

The Politics of Executive Pay

Ideology, not “social justice,” fuels calls for restraints on executive compensation.

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Current liberal ideology seeks “social justice” through the appropriation and redistribution of wealth — usually from members of the business class. Though we associate such redistribution schemes with places like the former Soviet Union, China, Cuba, North Korea, and Zimbabwe, it has a lengthy history in the United States. For example, in 1777, a Pennsylvania constitutional convention considered, but rejected, a provision that stated: “That, an enormous Proportion of Property vested in a few individuals is dangerous to the Rights, and destructive of the Common Happiness, of mankind; and therefore every free State hath a Right by its Laws to discourage the possession of such Property.”

Today, the demand for wealth redistribution comes clothed in populist appeals to the unfairness of the gross disparity between executive pay and that of the average worker. This claim resonates well in the press, but efforts to redistribute wealth through taxes, mandatory public disclosure, and corporate governance “reforms” have all failed. Nevertheless, compensation politics continues unabated, as demonstrated by the latest fight over the Bush tax cuts.

Redistribution by Taxation

Liberals (in the American political sense) have long viewed disproportionate taxation as a “fair” way to redistribute the wealth of U.S. businessmen. The “progressive” income tax is based on an

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ability-to-pay principle — that is, the wealthy’s higher income is reason enough for their being assessed higher tax rates.

Unsurprisingly, the wealthy have proved unwilling to part with their wealth and can avoid the worst effects of disproportionate taxes through various tax shelters. Anticipating the Laffer curve theory that lowering taxes can actually generate more revenue for government, then-secretary of the treasury Andrew Mellon convinced Congress in the 1920s to lower the top income tax rate on investment income from 65 percent to 24 percent. Despite the cut, Mellon was able to reduce the national deficit.

Mellon’s tax cutting efforts were cut short by the Great Depression, a period in which both political parties abandoned his common sense approach to taxation. President Herbert Hoover imposed a “temporary” increase in the top income tax rate to 63 percent in 1932. Revenues from the income tax promptly fell by about 50 percent. Calling businessmen a “stupid class,” Franklin Roosevelt proclaimed that the American public wanted “their fair share in the distribution of the national wealth.” He sought to give it to them through such legislation as the Revenue Wealth Tax Act of 1935, which raised the top marginal income tax rate on individuals to 75 percent. However, that and other punitive legislation directed against businessmen only served to worsen the economic situation during the Great Depression, as capital went into hiding. There was simply no incentive for businessmen to take risks when they would have to bear all of the losses and give the government most of the profits.

The highest marginal tax rate for individuals was raised to 94 percent during World War II, and the adoption of an “estate tax” applied another 50 percent tax on earnings that had already been taxed as income. Nevertheless, the wealthy continued to fight this wealth confiscation effort through various tax avoidance and evasion schemes. Indeed, higher taxes actually encouraged the preservation of wealth, rather than its redistribution. Before the estate tax, the successful formula for wealth redistribution in the United States was tried and true: “From rags to riches and back to rags again in three generations.” Tax-motivated trusts, however, not only avoided the estate tax, but also derailed the rags-to-riches-to-rags natural order of wealth redistribution. Those trusts placed family wealth in the hands of professional money managers who could prevent it from being squandered by the third generation. Hence, the Kennedy and Rockefeller dynasties put trust fund babies into high offices and concentrated wealth for generations.

President Harry Truman reduced the marginal tax rates on individuals to 86.45 percent, tax rates on corporate earnings were cut from 90 percent to 38 percent, and tax revenues increased. President John F. Kennedy, himself a trust fund baby, lowered the top income tax rate during his administration to 70 percent. He contended that lower rates would reduce the motivation for engaging in tax evasion. Interestingly, Republican lawmakers opposed Kennedy’s legislation because they believed lowering tax rates would increase the government deficit. Still, the high rate

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continued to provide a strong motive for tax avoidance, which became a cottage industry of oil depletion allowances, leveraged limited partnerships, and other schemes.

The Alternate Minimum Tax was another failed attempt at wealth redistribution. Congress enacted the AMT after it was revealed that 21 millionaires had paid not a single cent in income tax in 1967 because of various tax avoidance schemes. However, the AMT had little effect on wealth distribution. Instead, it is now increasingly falling on the middle class, as inflation sweeps more and more households into its arms.

President Ronald Reagan successfully launched a counter-revolution against high marginal tax rates. He embraced “supply side” economics, which posits that reduced taxes spur economic growth. Reagan was able to convince Congress to slash income taxes on both individuals and corporations. Economic prosperity followed, and tax cutting thereafter became a centerpiece of Republican politics.

