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The Use of Federal Law to Curb Excessive Executive Compensation: Lessons in Past Failures and Lessons for the Future

Kathryn J. Kennedy

THE USE OF FEDERAL LAW TO CURB EXCESSIVE EXECUTIVE COMPENSATION: LESSONS IN PAST FAILURES AND LESSONS FOR THE FUTURE

KATHRYN J. KENNEDY*

I. INTRODUCTION

WHEN one thinks of the use of legislative power to curb the size and the type of compensation paid to executives, one normally thinks such power is reserved to the states. That is, one tends to think that regulating corporate governance falls within traditional state police powers. However, while state courts have been willing to review the *processes* boards of directors use in setting the size and type of executive compensation, they have been less willing to review the actual *results* of such decisions.[1] Hence, it is no shock that Congress continues to dabble in the area of corporate governance in order to have an impact on the size and type of executive compensation, especially with the recent meltdown of the financial institutions.

This Article begins with a discussion of Congress's use of the Internal Revenue Code ("I.R.C." or the "Code")[2] over the past century to impinge upon and change corporate behavior, particularly in the area of executive compensation. Such a tactic is not startling due to the potential power of taxation over executives and corporations, and the recent congressional requirement that legislative initiatives be deficit-neutral in the totality.[3]

* Kathryn J. Kennedy is a professor of law at The John Marshall Law School and Associate Dean for Advanced Studies and Research. This article is a continuation of the dialogue raised in a previous article by Professor Kennedy, *Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*, 10 HOUS. BUS. & TAX. L.J. 196 (2010). The material in this Article was presented at the Villanova Law Review Norman J. Shachoy Symposium, *U.S. Taxation of Offshore Activity, and Regulating Executive Compensation*, held on Sept. 23, 2011.

1. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 705 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). Here, the court focused on process instead of results. The case involved a shareholder derivative suit alleging that the board of directors committed waste and breached its fiduciary duties by approving an employment agreement of a proposed president of the company without full disclosure of its terms and conditions, including a non-fault termination clause that could result in a hefty severance package. *Id.* As the court was reluctant to judge the board's decision made ten years earlier in light of current "notions of best practices," it found in favor of the defendants. *Id.* at 697. Upon appeal to the Delaware Supreme Court, the court affirmed as the shareholders had failed to rebut the business judgment presumption, which focused on the quality of the board's process rather than the quality of its decision. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 56 (Del. 2006).

2. The Internal Revenue Code, 26 U.S.C., may be referred to as the "Code" in the text and will appear abbreviated as I.R.C.

3. *See* Budget Enforcement Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified in scattered sections of titles 2 and 15 of the U.S.C.). Here, Congress

However, Congress's use of the Code has failed in this regard, resulting in further complexity of the Code[4] and unintended consequences.

As a result, we have seen a shift in the last decade on the part of Congress to use federal securities law to enact corporate governance rules, which focus the public spotlight on executive compensation. Congress hopes to cause public outrage over the size and type of executive compensation, resulting in a shift in the corporate culture. It is not unforeseen that Congress has used the federal tax code and the federal securities law to regulate in this area—the Code gets to the pocketbook of the executive and the corporation whereas the securities law uses disclosure and transparency to focus on the corporation's actions. Whether the use of securities law will be successful or not is too early to tell.

II. How Are Executives Paid?

Before beginning a discussion about executive compensation, it is important to distinguish between the pay package that the typical employee receives and that which the typical executive receives.[5] The typical employee is paid with salary, perhaps a year-end bonus, maybe overtime pay (if hourly), and benefits (e.g., health, retirement, severance, life insurance, and disability insurance). The predominant portion of the total pay package for the typical employee is their salary. The typical executive's pay package is poles apart:[6]

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mandated that direct spending and tax legislation be deficit-neutral in the totality. *Id.* The result has been massive procedural roadblocks to initiating tax relief legislation. *See* Jim Saxton, J. Econ. Comm., Extending the Budget Enforcement Act: Revisions of PAYGO Rules Necessary For Better Tax Policy 3 (2002).

4. *See* I.R.C. § 7803(c)(2)(B) (2006) (requiring National Advocate to provide annual reports to Congress as to any legislative Code amendments). In 2001, the Joint Committee on Taxation surmised that there are in excess of 1,395,000 words in the Code. *Id.* Another study approximated the number to be 2.1 million by 2005, triple the number in 1975. *See Christopher M. Pietruszkiewicz, The Complexity of the Tax Code*, 28 News Q., Spring 2009, at 12, 12.

5. *See* David J. Lynch, *Widening U.S. Income Gap Could Have Far-Reaching Effect*, Chi. Trib., Nov. 2, 2011, at 3 (noting that distribution of U.S. incomes since 1968 has become less equally distributed). Using the Gini coefficient, which acts as a distributional measure, ranging from zero (each individual has equal share of income) to one (one person owns all income), Lynch states that the U.S. Gini score has risen to 0.47 in 2010 from 0.39 in 1968. *Id.* The thirty-nation Organization for Economic Cooperation and Development remarks that the rich-poor divide has increased by twenty percent since the mid-1980s, higher than any other developed nation. *Id.* In the article, the author quotes Raghuram Rajan, the IMF's former chief economist, who criticizes countries with high levels of inequality as they contribute to "ineffective economic policies." *Id.* This could account for the inaction in Washington D.C. *Id.*

6. *See* Sarah Anderson et al., *Executive Excess 2011: The Massive CEO Rewards for Tax Dodging*, Institute for Policy Studies (Aug. 31, 2011), http://www.ips-dc.org/reports/executive_excess_2011_the_massive_ceo_rewards_for_tax_dodging (noting that in 2010, major corporate CEOs had compensation 325 times pay of America's average worker).

