problems are addressed in contemporary corporate governance.

Supporters of the optimal contracting theory argue that well-functioning boards of directors that are directly and fully accountable to shareholders govern most (if not all) public companies in North America. Proponents of this view suggest that these boards of directors form responsible and accountable compensation committees from their ranks with the sole responsibility to design executive compensation packages in the best interests of shareholders. By assumption, compensation committees achieve this goal by aligning optimally the incentives of managers with shareholders using instruments that tailor compensation to performance. At the other end of the spectrum are those commentators who argue that managers exercise a significant degree of influence over

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27 Berle & Means, supra note 24 at 86-88.
29 A forceful and comprehensive account of these two competing views is given by Lucien Bebchuck, Jesse Fried & David Walker in “Managerial Power and Executive Compensation” (2002) 69 U. Chicago L. Rev. 751.
their boards of directors. Proponents of this approach argue that senior executives are capable of extracting excessively high compensation from the firms they manage.

The existing financial economics and legal literature on executive compensation recognizes the wide gulf between these two characterizations of corporate governance in the compensation context. However, the literature in each discipline is subject to a discernible bias. Financial economists as a whole prefer the "optimal contracting" view of corporate governance, whereas legal academics are more inclined to buy into the "rent extraction" characterization of corporate governance. There is, however, a nascent realization of this possibility among some economists as well.

III.1 Optimal Contracting

The proponents of the optimal contracting side of the debate marshal several arguments to support their contention that there is nothing at all improper or excessive about prevailing pay practices at large US public corporations. These arguments include assertions that the labour market for CEOs is highly competitive and thus engenders competitive outcomes; that the market for corporate control serves as a restraint on lavish pay packages; that product markets serve as a constraint on managerial rent extraction; and finally, that it is necessary to pay executives a significant amount of money in order to impress upon them, or force them to at least partly internalize, the social costs and benefits associated with the quality of their performance. This is done, on the optimal contracting view, by tying compensation to various important indicia of managerial performance, most of which correlate strongly with the amount of effort expended and skill exercised in managing the firm for the benefit of shareholders.

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30 This position was perhaps forwarded most forcefully and famously by Victor Brudney in the early 1980s. See Victor Brudney, "The Independent Director—Heavenly City or Potemkin Village?" (1983) 95 Harv. L. Rev. 597. Brudney seeks primarily to address the potential for outside directors to increase corporate social responsibility, although many of the reservations he expresses about the ability of boards of directors to be adequately autonomous from the influence of managers to improve social responsibility directly map onto and are sustainable in the executive compensation context. Brudney remarks that, "[i]n sum, the ambiguity of the standards of fairness, the difficulty in ascertaining and weighing the relevant facts, the psychological and social pressure on independent directors, and the limited incentives and weak sanctions available suggest that to elicit disapproval from outside directors would take a transaction so grossly overreaching as not often to be proposed by management" at 616.

31 Bebchuck et al., supra note 29 at 754. The authors report that "[r]elational economists, both theoretical and empiricists, have largely worked within [the optimal contracting] model in attempting to explain the various features of executive compensation arrangements as well as the cross-sectional variation in compensation practices among firms." at 754.

III.1.1 Competitive Labour Markets

According to supporters of the optimal contracting view, the degree to which CEOs are able to exercise control over their own pay packages is dependent on the readily available market alternatives facing the board of directors for the delegation of the management function with which they are entrusted. To take a simplified example, imagine the bargaining strength individual CEOs would have if (1) all CEO positions were exactly alike, (2) all CEOs were completely fungible in that all came equipped with precisely the same set of abilities and experiences (in other words, identical human capital), and (3) there was a ready supply of talented (unemployed) CEOs on the sidelines who were indifferent about working at the prevailing wage but would work for remuneration only marginally exceeding the current rate of compensation. Under these circumstances, any CEO who attempted to bargain for a supra-market level of compensation would be immediately replaced by an equally effective CEO who, by assumption, would be willing to work at the current wage rate. Supporters of the optimal contracting view argue that although the market for CEOs is not perfect, it does not diverge dramatically from this ideal. In their view, there are three main ways in which the bargaining power of CEOs is constrained by the labour market: (1) there are many potential CEOs in the labour market, (2) information about past performance (and hence managerial competency) is easily available, and (3) mandatory disclosure laws publicize the prevailing market rates of remuneration.

III.1.2 Competitive Market for Corporate Control

The market for corporate control is also, at least in theory, capable of curbing the exercise of bargaining power that incumbent CEOs might be tempted to exercise. The reason is relatively straightforward. If a corporation is paying excessively high remuneration to managers (where the term "excessively high" is conditioned upon the performance of management) then, assuming argüendo that there is a well-functioning market for corporate control, it will not take long for market participants to recognize the potential gains associated with wresting control away from current shareholders and replacing the current managers with ones who will either not demand pay that is as high as that demanded by current management or who will deliver managerial performance that is sufficiently strong enough to merit the existing rate of pay.

In actual practice, however, the strength of this argument is debatable. Executives who have and exercise the bargaining power necessary to extract rents are likely to foresee the possibility that market participants may recognize the inefficiency and launch a takeover bid in an attempt to replace them. As a consequence, they may arrange for themselves generous "golden handshake" provisions in their compensation contracts providing that in the case that there is a change in the control of the corporation (and they are replaced) they will be generously compensated. In addition, many corporations have poison pill provisions in place, which help to ensure that the market for corporate
control will not be a persistent and binding constraint on corporate governance unless the gains from a change in control are highly significant.  

III.1.3 Product Market Constraints

The product market is also a source of constraint on executives seeking to influence a board of directors to pay them a sub-optimally high rate of remuneration. The reason is that any costs incurred by the corporation—including all wages and compensation paid—must eventually be reflected in the cost of the goods or services produced by the corporation. If product markets are sufficiently competitive, then any inefficiency in the operation of the firm will result in the erosion of market position vis-à-vis competing products. In egregious instances of excessive executive compensation, the firm’s products will be excessively priced, which in turn, will cause sales and revenues to fall. With lower revenues the corporation will be less profitable, ultimately causing the firm’s share prices to decrease. With a deflated share price the ire of shareholders will be aroused, which will cause shareholders to exercise voice and, in extreme cases, cause a proxy fight resulting in a new board of directors and management team.

III.1.4 Incentive Alignment

The incentive alignment argument is the strongest one available to proponents of the optimal contracting view of executive compensation. The argument is that CEO pay must be sensitive to shareholder value in order for senior managers to have incentives to maximize shareholder value. Since the incentives that managers face will necessarily be imperfect, the only way for managers to fully internalize the benefits of increasing the value of the firm would be to instate them as the full residual claimants of the corporation. Instead, the argument is that managerial compensation should be dependent to a significant extent upon changes in the market value of the firm’s equity. As described above in the discussion of principal-agent theory, the optimal compensation contract will be struck such that, at the margin, the benefits accruing to the manager in

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34 Of course, the full costs of excessive executive remuneration will not necessarily be “built into” the prices of the goods or services produced by the corporation. It is reasonable to assume that perhaps only a portion of the costs will be passed onto consumers with the remainder borne by frontline employees, shareholders and debtholders. To the extent that members of these various constituencies are able to identify these costs prior to entering into contracts with the corporation, however, they will be reluctant to bear the costs. If the firm has non-negligible market power, then the lion’s share of the costs will most likely wind up being passed on to consumers in the form of higher prices in the product market.
terms of increased compensation will be precisely offset by the increase in the value the manager generates with additional work effort. Since determining whether a particular contract has achieved this optimal tradeoff is difficult (if not impossible), proponents of the optimal contracting view argue that the foregoing disciplines on executive compensation ensure that any marked deviations from an optimal contract will engender a course of events that will result in an automatic, market-induced “course correction.” In this view, the market for corporate control, the product market and the market for managers will work together to ensure that compensation contracts that do not efficiently solve the principal-agent problem will be renegotiated until the principal-agent problem is solved efficiently.

III.2 Rent Extraction

Proponents of the rent extraction view, like the supporters of the optimal contracting perspective, have several arguments in the offing. These include the arguments that (1) there is only a very limited scope of judicial review exercised over executive compensation because of the common law “business judgment” doctrine, (2) that CEO pay appears to be only weakly correlated with corporate performance, (3); that the received model of an arm’s length board of directors is unsound,; and finally, (4) that the evidence supporting the optimal contracting view is indicative of the fact that extortive executives are sensitive to the reality that they must avoid shareholder and directorial outrage by camouflaging their rent extraction, not of the fact that optimal contracting is the appropriate story.