Reagan’s successor, George H. W. Bush, learned the hard way that deviating from this Republican ideology can be costly. After he broke his “Read my lips” campaign pledge not to raise taxes, he lost the enthusiasm and support of many of his supporters, and ultimately his 1992 reelection bid.

His successor, Bill Clinton, then raised taxes. Clinton’s action touched off a debate over whether taxes inhibit economic growth, because the economy boomed after the tax increase. Critics claim that the tax increase was, nonetheless, inhibiting because economic growth accelerated further after Congress enacted (minor) tax cuts during Clinton’s second term. That accelerated growth came at a time when business cycles normally experience a slowing economy.

Bush tax cuts | In any event, George W. Bush took his father’s loss to heart and promised tax reductions in his 2000 presidential campaign. Once in office, he convinced Congress to make significant tax reductions at all income levels, including those of the wealthiest. Capital gains and stock dividend taxes were reduced and the estate tax was phased out over a 10-year period. There was just one wrinkle in this program: it came with an expiration date of December 31, 2010.

“Bush tax cuts” became a term of derision and distaste for liberals because Bush had undercut their wealth redistribution efforts. Repealing the Bush tax cuts for the wealthy (those making over \$250,000) became a centerpiece of the Democratic presidential campaign in 2008. As candidate Barack Obama told one skeptical voter (Joe “the Plumber” Wurzelbacher), Obama intended to “spread the wealth around” when he became president by raising taxes on the wealthy.

Candidate Obama also promised to increase capital gains taxes “for purposes of fairness,” even though it was pointed out to him that the last two cuts in capital gains taxes had actually increased tax revenues. But it is unclear how increased rates would be fairer. The wealthy already bear the lion’s share of the tax burden. The top 1 percent of earners received some 20 percent of income in 2007, but paid almost 40 percent of all income taxes;

the top 5 percent of earners paid 60 percent of those taxes; the top 10 percent paid nearly 70 percent and the top 50 percent paid all but 3 percent of income taxes. This meant that nearly 50 percent of households paid no federal income tax.

Obama’s wealth redistribution views were extreme, but he nonetheless won the White House. The repeal of the Bush tax cuts for the wealthy then seemed assured, since the Democrats also controlled both houses of Congress — but fate intervened. The Obama administration lost popularity before it could end the Bush tax cuts. The Tea Party–fueled victories by Republicans in the 2010 midterm elections forced the president to agree to extend the Bush tax cuts for two years and to reinstate the estate tax at a rate of only 35 percent, with an exemption for estates below \$5 million. Although the Republicans won that fight, the timing of the expiration of those cuts will, undoubtedly, make them an important issue in the 2012 presidential election.

At the state level, there is also strong interest in increasing taxes on the wealthy, even though states that have done so have received much less revenue from the higher taxes than they expected. Oregon, for example, raised taxes on the wealthy in 2009, but received one-third less in revenue than was projected. The same phenomenon was observed in Maryland and California. Perhaps not coincidentally, the 2010 Census also showed a shift of population away from the high-tax states over the last 10 years, which portends an increase in Republican House seats.

Corporate Governance Reforms

Taxation is not the only arrow in the liberal quiver for wealth redistribution. Another arrow is attacking high executive compensation, under the questionable theory that reducing such compensation will mean higher wages for workers. These attacks have been disguised by the claim that restraining compensation would be good corporate governance reform.

Initially, it was claimed that high executive compensation constitutes a breach of the fiduciary duties owed by a corporation’s managers to stockholders. The high-water mark for this theory was the 1933 Supreme Court decision in *Rogers v. Hill*, involving a compensation scheme at the American Tobacco Company that provided its president with compensation of over \$1 million in 1930. The Supreme Court held that, at some point, excessive corporate compensation could constitute a waste of corporate assets in breach of the manager’s fiduciary duties. However, the court offered no guidelines for determining at what point that breach occurs. The case was settled on remand with few changes, and a state court threw out a companion case because the court had no means of determining whether the compensation was excessive.