- The executive is paid a base salary, which amounts to about 10% of the overall pay package according to the 2010 Wall Street Journal (WSJ) and Hay Group CEO Compensation study;[7]
- There may be signing bonuses and undoubtedly short-term bonuses (which could be based on meeting individual or group incentive goals), which can amount to around 20% of the overall pay package according to the study;[8]
- There are long-term incentive pay awards in the form of stock options, restricted stock units, phantom stock awards, or stock appreciation rights ("SARs"), which can amount to about 60% of the overall pay package, according to the study.[9] These benefits are tied to performance either by the executive, the employer, or both;
- There are qualified and nonqualified benefits, which can provide the same retirement, medical, insurance, severance, and disability benefits extended to the general employee community, as well as enhanced benefits that cannot be paid through those plans due to maximum limitations and nondiscrimination requirements imposed by the Code; and
- Finally there can be perquisites unavailable to the typical employee community but extended to executives (e.g., use of corporate aircrafts, club memberships, personal loans at favorable interest rates, relocation expenses, enhanced health benefits and executive physicals, and tax gross-ups (i.e., additional taxes owed by the executive because of the specific compensation that is paid by the corporation)).[10]

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7. *The Wall Street Journal/Hay Group Survey of CEO Compensation*, WALL ST. J. (May 8, 2011), http://graphicsweb.wsj.com/php/CEOPAY11.html. This study examines 350 U.S. public companies that filed proxies between May 1, 2010 and April 30, 2011. *Id.* The median CEO base salary was $1,127,363 as compared to the median CEO total direct salary of $9,271,865. *Id.*

8. *See id.* The median total CEO annual cash award was $3,354,950, which included a base salary of $1,127,363, as compared to a median CEO total direct salary of $9,271,865. *Id.*

9. *See id.* Median long term CEO incentives were $6,234,834 as compared to the median CEO total compensation of $10,273,500. *Id.* The option of equity-based awards goes further than the basic compensation strategy. These options have different implications such as: accounting and financial reporting issues, tax-related issues (for the employer and the employee), SEC disclosure requirements, as well as the possible impact on the company's stock. Analyst Michael Brush reported that three of the most overpaid CEOs during 2010 were: Philippe Dauman of Viacom, who earned $84.5 million; Larry Ellison of Oracle, who earned $70 million; and John Hammergren of McKesson, who earned $54.4 million. Michael Brush, *CEOs Got a Big Raise; How About You?*, MSN MONEY (May 30, 2011), http://money.ca.msn.com/investing/michael-brush/ceos-got-a-big-raise-how-about-you.

10. *See Executive Perquisites: A Changing Landscape*, HAY GROUP, http://haygroupnews.com/ve/7460r88LsB63Zbk6/VT=0/page=4 (last visited Mar. 16, 2012) (taking selection of 200 companies with revenues over $5 billion). "All but nine of the companies disclosed that they provided at least one perk to their executives." *Id.* Six of the companies provided no perquisites, whereas three companies noted no perquisites below the aggregate value mandated to be revealed. *Id.* The WSJ

Since the base pay is an insignificant part of the executive's overall pay package and is usually unrelated to the executive's or company's performance, Congress has largely targeted the short-term and long-term incentive components paid to executives, as well as the use of retirement benefits and severance benefits.

There has been a lot of commentary as to why executive compensation has increased exponentially over the past decades in comparison to the typical employee's compensation. There are a number of answers to that question, including: changes in the federal income tax legislation (as will be discussed later in the Article);[11] increased use of stock options as long term incentives due to their initial favorable accounting treatment and the employer's view that such awards were a low-cost method of compensation;[12] decreases in the maximum limitations on benefits and contributions under qualified retirement plans, resulting in more benefits in nonqualified retirement plans to make the executive "whole" with respect to such benefits;[13] and external corporate hiring—as opposed to internal—which generally results in higher pay packages to "make whole" the executive as to benefits left behind with the prior employer.[14]

III. USE OF THE FEDERAL INCOME TAX CODE

This next section will review, in chronological order of enactment, congressional use of the Code to curb the *level* of executive compensation and influence the *type* of executive compensation—all with unintended consequences. The section will begin with I.R.C. § 162(a) enacted in 1918 and proceed to § 280G and § 4999 enacted in 1984 and 1986, respectively, § 162(m) enacted in 1993, § 409A enacted in 2004, and end with § 457A enacted in 2008.

A. *I.R.C. § 162(a)*

I.R.C. § 162(a) permits business entities to take a deduction for both "ordinary and necessary" business expenses, and for reasonable salaries

study done in 2009 calculated that the most common perquisites given to the executives were: corporate jets (66%), financial planning (58%), company autos (52%), tax gross-ups (46%), and executive physical exams (40%). *Id.* Due to pressure from institutional investors and shareholders, companies now analyze executive perquisites to make sure there is a link between these perquisites and corporate performance. *Id.*

11. *See* Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 28 (European Corp. Governance Inst., Working Paper No. 44/2004, 2004), *available at* http://ssrn.com/abstract=561305.

12. *See id.* at 39.

13. Thomas Veal & Laura T. Morrison, *SERP Shifts and Sec. 409A*, The Free Library, http://www.thefreelibrary.com/SERP+shifts+and+Sec.+409A.-a0160760183 (last visited Mar. 16, 2012).

14. *See* Jensen et al., *supra* note 11, at 34.

paid for personal services rendered.[15] This same standard is used for justifying the deduction of deferred compensation payments for executives, even though that deduction may be deferred in time.

Assuming that services have been rendered, the issue of "reasonableness" is then raised in order for the entity to claim the deduction.[16] This issue will later become critically important to privately held or closely held entities as the Code will continue to impose a "reasonableness" standard on all base pay, which is not subject to the $1 million cap imposed under I.R.C. § 162(m), as will be discussed later in the Article.[17] The Internal Revenue Service (the "Service") uses an objective test.[18] The IRS Revenue Manual lists twelve different factors in ascertaining reasonableness.[19] The courts have fashioned as many as twenty-one factors,[20] resulting in a case-by-case analysis.[21] That fact-intensive analysis has made it harder for the Service to audit and track.

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15. I.R.C. § 162(a)(1) (2006 & Supp. 2009). This standard was added by the Revenue Act of 1918. Pub. L. No. 65-254, 40 Stat. 1057 (1919). I.R.C. § 404 has a comparable standard for deferred compensation. I.R.C. §§ 162, 404 (2006 & Supp. 2009).