III.2.1 Relative Lack of Judicial Review of Compensation

Commentators who promote the rent extraction view of executive compensation practices often point to the relatively deferential approach the courts have taken to shareholder objections to lavish executive compensation packages. From a formal legal standpoint, the substantive merit of compensation packages can be challenged in derivative actions under several heads of corporate law, such as a breach of the duty of care, a breach of the duty of loyalty (self-dealing), or though an allegation that the compensation is so high that the board of directors have “wasted” the assets of the corporation. Courts have shown a reluctance to actively label a particular payment as unreasonable or substantively unfair. Only rarely, if ever, are payments to executives

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35 See e.g. Bebchuck et al., supra note 29 at 779-80.
36 See e.g. Rogers v. Hill, 289 U.S. 587 (1933) where at 591 the US Supreme Court concluded that the company could not “justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property.” Another line of cases deals with tax authorities challenging compensation on the grounds that it is not “reasonable” and therefore not deductible from gross income. See the discussion under Part IV, section IV.1 infra.
struck down by courts as amounting to a waste of corporate assets.\textsuperscript{37} Proponents of the rent extraction view properly regard this as being one of the greatest enabling mechanisms by which CEOs are able to secure inflated compensation contracts.\textsuperscript{38} The lack of judicial oversight with regard to the deductibility of executive compensation in the taxation context is discussed in greater detail in Part IV, section IV.1.

### III.2.2 Senior Executive Performance is Weakly Correlated with Compensation

One of the most poignant arguments that proponents of the rent extraction view have leveled at those who advocate in favour of the optimal contracting perspective surrounds the empirical evidence of the relationship between corporate performance and executive compensation. In their influential 1990 article on executive compensation,\textsuperscript{39} Michael Jensen and Kevin Murphy analyzed compensation data on 2,213 CEOs listed in the Forbes Executive Compensation Surveys from 1974 to 1986. For the larger half of firms in the sample, they estimated that CEO wealth increased by $1.85 for every $1000 increase in shareholder wealth. CEOs of firms in the smaller half of the sample, however, had compensation that was significantly more sensitive to performance. On average, these CEOs realized increased remuneration of $8.05 per $1000 increase in shareholder wealth.\textsuperscript{40} A similar 1995 study in the Canadian context by Ramy Elitzur and Paul Halpern, yielded even weaker results. The authors could find no statistically significant relationship between the level of executive pay and firm performance in the 180 TSE traded companies that comprised their sample.\textsuperscript{41}

More recent empirical evidence, however, suggests that the pay-performance relationship may have strengthened in recent years in both the United States and Canada. Xianming Zhou used data taken from firms listed on the TSE 300 over the 1993-1995 period (immediately after the TSE introduced mandatory compensation disclosure, see discussion in Part IV, section IV.1 infra) and with it estimated that for every $1,000 increase in shareholder wealth, CEO pay increased by $5.62.\textsuperscript{42} Similarly, in a follow-up study to his earlier work with Michael Jensen, Kevin Murphy used data from the


\textsuperscript{38} See, e.g. Bebchuck et al., supra note 29 at 779-82.

\textsuperscript{39} See Jensen & Murphy, supra note 2.

\textsuperscript{40} See ibid. at 227-28.


companies composing the S&P 500 Industrials group over the 1992-1995 period and estimated that CEO pay increased by $5.93 for every $1000 increase in shareholder wealth.\textsuperscript{43} Recall also the evidence cited by Business Week, which suggests that 80 percent of CEO compensation is attributable to gains on stock options.\textsuperscript{44} However, one cannot conclude from this "four-fifths" figure that CEO pay is correlated strongly with managerial performance. It is misleading because the value of a corporation's stock can change for a number of reasons, many of which have little to do with managerial performance. Some of these reasons are systemic and broad (for example, market-wide trends such as rises in bull markets and declines in bear markets), some that are systemic and industry-specific (for example, an exogenous shock to demand for commodities can drive down the value of resource companies), and some that are firm-specific but unrelated to managerial performance (for example, winning an antitrust case against the Department of Justice). Finally, for true internalization of incentives, CEOs would have to realize an increase of remuneration of $1000 per $1000 increase in shareholder wealth. That they empirically do not realize an increase of even 1/100\textsuperscript{th} of this magnitude suggests to optimal contracting proponents that CEO pay is relatively unrelated to performance.

III.2.3 Non-Arm's Length Boards of Directors

One of the strongest and most fundamental arguments that proponents of the rent extraction story make is that the notion of an arm's length board of directors is a legal fiction bearing little resemblance to reality. One of the first critics of the received model of corporate governance was Myles Mace of Harvard Business School.\textsuperscript{45} Mace observed that the traditional model of corporate governance made three key assumptions about the functions of boards of directors of public corporations that were (and still are) routinely violated. The first assumption that Mace observed was that the board is expected to establish basic corporate objectives, policies, and corporate strategies. Second, the board of directors is assumed to make an effort to ask discerning questions of management and analyze critically the management team on a routine basis. Finally, the board of directors is assumed to select the CEO and the remaining members of the management team.

With regard to the first assumption, Mace’s research showed that most boards of directors actually delegate responsibility for setting performance targets, strategies and policies to CEOs. The second assumption—that directors ask difficult questions of management—was also violated almost universally, with a notable exception being directors with a substantial personal share ownership. Finally, Mace found the

\textsuperscript{43} See \textit{ibid.} Zhou claims that the figure of $5.93 is derived from taking the average of Murphy’s estimates for the S&P Industrials with above and below average sales. See Kevin Murphy, "Executive Compensation" in Orley Ashenfelter and David Card, eds., \textit{Handbook of Labor Economics, Volume 3} (Amsterdam: North-Holland, 2000).

\textsuperscript{44} See Lavelle & Jespersen, supra note 7.

assumption that boards of directors select the CEO dubious. According to Mace’s research, it is usually the outgoing CEO who selects his or her successor, although they will often get input from informal or formal committees composed of outside directors. These committees are then charged with evaluating potential successors with the final decision still resting with the CEO. Mace’s findings seriously challenge and, to a significant extent, undermine the prevailing wisdom that boards of directors serve the best interests of shareholders. A follow-up study, conducted by Mace ten years after his initial study, found that there was “little evidence to suggest that business leaders are responding affirmatively and constructively to rectify the shortcomings of board practices.”

Recent empirical evidence suggests that Mace’s critique remains a powerful one. David Yermack and Anil Shivdasani studied directorial appointments over the 1994-1996 period for Fortune 500 firms as of 1995. According to the authors, the data “suggests that when CEOs are involved in director selection, companies choose new directors who are less likely to monitor aggressively.” The authors go on to state that when CEOs are involved in the selection of new directors, the directors who are selected are more likely to have conflicts of interest and, are less likely to be independent directors. In addition, stock price reactions to independent director appointments are poorer when CEOs are involved in the selection of the appointee. The authors conclude that

A possible interpretation of this evidence is that influence in the director selection process is a mechanism used by powerful CEOs to curb the performance pressures that arise from monitoring by the board. More broadly, our results illuminate how the influence of the CEO serves as an important determinant of the governance structure of firms.