16. *See* Treas. Reg. § 1.162-7 (2009).

17. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a), 107 Stat. 312, 469–70 (inserting new subsection (m) into I.R.C. § 162 for tax years beginning on or after January 1, 1994).

18. *See id.* Such amount would ordinarily be paid for like services by like enterprises under like circumstances.

19. INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.35.2.5.2.2 (2006), *available at* http://www.irs.gov/irm/part4/irm_04-035-002.html#d0e212 (stating relevant factors for ascertaining reasonableness as: nature of employee's duties, background, expertise, and knowledge of business; size of employer; employee's contribution to employer's profitability; time spent with employer; local and general economic conditions; employee's character and extent of responsibility; when compensation is determined; relationship between shareholder's compensation to stockholdings; whether compensation is in full or in part for assets purchased; and comparison of amount paid by similarly situated employers to similar employees for comparable services).

20. *See* Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949) (listing eight factors). These factors are:

> [T]he nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; . . . the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

Id.; *see also* Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245–47 (9th Cir. 1983) (stating five factors); Kennedy, Jr. v. Comm'r, 671 F.2d 167, 173–74 (6th Cir. 1982) (listing twelve factors); Edwin's, Inc. v. United States, 501 F.2d 675, 677 (7th Cir. 1974) (documenting seven factors); Trucks, Inc. v. United States, 588 F. Supp. 638, 642–43 (D. Neb. 1984) (giving fifteen factors); Diverse Indus., Inc. v. Comm'r, 51 T.C.M. (CCH) 525, at *17 n.3 (1986); Foos v. Comm'r, 41 T.C.M. (CCH) 863, at *58–59 (1981).

21. *See* Perlmutter v. Comm'r, 373 F.2d 45, 47 (10th Cir. 1967).

The courts, especially the Seventh Circuit Court of Appeals, have also raised the issue of whether courts should decide what constitutes reasonable compensation.[22] The end result, however, is that denying the deduction simply hurts the employer—instead of the executive—and thus has little impact on reducing the *size* of executive compensation. This obviously depends on the extent to which the employer and executive agree to share the lost deduction. But, I.R.C. § 162(a)'s overall application to curb the size of executive compensation has been largely ineffectual.

B. *I.R.C. §§ 280G and 4999*

Due to the outbreak of mergers and acquisitions in the early 1980s, Congress perceived that executives were being unduly protected by enhanced severance packages that were payable in the event of a hostile takeover.[23] A corporation's board of directors guaranteed these enhanced severance packages as a tactic to incentivize executives to ward off a hostile takeover in order to keep their position. Of course, such arrangements could also be designed to incentivize the executives to agree to the acquisition, assuming that was in the best interest of the corporation, regardless of the executive's self-interest. Such arrangements were referred to as "golden parachutes," as they were apart from the typical severance arrangements paid to executives, and instead paid enhanced severance arrangements as a result of a change in control of the employer.[24] Thus, through the enactment of I.R.C. § 280G, Congress deemed that severance payments in excess of three times base pay were "golden parachute payments" for purposes of the Code, and therefore would be nondeductible to the employer—through I.R.C. § 280G—and result in a 20% excise tax payable by the executive through I.R.C. § 4999.[25]

To no surprise to the benefits community, these changes caused a variety of unintended consequences:

22. *See* Menard, Inc. v. Comm'r, 560 F.3d 620, 622–23 (7th Cir. 2009). The court held that although courts had tried to make uniform the multifactor reasonable salary standard, it remained opaque and awkward in application. *Id.* The court found the standard lacking in providing a neutral basis for a judicial analysis. *Id.* *See generally* Jones v. Harris Assocs., 537 F.3d 728 (7th Cir. 2008) (deciding whether courts are best arbitrators as to what is reasonable compensation).

23. *See* STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 199 (Comm. Print 1984).

24. *See* David P. Simonetti, *Applying* I.R.C. Section 280G's Golden Parachute Rules, J. OF DEFERRED COMPENSATION, Winter 2004, at 36 n.2.

25. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 67(a), 98 Stat. 494, 585 (adding § 280G to I.R.C.). Since 1984, Congress used the Dodd-Frank Wall Street Reform and Consumer Reform and Consumer Protection Act to impose new corporate governance initiatives. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

- Three times base became the new parachute payment minimum for most executives, thereby increasing the overall executive package;[26]
- Employers began to offer "tax gross-ups" as new benefits for executives—i.e., reimburse the executive for the additional excise taxes due on the parachute payment—to lessen the blow for the executives;[27] and
- Companies in danger of a takeover became more helpless and felt compelled to offer larger compensation packages to compete, making some companies more open to altering the date of the executive stock options (back-dating the option prior to the stock value increase or post-dating the option in anticipation of a loss).[28]

Since the original passage, the use of parachute payments by boards of directors has flipped—they now incentivize executives to welcome takeovers, rather than resist them.[29] But such use can be protective of executives who act in the best interest of the corporation and its shareholders regarding a takeover. The amount of such packages also continues to be noticed by the public, especially in light of the economic turmoil, as four highly profiled Chief Executive Officers (CEOs) could each receive parachute payments of $50 million or more, and four other CEOs could each receive such packages of $30 million or more, as of November 2011.[30]

C. *I.R.C. § 162(m)*

In 1993, Congress again corralled the size of executive compensation that could be paid with the enactment of subsection (m) to I.R.C. § 162.[31] In an effort to tighten the tie between compensation and performance for publicly held corporations,[32] Congress imposed a $1 million cap on the

26. I.R.C. §§ 280G(a), (b)(2)(A)(ii) (2006); *see also* Richard P. Bress, Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 963 n.38 (1987).

27. Companies use this practice of tax gross-ups to give executives the same compensation as if the executives were not assessed taxes/excise taxes on that income. *See* Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 139–40 (2001) (noting full gross-up would include executive's reimbursement for excise tax on golden parachute payments and taxes on gross-up).

28. *See* Glenn Curtis, *A Close-Up on Gross Ups*, INVESTOPEDIA (Oct. 18, 2007), http://www.investopedia.com/articles/stocks/07/gross-up.asp.

29. *See* Scott Thurm, *Mergers Open "Golden Parachutes"*, WALL ST. J. (Nov. 1, 2011), http://online.wsj.com/article/SB10001424052970204394804577010000947986974.html.

30. *See id.*

31. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified in scattered sections of U.S.C.). *See generally* Lee A. Sheppard, *Big Paydays Are Back!*, 124 TAX NOTES 99 (2009) (explaining first draft of § 162(m) developed from cap on compensation to cap on employer deduction). This progression occurred as a result of free market discussions. *Id.*

32. *See* H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877. "[T]he amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced" by the cap to limit compensation. *Id.*

employer's deduction for executive compensation that was not performance-based.[33]

Again the benefits community saw unintended consequences resulting from such legislation:

- Executives' base salary of $1 million became the new standard as its deductibility would not be questioned;[34]
- There began a real growth in stock option awards as they were considered to be performance-based;[35] and
- Using stock option awards changed the executive's perspective from that of a long-term perspective based on the employer's financial growth to that of a short-term perspective based on the changes in employer stock.[36]

The Joint Committee of Taxation examined Enron's executive compensation practices in the wake of that scandal.[37] Enron had a pay-for-performance attitude toward executive compensation,[38] relying heavily on the use of stock options. While most of the executives' compensation was performance-based, Enron did compensate a noteworthy amount of base pay that was nondeductible because it exceeded the $1 million cap—in fact, 11% of compensation for executives was nondeductible.[39] The Joint Committee concluded that Congress's $1 million deduction cap did not accomplish its goal and in fact recommended its elimination.[40] The Joint Committee also affirmed that Congress should use *non-tax* laws to affect executive compensation decisions.

Despite the Joint Committee's response to I.R.C. § 162(m), the Service continues to hone in on its utility. While the initial regulations stated that a compensation package would not fail to be performance-based simply because it allowed payouts upon death, disability, termination of employment, or retirement, regardless of whether the performance goals had been met,[41] the Service has proven more aggressive in a recent 2008 revenue ruling by holding that payments upon death, disability, or termination

33. I.R.C. § 162(m) (2006).

34. *See* John A. Bryne, *That's Some Pay Cap, Bill*, BUSINESSWEEK (Apr. 25, 1994), http://www.businessweek.com/archives/1994/b336854.arc.htm.

35. *See* Sheppard, *supra* note 31, at 99 ("Some banks are remunerating their employees with shares . . . .").

36. *See id.* at 100 ("'Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders.'").

37. STAFF OF J. COMM. ON TAX'N, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FED. TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 36 (Comm. Print 2003), *available at* http://www.gpo.gov/fdsys/pkg/GPO-CPRT-JCS-3-03/pdf/GPO-CPRT-JCS-3-03-1-1.pdf [hereinafter REPORT OF INVESTIGATION OF ENRON CORP.].

38. *Id.* at 13.

39. *Id.* at 42.

40. *Id.* at 42–43.

41. Treas. Reg. § 1.162-27(e)(2)(iii)(C)(v) (1996).

of employment prior to attainment of the performance goals would not be deemed performance-based.[42]

Under the existing regulations, in the context of stock options or SARs, the performance-based rule requires that the plan granting such options or SARs set forth the maximum number of shares that may be granted within a specified period to "any employee."[43] Proposed changes made in 2011 to those regulations would require the plan to disclose the maximum number of shares that may be granted per employee within a specified period.[44] Thus, disclosure of the aggregate amount of shares that could be granted under the plan would no longer be sufficient.

D. *I.R.C. § 409A*

Also regarding the Enron scandal, there were reports that Enron executives were able to dip into their deferred compensation arrangements[45] and accelerate the payment of such amounts—through the use of "haircut" provisions, which resulted in a forfeiture of a portion of the amounts—at the very time the stock value was plummeting, and the retirement benefits of the typical Enron employee, invested in company stock, were losing value. Thus, as part of the American Jobs Creation Act of 2004, Congress enacted I.R.C. § 409A, which severely limits the ability of an executive to defer compensation under a nonqualified arrangement.[46] The focus now was not on the *amount* of the compensation, but the *type* of compensation—deferred compensation. Instead of punishing the employer with the loss of a deduction, failure to comply with the rules results in immediate taxation of the deferred amounts and a 20% excise tax to the executive.[47]

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42. Rev. Rul. 2008-13, 2008-10 I.R.B. 518.

43. Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1006). This is referred to as "Individual Limitation."

44. *Id.* § 1.162-27(e)(4)(iv). *See generally* Andrew L. Oringer & Steven W. Rabitz, *Deducting from Flexibility under § 162(m)—New Proposed Treasury Regulations Released,* 39 TAX MGMT. COMPENSATION PLAN. J. 179 (2011).

45. *See* Eric Berger & Mary Flood, *The Fall of Enron: Deferred Payments Under Fire*, HOUS. CHRON., Aug. 17, 2002, at C1, *available at* http://www.chron.com/CDA/archives/archive.mpl/2002_3573528/the-fall-of-enron-deferred-payments-under-fire-han.html (noting that $32 million in deferred compensation was paid in October and November 2000 to Enron executives, still employed by Enron); *see also* REPORT OF INVESTIGATION OF ENRON CORP., *supra* note 37, at 13–14.

46. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.). Note that some authors argue that the passage of I.R.C. § 409A was driven by tax policy, arguing that deferred compensation receives more favorable tax treatment than current cash compensation and investments. *See* Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 573 n.7 (2007). *See generally* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986).

47. I.R.C. § 404A(a)(1)(B)(i) (2006).

The regulations took years to develop and resulted in onerous and detailed rules for compliance.[48] A correction program was announced in late 2008 to correct a limited number of operational failures.[49]

While it is too early to predict the unintended consequences, the onerous and complicated rules, coupled with the severe tax consequences to the executives, may result in the curtailment or elimination of deferred compensation. While that may have been Congress's ultimate goal, *deferred compensation does align the executive's self-interest with the long-term financial health of the employer, as he/she is dependent on that employer to make the payment sometime in the distant future*. Similar to the changes made to I.R.C. § 162(m), executives' focus on short-term changes in the employer's stock—which results in using stock options—may not be in the long-term best interest of the financial health of the employer.