The recent divisive battle between Carly Fiorina, the CEO of Hewlett-Packard (HP) and director Walter Hewlett represents a relevant and timely case study that confirms that the evidence unearthed by Yermack and Shivdasani is by no means out of date. The battle between Fiorina and Hewlett surrounded the $18 billion merger of HP with Compaq. HP shareholders voted on the proposed deal on March 19, 2002, passing the proposal by only a small margin. In the campaign leading up to the shareholder vote on the proposal, Hewlett reportedly spent over $32 million of his own private assets in opposing the proposed merger. Although this expenditure was significant, it pales alongside Walter Hewlett’s three-percent ownership stake in HP, which had a market value of approximately four billion dollars. In the wake of the narrowly successful passing of the merger proposal, Hewlett launched a lawsuit against the company alleging

\[\text{\footnotesize 46 See Myles Mace, “Directors: Myth and Reality - Ten Years Later” (1979) 32 Rutgers L. Rev. 293 at 297.}\]
\[\text{\footnotesize 48 See ibid. at 1851.}\]
\[\text{\footnotesize 49 Ibid. at 1852.}\]
\[\text{\footnotesize 50 See Tracy Seipel, “HP vote officially approved” The Mercury News (1 May 2002), online: Bay Area.Com <http://www.bayarea.com/mld/bayarea/business/technology/3178160.htm> There were reportedly 838 million votes for the merger and 793 million votes against, with 14 million abstentions.}\]
that Fiorina persuaded at least one large institutional shareholder to vote in favour of the proposal in return for future business. In April 2002, HP announced that the board of directors—including Fiorina—was not nominating Hewlett for reelection to the board of directors. In response to the news that he had not been nominated for reelection, Hewlett stated that

It is unfortunate that the HP board has seemingly missed what the company’s stockholders have clearly recognized: That dissent is not disloyalty, that healthy boards need not agree on every issue and that while the management and board may run a company, the stockholders are the true owners of a company.51

What is striking about this case is that Walter Hewlett quite clearly, given his major ownership stake in HP, had personal incentives that were well aligned with shareholders.52 More amazing was his vigorous personal battle—one which cost him $32 million of his own money—to oppose the proposed merger. Exercising his voice also cost him his position on the board of directors and the ability he once enjoyed to influence the management of HP and thus the value of his four billion dollar stake. Thirty years after Myles Mace’s initial study of corporate governance, the HP situation serves as a ringing, albeit anecdotal, endorsement of Mace’s claim that little has been done to rectify the shortcomings of corporate governance.

III.2.4 Role of the “Outrage Constraint” and Camouflage

One response to the assertion by optimal contracting proponents who favour the rent extraction perspective, such as Lucien Bebchuck, Jesse Fried, and David Walker,53 is that if CEOs are engaged in rent extraction, it would be pure folly to do so openly and without disguising it in some way. Moreover, it would be extremely difficult to convince boards of directors to comply with CEO requests or proposals to compensate them with exorbitant amounts of remuneration without at least arming them with plausible sounding explanations for providing such generous pay packages. This political or optical dimension to the compensation contract determination setting is not necessarily restricted to the rent extraction view, however. For example, Jensen and Murphy identify the same political constraints on compensation,54 but for them the optimal contracting outcome is likely to require compensation to be higher than is politically feasible, whereas Bebchuck et al. argue that political or optical constraints on compensation packages are an aid to curbing rent extraction since the optimal contract is likely to entail less remuneration than would be politically prohibitive.55

In order to induce boards of directors to buy into their proposals and, moreover, to avoid the ire of public outrage, rent extracting CEOs will seek to disguise their inflated

52 It is arguable, of course, that non-economic factors also played a role in his opposition to the merger, though the financial stakes alone make his opposition prima facie legitimate.
53 See Bebchuck et al., supra note 29 at 786-89.
54 See Jensen & Murphy, supra note 2 at 227.
55 See Bebchuck et al., supra note 29 at 789.
pay packages as performance-based when in fact they are not. 56 Recall the example of stock options being devalued in the wake of the stock market's sharp decline following the events of September 11, 2001. One of the most obvious and convenient ways for CEOs to accomplish this is by bargaining for stock options as part of their compensation packages. Stock options are attractive to boards of directors because if they are granted "at the money" (that is, with the current stock price equal to the exercise price), the option grant will have no accounting repercussions whatsoever until they are exercised. 57 This is because accounting conventions do not recognize the value of the option at the time of grant since nothing of value has actually been given to the executive. 58 However, the option to buy an asset of fluctuating value at a fixed price for a fixed period of time can be of considerable value, even if the option is not yet "in the money." Generally speaking, the greater the variability in the value of the stock and the longer is the life of the option, the more valuable a call option will be.

The main reason why options are such an attractive camouflage for CEOs and boards to employ is that while they capture some element of CEO performance, their value also responds (often strongly) to trends in the broader market. Since the stock market trends upward with the passage of time, stock options that are granted at the current share price are quite correctly expected to be in the money in five or ten years' time, even if the CEO's performance fails to improve corporate performance. Thus, although stock options are often touted as being one of the strongest tools in the optimal contracting toolkit, they are much weaker than most optimal contracting supporters cede.

One way to escape the problems associated with traditional stock options would be to use stock options whose exercise price is indexed to either a broad market index such as the S&P 500 or a more specific industry-based index. Indexing an option achieves the desired outcome of making the value of the option grant far less dependent upon general market trends (although it is difficult to escape this entirely) and connects it much more directly with the CEO's performance vis-à-vis competitors. However, indexed options are not a common feature of executive compensation contracts. Supporters of the rent extraction view suggest that the observable lack of indexed options is evidence that CEOs and boards of directors actually do use traditional call options as camouflage for higher compensation. Supporters of the optimal contracting view suggest that the reason why more indexed options are not observed has to do with the disadvantageous accounting treatment indexed options receive. Others argue that the likely administrative complexity of indexed options entails costs for their administration and management that might outweigh the refined incentives they would provide to executives. though the

56 An additional factor tending to encourage innovations that camouflage compensation (such as conventional stock options) is the one million deductible cap mandated by §162(m) of the Internal Revenue Code. See Part V, section V.3, infra, and the full text of the provision in Appendix A.
58 The Financial Accounting Standards Board (FASB) proposed changes in the mid-1990s that would have mandated expensing stock options at the time that they are granted. However, responding to pressure from Congress and corporations, the FASB did not follow through on this proposal. For a brief discussion, see Steven Bank, "Devaluing Reform: The Derivatives Market and Executive Compensation" (1995) 7 DePaul Bus. L.J. 301 at 331.
strength of this argument is dubious. Consequently, the absence of indexed stock options is a factor that weighs heavily in favour of the rent extraction view.\textsuperscript{59}

III.3. Synthesis of the Competing Theoretical Perspectives

The choice between the two theoretical characterizations of executive compensation is one that cannot be made based on the cogency of theoretical arguments alone. At its core, the issue is an empirical one that can be satisfactorily resolved only by resorting to empirical testing and analysis. Do corporate governance mechanisms actually result in optimal contracts? Or is there significant capture of boards of directors and rent extraction in the setting of executive compensation? The empirical evidence on the efficacy of corporate governance is illuminating but unfortunately, perhaps because of corporate camouflage, it does not offer evidence that unambiguously supports either viewpoint.

Recent empirical work by Marianne Bertrand of Princeton and Sendhil Mullainathan of MIT attempts to determine which of the polar extremes of the corporate governance efficacy continuum—optimal contracting or rent extraction—more accurately represents the process by which executive compensation is set.\textsuperscript{60} In order to determine which account has more purchase, Bertrand and Mullainathan first set out to determine how responsive CEO pay is to an exogenous positive shock that is completely beyond the CEO’s control. More specifically, they test how and to what extent the compensation of CEOs in the oil industry responds to shocks to oil prices. Interestingly, they find that, for the most part, CEO remuneration responds equally to a dollar earned fortuitously and to a dollar earned through strong CEO performance. This result reinforces an earlier empirical finding that suggested windfall accretions to shareholder wealth in the form of damage payments in tort cases positively influence executive compensation despite having little or nothing to do with managerial work effort or performance.\textsuperscript{61} As the authors note, such a finding is curious from an optimal contracting perspective because providing increased remuneration for exogenous positive shocks that are beyond the ambit of managerial control does nothing to improve performance; by definition, the manager can do nothing to influence such exogenous events. One possible explanation for payment for luck or windfalls includes the perceived value in the ability of CEOs to predict, anticipate, and respond to exogenous shocks; or for their \textit{ex ante} abilities to predict or anticipate which law suits are worth pursuing. A second explanation might be that the value of the CEO’s human capital might rise and fall with the fortunes of the company, thereby leading to remuneration that would rise and fall with the market value of the CEO’s labour. Finally, it may simply be that determining whether a given increase in firm value is exogenous or endogenous is difficult to do with readily available metrics. To the extent that all factors—both endogenous and exogenous—simply flow through to the bottom-line, it might be cost efficient to remunerate on the basis of what

\textsuperscript{59} See Bebchuck et al., supra note 29 at 799-800.

\textsuperscript{60} See Bertrand & Mullainathan, supra note 32.

is readily observable, assuming that there is at least some correlation between CEO effort, efficacy and observable outcomes.

Bertrand and Mullainathan conduct further tests in order to discover whether firms that are governed more effectively (due to having high concentrations of share ownership, a large shareholder on the board of directors, a smaller board size and a greater proportion of outside directors) pay executives less for luck than firms that are less well governed. They find that firms that have a shareholder who possesses a significant ownership interest on the board of directors, pay 23 to 33 per cent less for luck than corresponding firms without a large shareholder director.62 Other indicia of strong corporate governance do not have as strong of an impact upon payment for luck. The fact that 23 to 33 per cent less is paid for luck in well governed firms suggests that the three possible stories presented above regarding pay for luck are not a complete explanation of the phenomenon. Indeed, if pay for luck is consistent with optimal contracting (as it would be if the foregoing potential explanations had merit), then there would be no reason to believe that well governed firms would not pay for luck. That is, it must be that a not insignificant proportion of the pay for luck phenomenon is due to the extraction of rents or the skimming of corporate assets enabled by at least partial managerial capture of the compensation setting process.

Bertrand and Mullainathan conduct one final test that attempts to discriminate between the optimal contracting account and the rent extraction account of executive compensation. This test revolves around how much executives “pay” for their stock option grants. Optimal contracting proponents would argue that base salary decreases almost in step with the market value of the options they are granted, falling short only because a CEO might demand a higher expected value out of a risky component of compensation than out of salary, which is relatively less risky. Rent extraction proponents predict that in exchange for options, managers would forgo salaried income that amounts to far less than their Black-Scholes value. Consistent with their finding as regards pay for luck, the authors find that for an average one million dollar option grant, CEOs in well governed firms must forgo $30,000 to $50,000 more in salaried income than CEOs in less well governed firms, all things being equal. Having a director on the board who is a large shareholder (such as Walter Hewlett at HP), therefore, also contributed significantly to the effectiveness of the board of directors. In addition, as the tenure of a CEO increased (and in the absence of a shareholder director), the amount of salary forgone for an option grant decreased, reflecting perhaps the agency costs of managerial entrenchment and capture of the board of directors. Bertrand and Mullainathan ultimately conclude that on the whole there is something to each of the optimal contracting and the rent extraction stories. Specifically, they are that

In practice, executive compensation seems to be better characterized by either the skimming [rent extraction] or the [optimal] contracting model depending on the extent to which there is an active “principal” (or principals) present to actually design pay contracts. Better governance means that there is more of an active principal and optimal

62 Bertrand & Mullainathan, supra note 32 at 5.
contracting fits better. Worse governance means that there is less of an active principal and the CEO is more likely to set his own pay.63

This conclusion is also arrived at by Bebchuck et al. who, although they argue strongly in favour of the rent extraction view, are careful not to completely dismiss the fact that the optimal contracting view is not without some merit. The authors write:

Although the managerial power approach is conceptually quite different from the optimal contracting approach, the former is not proposed as a complete replacement for the latter. One can take the view that compensation arrangements are shaped both by managerial power and by what would be optimal. The managerial power approach merely implies that compensation practices cannot be adequately explained by optimal contracting alone.64

Ultimately, the choice between the optimal contracting story and the rent extraction story is not unambiguous from either a theoretical or an empirical standpoint. What can be said with considerable confidence, however, is that there is significant scope for managerial rent extraction in many corporations. The corporations that are most accurately characterized as susceptible to rent extraction are firms that do not have any directors who possess major shareholdings, firms whose management teams have been in office for 10 years or more, firms whose CEOs are involved in the nomination of directors for election, and firms that do not have a majority of outside directors. To the extent that the features of strong corporate governance are present, however, it is more likely that optimal contracting is the explanation with more purchase.

IV LEGAL CONSTRAINTS ON EXCESSIVE EXECUTIVE COMPENSATION

Aside from the market-based constraints on executive compensation—the market for managers, the market for corporate control and the product market—which, ceteris paribus, militate in favour of the optimal contracting view of corporate governance and constrain excessive executive compensation, there are three legal approaches to achieving the same end. These include the mandatory disclosure of compensation information, the tax law requirement that compensation be ‘reasonable’ (and the corresponding common law requirement that compensation not amount to ‘corporate waste’), and the million-dollar deductibility cap in §162(m) of the Internal Revenue Code. In this part, I will briefly describe the mechanics of the operation of each of these constraints and offer some tentative conclusions on their potential efficacy at restraining excessive executive compensation.

63 Ibid. at 7.
64 See Bebchuck et al., supra note 29 at 755.
IV.1 Mandatory Disclosure

Since 1934, the Securities Exchange Commission (SEC) in the United States has made the disclosure of the level of compensation to senior executives of publicly traded corporations mandatory. The precise requirements of the mandatory disclosure rules have shifted over time—almost always towards more detailed and expansive disclosure. The current rules involve the following five required elements of disclosure:

1) A “Summary Compensation Table” which outlines the compensation of the CEO and the four highest paid corporate officers;
2) A compensation committee report identifying the performance factors considered in making compensation decisions;
3) Tables setting out the details and values of stock options (and stock appreciation rights);
4) A graph illustrating the corporation’s total shareholder return vis-à-vis various broad market indices; and,
5) Information regarding any conflicts of interest between members of the compensation committee and the corporation that might impinge upon their independence.65

Clearly these rules attempt to facilitate the disclosure of what are often complex compensation packages by mandating a standardized and highly digestible format for investors seeking to understand how executives are compensated. Ontario introduced mandatory disclosure rules modelled closely on those of the SEC in 1993. Although Ontario was a little late to the party (the SEC introduced mandatory disclosure of compensation nearly 60 years earlier), companies listed on the TSX are now subject to approximately the same level of mandatory disclosure as are American public corporations.66

The function of mandatory disclosure laws is to make shareholders—especially institutional shareholders, although also to a lesser extent retail investors—aware of abuses perpetuated against the corporation by senior executives and/or the board of directors. That is, clearer and more transparent disclosure is useful only to the extent that the additional information engenders a response by shareholders. To the extent that shareholder apathy is rational, due to the collective action problem inherent in widespread share ownership, the most likely response will be for aggrieved shareholders with small ownership interests to sell their shares. Other potential responses such as the exercise of voice are only likely to be engaged by institutional shareholders who might find the exercise of voice worth the necessary time and energy. Initiatives taken by

66 For details on the requirements of the new legislation in Ontario upon its introduction, see “Disclosure of Executive Compensation” Torsys (22 October 1993), online: Torsys.Com <http://www.torsys.com/publications/pdf/CM1993-10T.pdf>. The Canadian disclosure requirements and US requirements are not identical because, despite being nearly identical in 1993, they have evolved independently since.
institutional shareholders are likely to include lobbying boards of directors to reduce (or, at the very least, not continue to increase dramatically) executive compensation. Mandatory disclosure laws, however, also have the potential to backfire. They may perhaps incite an even more inflationary executive compensation environment. The reason is that most boards of directors, provided the company’s share price has performed relatively well, are likely inclined to pay their executives at a level that is at least slightly above average for their industry. They are inclined to do so in order to maintain a positive relationship between the board and the CEO, to demonstrate the board’s confidence in the management team, and in the belief that a happy manager is a productive manager. However, if all firms seek to pay their executives at, for example, the 75th percentile of other firms in the industry, there will be an observable and pronounced "ratcheting-up" effect over time in the compensation paid to executives in any given industry. Thus mandatory disclosure rules may be one of the reasons why we have observed growing rates of increase in executive compensation over the past three decades. On the other hand, institutional shareholders would have nothing to voice concern about in the absence of mandatory disclosure. Consequently, the most that can be said of mandatory disclosure rules is that they have had an ambiguous impact on the overall level of executive compensation, with both inflationary and constraining elements.

IV.2 Common Law Rule of ‘Reasonable Compensation’

The reasonable compensation rule as it exists in the United States (in §162(a)(1) of the Internal Revenue Code) requires that in order for compensation to be tax deductible, it must be “a reasonable allowance... for personal services actually rendered.” Similarly, Canadian tax law provides under s. 67 of the Income Tax Act that, “[I]n computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.” Courts, however, have been extremely reluctant in the corporate context to determine the appropriateness of or evaluate whether a given rate of compensation is in fact “reasonable.” The primary exception to this is the courts’ willingness to generally apply the reasonable compensation rule “to limit payments by closely-held companies where nondeductible dividends are disguised as deductible compensation.”