E. *I.R.C. § 457A*

Hidden within the Troubled Asset Relief Program (TARP) legislation was yet another example of congressional intent to further limit deferred compensation by executives through the passage of I.R.C. § 457A.[50] Again the focus was on the *type* of executive compensation—deferred compensation. Originally, it was targeted to limit the deferred compensation of hedge fund managers—sheltered in offshore tax jurisdictions—by subjecting such deferrals to taxation upon vesting. Nevertheless, the final terms of the provision were more expansive in order to act as a revenue enhancer to negate tax extenders within the bill.[51]

Normally under the Code, the employer's deduction for deferred compensation is postponed until the employee reports the compensation as income, referred to as the "matching" principle.[52] For a typical U.S. employer, the tax rules do not incentivize the employer to defer the payment of employee compensation, as the deduction is also deferred. However, there may be no similar rule in the context of a foreign employer. Thus, such employers may be happy to allow deferrals by executives since

48. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,278 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1). The deadline for complete compliance was postponed until December 31, 2008. *See* I.R.S. Notice 07-86, 2007-2 C.B. 990.

49. *See* I.R.S. Notice 2010-6, 2010-3 I.R.B. 275, *available at* http://www.irs.gov/pub/irs-drop/n-10-06.pdf.

50. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified in scattered sections of 31 U.S.C.); *see* I.R.S. Notice 09-8, 2009-4 I.R.B. 34; I.R.S. Notice 8-115, 2008-2 C.B. 1367.

51. I.R.C. § 457A(a) (West Supp. 2009). Although the TARP legislation offers several ways of delaying the payment of taxes, the legislation has offset this by creating other revenue measures. *Id.* It was estimated that the arrival of I.R.C. § 457A would generate between $24 and $26 billion in revenue over the scoring period. *Id.*

52. *See* I.R.C. § 404(a)(5) (2006); *see also* Albertson's, Inc. v. Comm'r, 42 F.3d 537, 541 (9th Cir. 1994).

there is no tax consequence to the employer. I.R.C. § 457A subjects compensation deferred under a nonqualified plan of a nonqualified entity to immediate taxation when such compensation is no longer subject to a substantial risk of forfeiture.[53] If such amounts are not ascertainable as of the date of vesting, such amounts become includible in income when they are ascertainable, with a potential 20% excise tax plus interest imposed.[54]

I.R.C. § 457A shows Congress's continued dislike of deferred compensation arrangements and its continued use of the Code as a method to affect corporate governance. It is certainly too soon to predict whether this section will also produce unintended consequences.

IV. USE OF FEDERAL SECURITIES LAW

A. *Introduction*

In the aftermath of the WorldCom and Enron outrage, Congress turned to federal securities law in 2002 as another tool to regulate corporate governance, using the Securities Act of 1933[55] and the Securities Exchange Act of 1934.[56] As the federal securities laws were designed as full-disclosure laws for publicly traded entities, Congress decided to use those disclosure rules to spotlight and direct the actions of boards of directors of publicly held corporations. In 2002, Congress enacted the Sarbanes-Oxley legislation ("SOX"),[57] requiring publicly held corporations to create independent audit committees and to mandate certain responsibilities for such committees.[58]

Through this legislation, the audit committee was to have meaningful control over the audit process,[59] and the ability to hire financial advisors and special counsel as needed.[60] The CEO and the Chief Financial Officer ("CFO") must now certify that all reportable financial disclosures are accurate and dependable.[61]

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53. I.R.C. §§ 409A(d), 457A.

54. *See id.* § 457A(c)(1).

55. Securities Act of 1933, 15 U.S.C. § 77(s) (2006).

56. Securities Exchange Act of 1934, 15 U.S.C. § 78(d) (2008).

57. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 18 U.S.C. §§ 1341, 1343).

58. *Id.* § 301 (codified at 15 U.S.C. § 78j-l) (mandating SEC to announce new rules to clarify role and structure of corporate audit committees).

59. *Id.* § 301(m)(2) ("The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer . . . for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.").

60. *Id.* § 301(m)(5).

61. *Id.* § 302. The purpose of this rule is to make certain that the flow of information is reliable and complete through the company's controls. *Id.*

SOX's accomplishment can be credited with the ability "to get auditors to start being auditors again."[62] But what benefits practitioners saw in SOX was a model that Congress would ultimately use in drafting future legislation.

B. *SEC Regulation*

Then in 2006, the Securities and Exchange Commission (SEC) used its powers under the Securities Act of 1933 to propose new disclosure rules, which honed in on the various components of executive compensation packages.[63] These included:

- A narrative in the Compensation Discussion and Analysis (the "CD&A"), which focused on the CEO, CFO, and top three executive officers, and would describe new executive and director compensation disclosures, including tables that listed the various compensation components and their totals;[64]
- Additional disclosure rules for describing stock option programs, plans, and practices, with the table disclosing grant dates, grant fair market value, whether the exercise price of the option differed from the closing price on grant date, and the particulars of the timing of the grants;[65]
- Additional disclosure as to independence of directors and expanded disclosure around related person transactions;[66]

62. Joseph Nocera, *For All Its Cost, Sarbanes Law is Working*, N.Y. TIMES, Dec. 3, 2005, at C1. *But see* Robert Cole and Reynolds Holding, *Buffett Makes a Value-Growth Bet*, N.Y. TIMES, Nov. 15, 2011, at B1 (noting 2009 survey by SEC stated average cost per employer of complying with law was about $2.3 million per year).

63. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274) (describing significant adjustments made to rules in December 2006 which helped equity compensation disclosures conform with financial statements reported pursuant to Financial Account Standards Bulletin (FASB)); *see also* Executive Compensation, 17 C.F.R. § 229.402 (2008). These disclosure rules are expected to influence plan design since the limitations of the plan will be published for public consumption; therefore, these disclosure rules are often referred to as "the tail wagging the dog."

64. Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm. The CD&A requires the company's CEO and CFO to file and certify the disclosure form. *Id.* The disclosure form was initially intended to give details about the compensation packages for the organization's Chief Executive Officer, Chief Financial Officer, and the three other most highly compensated executive officers. *Id.*

65. *Id.* Equity interests were tabulated showing awards that could be received in the future and "the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option . . . ." *Id.*

66. *Id.* The amendment increased the dollar threshold for transaction disclosures, required disclosure of related company policies and procedures, and specified exceptions for certain categories of transactions. *Id.*

- Required disclosure of the number of shares pledged by management;[67]
- Required Form 8-K description of *employment* agreements and their amendments;[68]
- All disclosures to be in "plain English;"[69]
- More extensive disclosure requirements for registered investment and business development companies;[70] and
- An additional compliance portion, which describes the triggering events and time frame of these new disclosure rules.[71]

The notion was to spotlight disclosure of the specifics of the top executives' employment arrangements and pay packages to elicit responses from the general public and institutional investors who had significant ownership interest in the employers. As the SEC was dissatisfied with the results of such enhanced disclosures, it later modified its proposals.[72]

C. *SEC Proposed Corporate Governance Initiatives*

By July 2009, the SEC altered its proxy disclosure requirements, now examining whether the company's compensation arrangements in general—going outside the packages of the CEO, CFO, and the top executive officers—put the company at risk, and if so, how the company would handle such risk.[73] It specifically proposed that the board's Compensation Committee evaluate all compensation arrangements, not only for the size and the type of compensation, but also as to the risk they could pose to the employer's financial health.[74] This was obviously a reaction to the finan-

67. *Id.* Also, "the inclusion of directors' qualifying shares in the total amount of securities owned" needs to be disclosed. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *See* Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270, and 274). SEC Chairman Mary Schapiro stated:

> The Commission will be considering whether greater disclosure is needed about how a company—and the company's board in particular—manages risks, both generally and in the context of setting compensation. I do not anticipate that we will seek to mandate any particular form of oversight; not only is this really beyond the Commission's traditional disclosure role, but it would suggest that there is a one-size-fits-all approach to risk management.
>
> Instead, I have asked our staff to develop a proposal for Commission consideration that looks to providing investors, and the market, with better insight into how each company and each board addresses these vital tasks.

Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Address to the Council of Institutional Investors (Apr. 6 2009), *available at* http://www.sec.gov/news/speech/2009/spch040609mls.htm.

73. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,077–78.

74. *Id.*

cial meltdown during 2008 during which certain compensation arrangements allowed executives to take excessive risks, subjecting the corporation and its shareholders to greater vulnerability.

In addition, the SEC made specific recommendations with respect to corporate governance issues.[75] Four new areas of corporate governance that were being proposed included:

- Disclosure as to whether the board's Compensation Committee was operating under any conflict of interest[76]—that is, to the extent outside consultants were being utilized by the Committee, what fees were being paid to such consultants from the employer in total, management's contribution in appointing these consultants, and whether the board or Compensation Committee consented to the use of these consultants for *other* services;[77]
- Disclosure regarding the unique qualification, knowledge, and practice-set of individuals recommended to be board members;[78]
- Disclosure as to the corporation's leadership structure (asking the question as to whether the CEO could also be the chairman of the board);[79] and
- Disclosure regarding the board's responsibility in engaging in risk analysis, not only with respect to compensation levels, but also in general.[80]

D. *TARP*

The meltdown in the financial sector during 2008 set the stage for the Administration and Congress to set forth a new regime of regulation for those companies that would receive public aid through the Capital Purchase Program ("CPP") formed under TARP, which was created under the Emergency Economic Stabilization Act of 2008 (EESA).[81] Initially,

75. *Id.* Additionally, the new proposed SEC requirements would require companies to report the full grant date fair value of stock and options in the year of the grant. *Id.* at 35,079.

76. *Id.* at 35,086.

77. *Id.* at 35,108.

78. *Id.* at 35,105.

79. *Id.* at 35,108. *See* Matthew G. Isakson, Meridian Compensation Partners, LLC, 2011 Corporate Governance & Incentive Design Survey 5 (2011), *available at* http://www.meridiancp.com/images/uploads/Meridian_2011_Governance_and_Design_Survey_Results.pdf (surveying 250 large publicly traded companies and finding about one-third of such companies separated role between CEO and chairman of board). When such roles were separated, in the majority of cases, the non-CEO Chairman was also an independent director. *Id.*

80. *See* Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. at 35,076–78, 35,108.

81. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified in scattered sections of 5, 12, 15, 26, and 31 U.S.C.); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Encourage Participation in Treasury's Capital Purchase Program, FDIC's Temporary Liquidity Guarantee Program (Oct. 20, 2008), *available at* http://www.federalreserve.gov/

nine banks[82] used the resources available through the legislation. The TARP requirements were viewed as a preview of what the government was prepared to impose on the vast number of publicly held corporations.[83] For TARP participants, the government subjected executive compensation to four new restrictions:

- The I.R.C. § 162(m) deduction of $1 million was lowered to $500,000 for any Senior Executive Officer ("SEO")—defined as the top five highly paid executives whose compensation is subject to SEC proxy disclosure rules—for any year that the company continued to receive TARP money, not only for base pay but also for performance-based compensation;[84]
- Several of the § 162(m) exclusions were eliminated or paired down;[85]

newsevents/press/bcreg/20081020a.htm. The Secretary of the Treasury gained authority from EESA to re-establish the financial markets and "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary." Emergency Economic Stabilization Act of 2008 § 101(a)(1). TARP recipients now had corporate governance and executive compensation limits under Section 111 of the EESA. *Id.* at § 111(b)(2)(A). EESA was modified and replaced on February 17, 2009 by the enactment of § 7001 of the American Recovery and Reinvestment Act of 2009 (ARRA), which prescribed new executive compensation limits and required the Treasury to publish regulations to implement section 111 of EESA. *Id.*; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 sec. 7001, § 111(a)(2) (amending 12 U.S.C. § 5221(a)(2)).