However promising or appealing these corporate law and tax law grounds for challenging excessively remunerative contracts may appear to be, the deference accorded by the courts to business decisions largely transforms what might otherwise be the substantive review of compensation contracts into a procedural review of how the

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68 Ibid. at s.67. Section 18(1)(a) of the Income Tax Act is also relevant in this regard. It provides that "[I]n computing the income of a taxpayer from a business or property no deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."
69 See Salvy, supra note 1 at 815.
details of the contracts were agreed upon in the first place. This deference has grown out of the unwillingness of the courts in the United States to review the substantive merit of business decisions that it does not feel fully competent to rule upon. This reluctance is especially severe when the courts were asked to substitute their judgment for that of the marketplace. This is not an unreasonable position for the courts to take in at least two respects. First, the duty of care and the duty of loyalty do not demand perfection on the part of those exercising power that has been delegated to them by shareholders. The twin duties of loyalty and care simply demand that directors and managers respect the interests of shareholders and that reasonably well-informed decisions be made on their behalf. Second, the temptation must have been and must continue to be great for courts to yield to “hindsight bias,” such that business decisions that turn out to be ruinous ex post, are imagined to have been clearly inferior ex ante, even though at the time it would have been extremely difficult to predict how events would unfold. The deferential stance taken by North American courts is sensitive to these two concerns, although it tends to broaden the scope considerably for rent extraction in the executive compensation context.

In the landmark 1941 case of *Heller v. Boylan,* the New York Supreme Court expressed well the reluctance of courts to examine compensation contracts for substantive, rather than procedural, fairness. In that case, the Court wrote:

> Assuming, arguendo, that the compensation should be revised. What yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity?... Can equity be so arrogant as to hold that it knows more about managing this corporation than its shareholders?

> Yes, the court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytical or scientific. Whether or not it would be fair and just is highly dubious. No blueprints are furnished. The elements to be weighed are incalculable, the imponderable manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact – it would be the precise antithesis of justice; it would be a farce.

Although the Canadian case law is not nearly as developed on this point as is the US case law, there is little reason to believe that Canadian courts are any more inclined to review the substantive merit of executive compensation than their US counterparts. In

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70 See *Smith v. Van Gorkom,* 488 A.2d 858 (Del. Sup. Ct. 1985) [Smith]. In *Smith,* the Delaware Supreme Court found that the business judgment rule applied primarily to the procedures used in arriving, in the facts of the case, at a decision regarding whether or not to endorse a takeover bid made by a third party. In the opinion of the court, because the board of directors did not act with full information gleaned from a full consideration of the details of the bid and any other possible competing bids the company was likely-regardless of the substantive merit of the decision. This concentration on procedure over substance plays heavily to the advantage of CEOs who might be engaged in rent extraction; so long as a compensation committee composed primarily of independent directors is responsible for determining the appropriate pay package (or indeed, endorsing the one proposed by the CEO), then the business judgment rule suggests that unless it can be shown that the payment was not made to the CEO *qua* CEO, the compensation decision appears to be nearly bulletproof.


72 As quoted by Iacobucci & Trebilcock, *supra* note 2 at 34-35.
the 1968 Canadian case of *Gabco Limited v Minister of National Revenue,* Cattanach J. of the Exchequer Court stated that

> It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.  

While this may sound like a less deferential stance than has been taken by US courts, it is important to recognize that this case was decided in the context of a private corporation. In a public corporation context, it would be very difficult to satisfy a Canadian court that “no reasonable business man” would have arrived at the same contractual arrangement given that compensation matters in Canadian public companies are generally handled by a compensation committee made up solely of outside directors who are, more often than not, business persons.

In the more recent Canadian case of *Maduke Foods Ltd. v. Canada,* Strayer J. did in fact deny the taxpayer corporation the right to deduct payments made to the part-owner’s wife and four children, although in this case the review of the substantive merit of the compensation paid was triggered by the fact that the recipients of the payments received the payments *qua* relatives and not simply *qua* employees (which was, as in the *Gabco* case, relatively straightforward to establish because *Maduke Foods Ltd.* was a private corporation and family ties were easily discernable). In general, so long as payments can only reasonably be considered to have been motivated by business purposes, Canadian courts (like their American cousins) appear to be unwilling to review their substantive merit. This attitude, though valuable to the extent that courts will not substitute their perception of fairness or desert for that of the board of directors (which would be a perfectly reasonable stance in a world with optimal contracting), is damaging to the extent that it allows rent extracting CEOs to fly under the radar of substantive judicial review.

Clearly, given that the administrative and judicial practice is to apply the reasonable compensation rule almost exclusively in the context of closely-held corporations, the law in this regard does little to combat the issue of excessive executive compensation in the very largest, public corporations, which are almost invariably widely-held and publicly traded. As described earlier, one of the ways that lawmakers in the United States have attempted to surmount this reluctance on the part of the courts to evaluate compensation packages at public corporations for substantive fairness is to operationalize what ought to be meant by ‘reasonable compensation.’ This has been arguably accomplished in the US through §162(m) of the *Internal Revenue Code.*

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73 [1968] 2 Ex. C.R. 511 [*Gabco*].


75 (1989) 89 D.T.C. 5458 [*Maduke Foods Ltd.*].
IV.3 Internal Revenue Code §162(m)

The 1993 addition of §162(m) to the Internal Revenue Code represents the most direct challenge yet to the compensation practices employed by large, publicly-traded US corporations. The rule is designed to restrict the tax deduction associated with executive compensation to one million dollars per year per senior executive. However, the rule is not hard and fast. There are five main exclusions contained in §162(m) that in specific circumstances allow companies to deduct executive compensation that is in excess of one million dollars per year.

IV.3.1 The Publicly-Held Corporation Requirement

In order to be subject to §162(m), a corporation must be a “publicly held corporation.” §162(m)(2) defines such a corporation as an issuer of any class of common equity securities required to be registered under s. 12 of the Securities Exchange Act of 1934. In general terms, s. 12 requires that any corporation whose common equity is traded on a national securities exchange be registered with the SEC. Thus, prosaically §162(m) applies only to firms whose common equity is registered for trading on a national securities exchange in the United States. Any private corporation or any corporation that is not traded on a public stock exchange in the United States is exempted from the rule.

IV.3.2 The “Covered Employee” Requirement

The deductibility limit of one million dollars of §162(m) applies only to employees of the corporation who are “covered employees.” According to §162(m)(3), covered employees include the CEO of the corporation (or someone acting in the capacity of the CEO) and also, other than the CEO, the four highest compensated officers of the corporation. This language mirrors that used in the Securities Exchange Act of 1934 regarding the mandatory disclosure of compensation information. The net result is that any officer or employee whose compensation is subject to mandatory disclosure is prima facie subject to the million-dollar maximum deductibility limit. Thus employees who are not the CEO or one of the four next highest: remunerated employees are (curiously) not subject to the deductibility limits imposed by §162(m).

IV.3.3 The Exemption for Commission Compensation

§162(m)(4)(B) creates an exemption from the non-deductibility rule for compensation that is paid on a commission basis solely due to income generated by the sales attributable to the performance of the individual to whom the commission payment is

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76 The full text of §162(m) is reproduced in Appendix A.
made. The cases in which commission income exceeds one million dollars per year are likely to be few and far between. However, public corporations whose salespersons oversee extremely large accounts, who generate the lion’s share of their compensation from commissions, and consequently earn more than a total of more than one million dollars per year are not subjected to the constraints otherwise imposed by §162(m).

IV.3.4 The “Binding Contract” Exemption

This exemption is basically a grandfathering rule whereby employment contracts with structured compensation terms that were entered into prior to the enactment of the provision shall enjoy the tax consequences they would have been subject to had §162(m) not been introduced. This grandfathering rule reflects a notion of reasonable reliance and fairness. In effect, it would be unfair to attach vastly different tax consequences to a transaction after that transaction has already been consummated.

IV.3.5 The Exemption for Performance Based Compensation

The largest exemption to the million-dollar rule is contained in §162(m)(4)(C). It provides that the non-deductibility rule does not apply to remuneration that is contingent solely on the attainment of certain specified performance goals provided that three main criteria are met. The following three requirements must be met before a corporation can make use of the performance-based exemption for deducting executive compensation in excess of one million dollars:

(a) the performance goals must be determined by a compensation committee of at least two outside directors;

(b) the material terms of the compensation contract must be approved in a separate vote by a majority of shareholders; and,

(c) before the payment of any deductible compensation that is in excess of one million dollars, the compensation committee must certify that the performance goals they specified were met by the executive.

Taken together, these criteria seek to ensure that the exemption for performance-based compensation is not blatantly abused by boards of directors and rent extracting executives. This is accomplished by ensuring that outside directors (those least subject to suasion by CEOs) are responsible for determining the quantum of performance-based compensation, the requirements for realizing it, and for ensuring that the pre-stated requirements have been met. Demanding that shareholders ratify any performance-based remuneration in a separate shareholder vote provides an additional level of protection.
IV.4 Synoptical Assessment of the Existing Constraints on Executive Compensation

Of the three main constraints—mandatory disclosure, the requirement that compensation be ‘reasonable’ and the deductibility cap imposed by §162(m)—the most promising is §162(m). Mandatory disclosure rules have an ambiguous effect on compensation practices—feeding increases by publicizing executive compensation rates and by providing fodder for institutional investors eager to rein in high flying executive pay packages. The case law strongly suggests that the requirement that compensation be ‘reasonable’ is, for the most part, not enforced by the courts and largely ineffectual outside of the private corporation context. Since §162(m) serves to add teeth to the requirement that compensation be reasonable (though it also provides several exemptions that at least some commentators consider to be devastating to its efficacy), it appears to be the most promising avenue going forward for curbing excessive executive compensation. In the next part, I draw upon empirical evidence gleaned from the US experience with §162(m) in order to determine to what extent this prima facie promise is likely to be realized in the future and how transferable or translatable its efficacy is likely to be in the Canadian executive compensation context through the introduction of a similar Canadian provision.

V LESSONS FOR CANADA: THE EFFICACY OF INTERNAL REVENUE CODE §162(M)

The five exemptions to §162(m) outlined in the previous section collectively present a considerable impairment on the ultimate efficacy of the rule to constrain excessive executive compensation. Of these, the greatest weakness of §162(m) is the performance-based compensation exemption. The three criteria that must be satisfied in order for companies to make use of the performance-based exemption have not proven to be a major impediment to its use by corporations. Of course, the performance-based exemption is also, at least theoretically, desirable and appropriate. Without a performance-based exemption, even compensation paid to executives in a manner entirely consistent with the optimal contracting approach would be taxed twice. Moreover, without a distinction in tax treatment between performance-based compensation and base salaries or bonuses, boards would have little incentive to insist on forms of payment that qualify as performance-based compensation, the idea being that if many other firms are exceeding the cap, then any given firm would be required to remain competitive and retain the best people possible.

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78 According to Walter Henderson Jr., §162(m) is “one of the most inappropriate provisions in the code.” This is the case, he argues, because there are many ways to circumvent its application (all of which are economically distorting) and because it is more appropriately included as part of securities law, not tax law. See Walter Henderson Jr., “Executive Compensation: New Section 162(m) Limits Excessive Remuneration” (1994) 21:3 J. Corp. Tax’n 195.

79 Since the payments would not be deducted from gross income, they would be taxed as income at the corporate level and then again in the hands of the executive at the personal level.

80 See Barris, supra note 5 at 80.
In a recent study, Brian Hall and Jeffry Liebman of Harvard found that although the introduction of §162(m) led firms to change the composition of executive pay such that gains on options represented a larger proportion of compensation, they found no evidence that the introduction of the rule resulted in a net reduction of executive compensation.\footnote{See Brian Hall & Jeffry Liebman, "The Taxation of Executive Compensation" (2001) 14 Tax Policy and the Economy 1.} According to Hall and Liebman

We find that the million-dollar rule led companies to substitute performance-based pay for salary. But our evidence suggests that this substitution was quite modest, and there is no evidence that the total level of pay was reduced. Overall, although the stock-option explosion has dramatically increased the link between pay and performance, this change is due almost entirely to non-tax factors.\footnote{Ibid. at 42.}

Although the increased reliance on performance-based pay is itself promising since, ceteris paribus, it increases managerial accountability, the hope had been to rein in excessive executive compensation, not merely change its composition.

The Hall and Liebman findings largely confirmed earlier work that had been done by Todd Perry and Marc Zerker. In 1999, Perry and Zerker identified 25 affected firms who reduced CEO salaries below one million dollars subsequent to the introduction of §162(m). Of these, 23 of the firms reported that the move was motivated by the new provision.\footnote{See Perry & Zerker, supra note 32.} Indeed, from an intuitive perspective and not controlling for other factors, given that the 1990s witnessed an increase of average CEO compensation at large publicly traded firms of 550 percent it is difficult to see how the introduction of §162(m) stemmed larger increases in executive compensation from occurring. At the same time however, it is relatively easy to see why the increases in compensation—especially increases that would drive total compensation to levels greater than one million dollars—would be made in the form of performance-based pay (i.e. stock options) rather than salary.

According to a survey of corporate proxy statements in 1997, Peter Woodlock and Joseph Antenucci found of the 359 companies whose proxy statements they analyzed, 256 companies (71.3 per cent) intended to qualify compensation in excess of one million dollars annually under §162(m). Many of the companies which did not intend to qualify their executive compensation practices were already in compliance with the performance-based exemption or did not pay any of their executives more than one million dollars per year. Indeed, of the remaining firms, only 28 companies (7.8 per cent) stated that they would not restructure their compensation packages in order to gain tax deductibility for amounts paid over one million dollars under §162(m).\footnote{See Peter Woodlock & Joseph Antenucci, "Corporate Responses to Executive Compensation Deductibility Limits" (1997) 97 Tax Notes Today 198-95.} It appears that Congress did not anticipate the strength of the reaction towards qualifying excess compensation under §162(m) by firms, since initial projections suggested that §162(m) might generate an additional $335 million annually in tax revenues.\footnote{Ibid. at paragraph 14.} Thus, the primary
effect of the introduction of §162(m) has not been to reduce rates of executive compensation, but to bias compensation committees strongly in favour of granting stock options to executives in lieu of salaries greater than the million-dollar annual cap.

The bias induced by the introduction of §162(m)—like the inflationary pressures created by mandatory disclosure—may have backfired to some extent. Recasting the entire issue into somewhat different terms, it is quite possible that the introduction of §162(m) not only predated, but also occasioned the record levels of executive compensation witnessed in 2000. The extremely strong performance of North American stock markets over the course of the mid to late 1990s, combined with the shift toward option-based compensation engendered by the 1993 introduction of §162(m), led to much higher levels of performance-based pay than executives had been hitherto accustomed. Thus, in a perverse sense, what should have been the most effective constraint on excessive compensation actually caused executive compensation levels to increase. To reiterate, however, this perverse effect was probably due more to the exuberant dot-com stock market rather than anything specific about §162(m), notwithstanding the fact that it carves out a fairly wide exemption for performance-based remuneration.

The lessons that Canadian policymakers can take from the experience of the United States with §162(m) over the course of the 1990s are fourfold. First, provision should be made for performance-based compensation, but it should be much more targeted so that conventional stock options are not considered to be performance-based instruments, unless they are appropriately indexed to the market. Second, in the design of a deductibility cap, like the one in §162(m), policymakers should be conservative in their estimates of its efficacy across several dimensions, including tax revenue generation, prevailing rates of remuneration, and the ability of CEOs to extract rents. Third, any provision similar to §162(m) under consideration for adoption in Canada ought to mandate that performance-based incentives cannot be unraveled by executives through hedging positions that might otherwise be legally taken in the marketplace. Finally, Canadian policymakers would be wise to remain keenly cognizant of the fact that they operate in an international milieu and that certain strategic considerations should be weighed and seriously considered before they enact a provision modeled on §162(m) of the Internal Revenue Code.

V.1 Narrow the Performance-Based Exemption

The most significant weakness in the design of §162(m) is that it does not close the door on compensation practices tightly enough, so as to prevent excessive executive compensation from qualifying for tax deductibility. This weakness may have had two undesirable consequences that Canadian policymakers can learn from. The first is that the camouflage available to executive compensation has been inadvertently improved. As a result of the breadth of the performance-based exemption, rent extracting CEOs can camouflage excessive executive compensation as performance-based compensation and their companies can deduct such payments for tax purposes. The newfound legitimacy
such payments have found in §162(m) may serve to merely increase the frequency with which massive stock option grants are made to executives.