82. Citigroup, JPMorgan, Wells Fargo, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America, Bank of New York Mellon, and State Street Bank were the banks participating in TARP.

83. *See* Stephanie L. Soondar & Allen Major, *Litigation and Recoupment of Executive Compensation*, 6 HASTINGS BUS. L.J. 397, 399 (2010). The Department of Treasury stated that the implementation of TARP was within "the ultimate goal of systemic regulatory reform" and was part of an investigation into "how corporate governance regulation can be improved to better promote long-term economic growth and to prevent future financial crises." *Id.; see also* Jonathan G. Katz, *Who Benefited from the Bailout?*, 95 MINN. L. REV. 1568, 1569 (2011). The money disbursed by TARP was "merely one component of a much larger governmental intervention . . . ." *Id.;* Lisa M. Fairfax, *The Legal Origins Theory in Crisis*, 2009 BYU L. REV. 1571, 1595 (2009) (stating that Treasury Regulations associated with receiving TARP funds were in step with President Obama's plan to "'promote systemic regulatory reform'").

84. *See* Emergency Economic Stabilization Act of 2008 § 302(a) (amending I.R.C. § 162(m)) (defining special Rule for Application to Employers Participating in TARP). Congress may be wary of using performance–based compensation as the measure for performance since it can be easily met, which is evident by not including a performance based compensation exception in EESA. *See id.*

85. *Id.*; *see* I.R.C. § 162(m)(5)(D)(i)-(iii) (West 2011). Once an executive is identified and meets the qualifications for a "covered executive" for any applicable year, that individual is considered to be a "covered executive" in all subsequent tax years. *Id.* This is true regardless if the executive meets the requirements of "covered executive" in future years. *Id.*

- The amount of any golden parachute payment[86] payable to a SEO or any of the next five most highly compensated employees[87]—not just simply a limit on the employer's deduction—would be limited to three times the base pay,[88] and the scope of the compensation for such payments was expanded to include any payment for departure (1) due to involuntary termination or (2) as a result of the employer's bankruptcy, liquidation, or receivership;[89] and
- The ability to rebut the presumption that arrangements made within the last year were parachute payments was eliminated.[90]

The TARP legislation ushered in the following new corporate governance requirements:

- For the SEOs,[91] the Compensation Committee would be mandated to examine the SEO incentive compensation packages to make sure that such packages would not promote unwarranted risk-taking on their part, and if so, to alter such packages;[92]
- SEO compensation arrangements must now afford the company the ability to "clawback" bonuses/awards that later were found to be ill-gotten as the company's "statements of earnings, gains, or other criteria" were "materially inaccurate;"[93] and
- Subsequent golden parachute arrangements for the SEOs that would be triggered upon an involuntary termination, bankruptcy, insolvency, or receivership could not be entered into.[94]

86. The definition of a parachute payment is any compensation payment that was or is "(i) . . . contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation, and (ii) the aggregate present value of payments [which] exceeds" three times the recipient's "base amount." I.R.C. § 280G(b)(2)(A) (West 2006).

87. Emergency Economic Stabilization Act of 2008 § 111(b)(2)-(3), 122 Stat. 3765, 3776-77 (codified in scattered sections of 5, 12, 15, 26, and 31 U.S.C.).

88. In determining the base amount, one takes the executive's annualized includible compensation averaged over the five calendar years determined prior to the change of control year. I.R.C. § 280G(b)(3) (West 2008).

89. Emergency Economic Stabilization Act of 2008 §111(b)(2)-(3) (barring any SEO from receiving golden parachute when Treasury retains equity or debt position in employer).

90. I.R.C. §§ 280G(b)(2)(C), (e)(1)(D).

91. Emergency Economic Stabilization Act § 111(b)(3).

92. *Id.* § 111(b)(2)(A). There is no definition of "risk" or "excessive risk" in the legislation. Typically risk is considered as an anticipated harm that could result in attempting a given objective, a balancing of risks versus rewards. Although EESA does not disallow using risk as a criterion in determining compensation, it disallows excessive risk-taking. *See* Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1131 (2007) (explaining "risk-and-rewards" method in general business context as "estimation of expected losses and returns").

93. Emergency Economic Stabilization Act § 111(b)(2)(B).

94. *Id.* § 111(c). Additionally, covered employers are barred from giving any golden parachute payments to the five highest paid executives who are under existing arrangements. *Id.*

As Congress viewed itself as a major shareholder of these banks, it decided to not only limit the employer's deduction, but to set the size and type of *existing*, as well as new, executive compensation arrangements.

E. *TARP II*

One of the original TARP participants, Merrill Lynch, decided to advance certain bonus payments to executives beginning in January of 2009, prior to its sale to Bank of America.[95] The Administration and the Treasury Department issued press releases in early February setting forth even more rigorous limitations on the executive compensation programs of TARP recipients.[96]

This set the stage for Congress to pass the American Recovery and Reinvestment Act of 2009[97] (ARRA) on February 17, rewriting the prior TARP restrictions on executive compensation and imposing new requirements. While these new rules were applicable only to companies receiving TARP funds (both financial and nonfinancial corporations), they caught the attention of most publicly traded corporations in the event such limitations would one day become universal. The changes included:

- Clawback provisions were to be imposed not only on the SEOs, but also on the next twenty most highly compensated employees;[98]
- A new prohibition existed against "paying or accruing any bonus, retention award, or incentive compensation" for certain SEOs while the company was the recipient of TARP monies;[99]
- A new requirement that the company institute policies regarding excessive or luxury perquisites;[100]

95. *See* Rick Newman, *More Outrage over the Merrill Bonuses*, U.S. NEWS AND WORLD REPORT (Mar. 12, 2009), http://money.usnews.com/money/blogs/flowchart/2009/03/12/more-outrage-over-the-merrill-bonuses (describing bonus payments to Merrill Lynch executives). Newman describes it as:

> [A] crystallizing episode in the Great Financial Meltdown. To most Americans, it's absurd for a company that lost nearly $28 billion in 2008, nearly collapsed, and survived thanks only to a taxpayer-subsidized rescue, to lavish million-dollar bonuses on dozens of executives. . . .
>
> This can only end badly for Merrill and BofA, with repercussions that could ricochet throughout Wall Street and dramatically change established practices.