The second negative ramification is that executive compensation might actually be rising as a result of the cap. Higher executive compensation might be an unintended consequence of §162(m) because (1) the stock market will always have the potential to appreciate considerably in as it did in the late 1990s; and (2) CEOs and other senior executives are generally risk averse and may demand higher overall expected compensation if they are forced to exchange relatively certain income (salary) for relatively less certain income (a lower salary plus stock options). In any event, Canadian policymakers should be aware of the potential problems associated with failing to create a performance-based exemption that is narrower than what is contained in §162(m).

Accepting, arguendo, that the performance-based exemption should be narrowed, what should qualify as performance-based compensation? This is a difficult issue to grapple with and, as one commentator noted, “[I]ngenuity knows no bounds when the challenge is to beat the IRS.” Nonetheless, at least two propositions—one positive and one negative—can be advanced. First, conventional stock options are not acceptable. The value of conventional stock options is not sufficiently connected to the performance of management to be an acceptable proxy for managerial performance. Second, managers should be rewarded primarily for above-average performance or, at most, improvements in performance. How performance ought to be measured will vary from industry to industry and from firm to firm, depending on the firm’s market position, competitive threats, strategic plan, and various other considerations familiar to the officers and directors of the corporation.

The ingenuity of taxpayers being what it is, it will be very difficult to arrive at a system that does not allow some element of rent extraction to remain. However, the elimination of conventional ‘vanilla’ stock options plans would be a vast improvement in the design of §162(m) and in any comparable Canadian provision. One possible way to simultaneously satisfy both of the above propositions would be to allow indexed options to qualify for performance-based treatment in lieu of ordinary options. Indexed options would have an exercise price that varied with the value of a general market index such as the S&P 500 or, better yet, with an index of the industry in which the company participates.

Indexed options have several advantages as a potential solution to the overly broad performance-based exemption problem. First, given that the exercise price of an indexed option will rise and fall with the fortunes of the market or industry generally, a manager would have to improve the position of the firm vis-à-vis a broader or narrower selection of other firms (depending upon the nature of the indexing of the options) in the market. This would remove various elements of market noise—including inflation—from influencing the value of stock options.

Second, the use of ‘at the money’ options would become less useful as a form of rent extraction camouflage and less problematic than the issuance of ‘at the money’

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86 Barris, supra note 5 at 80.
87 Others have also suggested this approach. See e.g. Robert Gibbons & Kevin J. Murphy, “Relative Performance Evaluation for Chief Executive Officers” (1990) 43 Indus. & Lab. Rel. Rev. 30-S; and Bengt Holmstrom, “Moral Hazard and Observability” (1979) 10 Bell J. Econ. 74.
options has been to this point. The reason is that any change in the value of the indexed options would reflect only changes vis-à-vis other firms and not absolute changes that are expected, on the whole, to be positive over the long term. Therefore, instead of being concerned that executives are receiving massive options plans with frequent vesting and maximum time value (conditioned on the options not being ‘in the money’ and therefore having zero intrinsic value), we will instead readily accept as desirable indexed options issued ‘at the money,’ as an ‘at the money’ issue price will not result in valuation distortions associated with positive market trends and not with managerial performance. Third, pressures exerted by managers on boards of directors to reprice options, ostensibly so that there remains some incentive to perform (but interpreted less charitably as being motivated by a desire on the part of managers to benefit from a turnaround in the equity markets generally) would have far less punch. When options are indexed, calls by managers for repricing are apt to fall on deaf ears. Indexed options will fall in value only because a firm underperforms relative to its peers. Unless managers can concoct a convincing story as to why the firm has suffered under their leadership, with no fault accruing to them, it is unlikely that they will be able to obtain the same ‘heads I win, tails you lose’ repricing argument so common with conventional stock option plans. Although repricing of indexed options will not likely garner much support with even the most compliant boards, if it was thought to be a problem, any Canadian provision inspired by § 162(m) might prohibit the repricing of indexed options altogether.

Despite their advantages, indexed options are not without their weaknesses. First, any attempt at indexing options in Canada will be tricky because of the limited depth of our equity markets. This is reflected by the fact that certain large companies can truly come to dominate our equity markets. For example, at its height, Nortel Networks Corporation made up more than 28 per cent of the market capitalization of the TSE 300 and more than 37 per cent of the S&P/TSE 60. Given the volatility of its stock price, the direction that the price of Nortel shares moved on any given day when Nortel was at its height often dictated the direction that the market moved. If indexed options had been common at that time, many CEOs would have had valid complaints that they were unfairly being punished for the runaway success of one company. During Nortel’s stock’s demise, of course, these same (imaginary) CEOs would have been ebullient and trumpeted their success compared to the market at large. One of the ways to potentially surmount this Nortel scenario would be to mandate the use of industry specific indexes. In some cases, however, an indexing approach would exacerbate the problems associated with the limited depth of Canadian equity markets.

Second, indexed options are not able to make use of the same advantageous accounting rules that are currently associated with traditional option grants. Douglas McCabe and James Angel find that although indexed options would be in the neighbourhood of 41 per cent less expensive, all else the same, for firms on the New York Stock Exchange

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Few firms have issued such adjusted options, despite their compelling theoretical attractiveness. The primary reason for this is that the standard executive stock options have been designed to avoid recognizing their cost on the income statement under present accounting rules. Adjusted options, because they are classified as variable price options, may result in charges on the income statement and thus depress earnings. This different accounting treatment gives firms that are concerned about reported earnings a strong incentive to choose the less-efficient standard options rather than a market-adjusted option.89

The accounting advantage associated with traditional options, however, may well change in the very near future. According to The Economist

In 1994, when FASB first tried to require companies to treat share-based payments as a cost, it nearly perished in the effort. Congress threatened to take away its standard-setting powers, and the chairman of the Securities and Exchange Commission (SEC), Arthur Levitt, urged it to back off.90

In the wake of the various corporate scandals earlier during the 2001-2002 period and a planned move by the International Accounting Standards Board (IASB) to mandate that all publicly traded European firms expense options grants by 2005, it appears that the FASB may have its way in demanding that options be expensed rather than simply footnoted in financial statements.

A third problem with indexed options is the fact that they only crudely control for market-wide influences on a firm's stock price. Firms that have greater financial or operating leverage will tend, all else the same, to have their share prices move proportionally more than the market. In the terminology of the CAPM (the Capital Asset Pricing Model), such firms have high 'betas.' Rectifying this leveraging problem in the design of indexed options would be a complex undertaking, involving a myriad of issues surrounding the measurement of beta, the selection of the proper index, and how to adjust for changes in a firm's beta with the passage of time.91 These implementation problems are troubling, but not impossible to cope with. In fact, despite these issues, there is little doubt that indexed options are a far better instrument for aligning incentives than traditional stock options.

V.2 Estimate the Behavioural and Fiscal Effects of the Provision Conservatively

In considering the likely ramifications of the introduction of a provision similar to §162(m), Canadian policymakers should exercise caution in setting their expectations with regards to the expected revenues from the new tax, the expected impact upon the


91 See Angel & McCabe, supra note 89 at 9-10.
prevailing rates of executive compensation, and upon the ability of CEOs to extract rents from their corporations. Caution should be exercised in attempting to predict how much additional tax revenue would be generated because the American experience suggests that even a carefully planned performance-based exemption may be capable of being worked around quite easily.

As for expectations regarding changes in the prevailing rates of compensation, policymakers should recognize that a provision similar to §162(m) does not per se combat or reduce the possibility of rent extraction on the part of CEOs and boards of directors except, insofar as institutional shareholders will make life difficult for CEOs and boards that agree to compensation packages that pay considerable remuneration to executives in after-tax dollars. Important in this regard is the fact that Canadian public companies tend to be less widely held than their American counterparts. This fact suggests that the shareholder voice may be exercised more vociferously in Canada, should corporations decide to maintain pay schemes that are tax disadvantaged.

Finally, a provision similar in design to §162(m) cannot reasonably be expected to work a miracle for Canadian policymakers, even if it is designed to improve upon the US model. The attitudes and incentives facing CEOs and the boards of directors in Canadian public corporations will not change overnight. CEOs will still have an incentive to participate in the process of nominating new directors so as to secure principals who are apt to support them. For their part, board members will still be receptive to maintaining social and political harmony by remunerating managers well. What might reasonably be expected to change are the attitudes harboured by CEOs and board members alike about the acceptable designs of compensation schemes. So long as compensation committees are sensitive to the need to ensure a tight correlation between CEO performance (which is not necessarily the same as share price performance) and CEO remuneration, institutional shareholders, retail shareholders, Canadian policymakers, and employees of these firms will have less to justifiably complain about.