Id.

96. *See* Macon Phillips, *New Rules*, THE WHITE HOUSE BLOG (Feb 4, 2009, 2:51 PM), http://www.whitehouse.gov/blog_post/new_rules.

97. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified in scattered sections of U.S.C.).

98. *Id.* sec. 7001, § 111(b)(3)(B) (amending 12 U.S.C. §5221(b)(3)(B)).

99. *Id.* sec. 7001, § 111(b)(3)(D)(i).

100. *Id.* sec. 7001, § 111(d)(1)–(4). These luxury expenses include: "(1) entertainment or events; (2) office and facility renovations; (3) aviation or other transportation services; or (4) other activities or events" to the extent that those expenditures "are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the business . . . ." *Id.*

- A new requirement that the Compensation Committee perform a semiannual review of the executive compensation arrangements to evaluate risk, along with certifications and disclosure narratives;[101]
- A new requirement for shareholder say-on-pay vote on the compensation of executives in the annual proxy statement[102]—while non-binding, a negative vote was hoped to carry weight and result in changed corporate behavior;[103] and
- The creation of a "Special Master" (i.e., the new pay czar), who would review the compensation packages of seven of the TARP recipients receiving "exceptional assistance" and make recommendations accordingly.[104]

V. DODD-FRANK PASSAGE IN 2010

The series of TARP legislations certainly provided the template for the Administration and Congress to extend many of the TARP restrictions to all publicly held companies through the passage of the Dodd-Frank Wall Street Reform & Consumer Protection Act in 2010.[105] By amending the Securities Exchange Act of 1933 and adding a new Section 14, publicly held companies would now be subject to the following new requirements:

- The shareholder say-on-pay initiative would now be universal for publicly held companies beginning with the 2011 proxy season.[106] While the vote would be non-binding, shareholders would be given the right to vote on executive pay packages for the named executive officers, as well as the right to vote on the frequency of such vote.[107] The say-on-pay vote was also extended to the offering of any golden parachute packages requested in the event of an acquisition, merger, consolidation, or sale of assets of the reporting company that would occur within six months;[108]

101. *Id.* sec. 7001, § 111(c)(2).

102. *Id.* sec. 7001, § 111(e).

103. *See* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30). The Interim Final Rule "revises in its entirety 31 CFR [sic] Part 30, which comprises Treasury's regulations implementing section 111 of EESA." *Id.* at 28,396.

104. *Id.* at 28,416.

105. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

106. *Id.* sec. 951, § 14A(a)(1); *see* Jeff Green, *America's Teflon Corporate Boards*, BLOOMBERG BUSINESSWEEK (July 14, 2011), http://www.businessweek.com/magazine/americas-teflon-corporate-boards-07142011.html (noting that in past three years, more than 200 directors received negative say-on-pay votes, but continued in leadership roles).

107. Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 951, § 14A(a)(2). Shareholders can elect to hold a vote on executives' compensation every one, two, or three years. *Id.*

108. *Id.* sec. 951, § 14A(b)(2).

- Enhanced independence standards would be imposed on the Compensation Committee of the board[109] and its use of independence factors in selecting and using outside compensation consultants and other advisors;[110]
- All publicly traded companies would be required to have clawback policies in order to recover from former or existing executive officers in the event the financial statements had to be restated for material noncompliance with securities law;[111] and
- New disclosures on the proxy summarizing the pay packages of any named executive officer of the company and the size of the package, including comparing the CEO's pay to the pay of the average employee (the so-called "internal pay equity") and the CEO's pay to total pay of all employees (excluding the CEO's pay).[112]

VI. CONCLUSION

The use of the Code in curbing the size and type of executive compensation has not only been unsuccessful, but has also created unintended consequences that contributed to the growth of executive pay. It has also led to more complexity in the Code, adding to the cost of complying and auditing such provisions. As Congress directs its corporate governance mandates under federal securities law, its reach is obviously limited to publicly traded corporations. Undoubtedly, it hopes that such mandates will become "best practices" for all businesses. This is undoubtedly a huge leap of faith for small businesses that struggle with low profit margins with a small group of insiders that are employed and control the business.

It is too early to tell whether the use of federal securities law will be successful in legislating corporate governance "best practices" for publicly traded corporations. The 2010 Wall Street Journal/Hay Group CEO Compensation Study saw little change in the median CEO base salary amount, but did see a shift in the long-term incentive portfolio away from stock options to a mixture of stock options, restricted stock, and performance awards.[113] As to executives' perquisites, the only fade away has been tax gross-ups. The results of the 2011 proxy season showed that the vast majority of employers received favorable say-on-pay votes regarding executive compensation,[114] indicating either a strong endorsement of executives' pay packages or apathy on the part of shareholders.

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109. *Id.* sec. 952, § 10C(a)(2).

110. *Id.* sec. 952, § 10C(b)(2).

111. *Id.* sec. 954, § 10D(b)(1).

112. *Id.* sec. 953(a)–(b) (amending 15 U.S.C. § 78n).

113. *The Wall Street Journal/Hay Group Survey of CEO Compensation*, *supra* note 7.

114. *See* Matt Vnuk et al., *2011 Proxy Season Summary—Say on Pay*, CAPFLASH NEWSLETTER (Compensation Advisory Partners, New York, N.Y.), Sept. 13, 2011, at 2, *available at* http://www.capartners.com/uploads/news/id64/capartners.com-capflash-issue22.pdf.

As Congress encroaches on the States' traditional police powers to regulate corporate governance issues, it will continue to find resistance from business entities and executives, as well as the federal courts, as they query federal mandates in such areas that normally would be perceived to be within the States' traditional police powers. A similar fight between the lines of federal mandates and States' traditional police powers—which include insurance regulation—is being waged in the recent health care reform legislation, as health insurance has been typically regarded as within the purview of the States' traditional police powers. How far federal legislative powers can extend to regulate individuals' and corporations' abilities to receive compensation and benefits will be the subject of continued debate for decades to come.