V.3 Prohibit Hedging by Executives

One key aspect of the performance-based setting that ought to be addressed—but is completely ignored by §162(m)—is the potentially dangerous role of hedging by executives.92 If Canadian policymakers entertain the idea of introducing a provision not markedly unlike the US rule, the Canadian rule ought to expressly prohibit Canadian CEOs and other executives from taking personal positions in the equity or derivatives markets that counteract the risk profile that they face based upon their compensation contracts. If hedging is not prohibited, executives will be able to take offsetting positions

92 For a comprehensive discussion of the problems associated with the unravelling of incentives that can be accomplished through the use of derivative instruments by corporate executives, see David Schizer, “Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility” (2000) 100 Colum. L. Rev. 440.
in the market (though imperfectly so) so as to reduce the volatility of their compensation dramatically.\textsuperscript{93}

Consider a simple example. If a US CEO is granted options to buy 100,000 shares of stock X at $10 per share and these options vest over a period of five years at 20,000 shares at the end of each year, then the CEO has an incentive to underwrite call options in the market that allow others to buy 70,000 shares from him at the end of each year for the next five years at the current market price. If the company’s stock is volatile, these options will be worth a considerable sum of money. In this way, the executive can collect up-front on options that have not yet vested and thus guarantee a fixed level of remuneration in exchange for a highly volatile source of remuneration. Given the relative ease with which a rent extracting, risk-averse executive could take such an action absent contractual obligations imposed on him or her by the company, policymakers would be well advised to consider prohibiting such arrangements.

V.4 Consider the Competitive Threats in the International Context

The fact that §162(m) has not led to a mass exodus of corporations from the United States to other countries (such as Canada) is not surprising. The increased tax burden that would otherwise be associated with the provision can be circumvented fairly routinely through performance-based compensation in the form of stock options. To the extent that it is not, it is hardly cost-justified to pick up roots and move offshore merely because several million dollars in additional taxes must be paid. Moreover, the United States is the jurisdiction in which the lion’s share of the institutional investors and retail shareholders of these companies are resident. A proposed move triggered by §162(m) would likely serve as a negative signal to investors that rent seeking is endemic among the current slate of directors and the CEO, resulting in a negative vote of the proposed relocation. This is especially the case given that arguably no jurisdiction has corporate laws as desirable as those of Delaware.\textsuperscript{94} However, Canadian policymakers do not enjoy the same carte blanche power to introduce a provision similar to §162(m) without first considering the international corporate taxation landscape—especially the competitive threat posed by the United States.

A strengthened version of §162(m) would not impose massive costs on Canadian corporations, provided such corporations complied with the stricter performance-based

\textsuperscript{93} There are already constraints in US securities law that prevent executives from hedging the risk associated with their stock options losing value. See \textit{ibid.} at 461-66. However, as Schizer notes, many of these constraints are imperfect. Many (if not all) of these US securities law constraints have analogs in Canadian securities law.

exemptions a strengthened version of §162(m) would include. Such a provision and the rents it would constrain executives from extracting, however, might prove sufficiently irksome to rent-extracting CEOs and their boards to merit them thinking seriously about relocating to the United States. While a move to the United States would automatically make a footloose corporation subject to §162(m), to the extent that the Canadian equivalent would be more effective at constraining rent seeking, on the margin a move would appear to be attractive. At the very least, Canadian policymakers should anticipate that CEOs and boards will make the threat that relocation is a strong possibility if a provision similar to §162(m) is considered seriously by the Canadian government.

This corporate lobbying pressure itself might be enough to stifle any fledgling proposal to constrain executive compensation in Canada. Canadian policymakers should be forewarned that this is a significant possibility (if not a foregone conclusion) and brace themselves with data and compelling evidence of rent extraction and the exercise of managerial power in advance of the corporate outcry that would almost certainly follow a public announcement that a proposal of anything like §162(m) is in the works.

VI CONCLUSION

Executive compensation has grown at an amazing rate over the course of the past 30 years. A public outcry was triggered in the early 1990s regarding what was then considered to be excessive executive compensation. Since that time, the average rate of remuneration for CEOs of large, publicly held corporations has increased 550 per cent. Comparisons with Major League Baseball players, foreign CEOs, and frontline employees all suggest that executive compensation—especially in the United States, but also to a somewhat lesser extent in Canada—is excessive. Moreover, the most convincing explanation for this excessive compensation is not that it is optimal in the sense that executives are getting paid what they are worth and that they are doing so at the behest of shareholders. On the contrary, the rent extraction viewpoint seems to accommodate the empirical evidence better than optimal contracting.

The legal and regulatory measures that have been taken against excessive executive compensation have been ineffectual for fundamental reasons and will likely continue to

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\(^{95}\) It is not unreasonable to think that corporate Canada would object strenuously to any proposal to introduce a provision similar to §162(m). For instance, at its 1999 Annual Shareholders Meeting, the then CEO of Nortel Networks, John Roth, remarked that:

> Taxation is testing the allegiance of some of Canada’s best and brightest. The people we need are being forced out. They’re highly paid and are faced with a huge gap between what their talents and skills can bring them in Canada versus what they command elsewhere .... The issue in the recent controversy isn’t about Nortel Networks leaving Canada. It is about the shortage of scarce skills and high tech stars Nortel Networks needs to continue to grow in the country. It is about the movement of Canada’s best and brightest out of the country, the difficulty in drawing experienced people from abroad, and the dampening effect this causes on growth here.

remain so. The possible exception is §162(m), which was a promising reform at the time of its introduction in 1993, but has since proved to be too exemption-ridden to be efficacious at curbing excessive executive compensation. At best, the empirical evidence suggests that §162(m) has changed the composition of executive pay packages, rather than stifled the quantum of remuneration.

Given that excessive executive compensation is perhaps not as troubling an issue in Canada as it has been for the last decade in the United States, it is debatable whether the political will exists in this country to carry through with a provision similar to §162(m) here. If it does, however, there are several lessons that Canadian policymakers should take from the American experience in the 1990s.

First, we should consider improving upon the performance-based exemption that has undermined the efficacy of the US provision by tightening it significantly. For instance, only indexed options should be eligible for the exemption. Second, we should not expect a deductibility cap to raise a considerable amount of tax revenue, reduce prevailing levels of executive compensation, or prevent CEOs from rent seeking. Companies for the most part appear willing and able to convert their compensation schemes into performance-based ones that are exempt from the cap. Third, we should strongly consider explicitly prohibiting the ability of executives to unravel the incentives they face as a result of performance-based compensation. Taking countervailing positions in the marketplace (such as underwriting call options identical to the those granted but as of yet unvested or vested and unexercised) would not only be reportable as they are under most insider trading laws at present, but also strictly forbidden. Finally, Canadian policymakers would be wise to consider the competitive international environment in which we compete for corporate patronage. While a proposal to introduce a provision similar to §162(m) might seem insignificant in the grand scheme of international competition for corporate charters, policymakers should, at the very least expect, considerable corporate backlash and threats of exit—although actual exit would be unlikely.
Appendix A – §162(m)

§162(m) Certain excessive employee remuneration

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

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

(3) Covered employee
For purposes of this subsection, the term "covered employee" means any employee of the taxpayer if –

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

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

(4) Applicable employee remuneration
For purposes of this subsection –

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

(B) Exception for remuneration payable on commission basis
The term "applicable employee remuneration" shall not include any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual to whom such remuneration is payable.
(C) Other performance-based compensation
The term "applicable employee remuneration" shall not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if -

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

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

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

(D) Exception for existing binding contracts
The term "applicable employee remuneration" shall not include any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration is paid.

(E) Remuneration
For purposes of this paragraph, the term "remuneration" includes any remuneration (including benefits) in any medium other than cash, but shall not include -

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

(ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter. For purposes of clause (i), section 3121(a)(5) shall be applied without regard to section 3121(v)(1).

(F) Coordination with disallowed golden parachute payments
The dollar limitation contained in paragraph (1) shall be reduced (but not below zero) by the amount (if any) which would have been included in the applicable employee remuneration of the covered employee for the taxable year but for being disallowed under section 280G.