Fiduciary duty claims brought against executives at other companies were also unsuccessful. Those setbacks led Cornell law professor George T. Washington to conclude in the *Harvard Law Review* in 1941 that the courts had decided to leave the issue of the reasonableness of executive compensation to the judg-

ment of the corporate board of directors. Washington's claim lay virtually uncontested until this century when shareholders of the Walt Disney Co. filed suit demanding that the courts stop what they claimed was an instance of excessive compensation. The lawsuit charged a breach of fiduciary duties when the Disney Board authorized a mind-boggling \$130 million severance package for deposed Disney president Michael Ovitz. Although Ovitz had served only 14 unproductive months at Disney before being fired, the Delaware Supreme Court could find no breach of fiduciary duty. This will probably quiet attacks on executive compensation through fiduciary duty claims for a time, but — like wealth taxes — the issue will undoubtedly resurface in future decades.

Mandatory disclosure | Another tax-the-rich scheme disguised as corporate governance reform is the requirement for “full dis-

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closure” of executive compensation under the federal securities laws. The theory behind this requirement is that executives will eschew high compensation because they would be shamed by its public disclosure.

Ironically, this theory seems to have backfired on its proponents. Instead of being shamed, executives appear to relish having their compensation reported and to compete with each other over who gets the best deal. What shame they do experience seems to occur when they are topped by a competitor. Instead of reducing compensation, the disclosure requirement seems to have set off an “arms race” of spiraling executive compensation.

In 1992, the Securities and Exchange Commission substantially increased its executive compensation disclosure requirements. The result was that, by 2006, executive compensation had quadrupled. Incomprehensively, this caused the SEC to further increase its disclosure requirements. Executive compensation then continued to rise until the subprime crisis resulted in a somewhat minor decline in the overall level of executive pay.

Incentive pay | Another effort to redistribute wealth was a proposal to require that executive pay be “aligned” with the interests of shareholders by basing most executive compensation on grants of options on company stock. It was theorized that this would give executives an incentive to increase their firm's share price, which would benefit shareholders as well as the executives. Congress assisted in this effort through

a provision in the Omnibus Revenue Reconciliation Act of 1993 that limited the deductibility of corporate salaries (non-incentive pay) to \$1 million, but placed no such limits on incentive pay in the form of stock options. A chairman of the SEC later ruefully remarked that this change in the tax laws “deserves pride of place in the Museum of Unintended Consequences.”

Instead of a ceiling, the \$1 million tax deduction limitation became the corporate executive's “minimum wage.” Moreover, rather than curbing executive pay, options bestowed incredible amounts of wealth on executives as the stock market boomed in the 1990s. Another unintended consequence was that option-based compensation spurred management to manipulate company accounts in order to increase their company's stock price. Those machinations unraveled when the economy slowed in 2001. The resulting accounting scandals were legendary and included the bankruptcies of the energy firm Enron and the telecommunications firm WorldCom, where top executives had received hundreds of millions of dollars in options-based compensation.

The congressional response to the scandals was the Sarbanes-Oxley Act of 2002, which imposed much costly and unnecessary regulation on public companies and their managers. Not surprisingly, that legislation did nothing to halt the rise in executive compensation. It also did nothing to prevent or deter the scandals associated with executive compensation that arose during the subprime crisis.

Criminalizing executive compensation | Another response to the options-related accounting scandals was the high-profile criminal prosecutions of executives receiving large compensation packages, including Jeffrey Skilling at Enron and Bernie Ebbers at WorldCom. Those prosecutions exposed the dark side of compensation politics, as prosecutors and the press demonized the executives for the compensation they received. Those attacks prejudiced juries and were used to justify draconian prison sentences, which often exceeded those typically given to murderers and serial child molesters.

Prosecutors also employed some unseemly tactics to obtain convictions of business executives and to coerce them into guilty pleas. Executives were arrested in dawn raids and given a public pillorying through a “perp walk” in which they were shackled and paraded before the press. More charges were piled on if the executive refused to enter a guilty plea. Family members were threatened, and even indicted, in order to coerce guilty pleas. Prosecutors intimidated defense witnesses to discourage them from testifying by sending them so-called “target letters.” The government also employed a convoluted legal theory under the mail and wire fraud statutes to obtain numerous executive con-

victions that were subsequently set aside by the Supreme Court.

Companies employing indicted executives were threatened with destruction by indictment if they did not “cooperate” with prosecutors. This meant that, in order to survive, public companies had to waive their attorney-client privilege. Prosecutors also illegally demanded that the companies cut off attorney fees for executives, even though they were required to pay those fees by law or contract. The companies were required to enter into “deferred prosecution” agreements in which they were allowed to escape indictment only after paying massive fines, making forced confessions worthy of a Stalinist show trial, and agreeing to the forced hiring of former prosecutors and government officials as high-paid “corporate monitors.”

The result of this criminalization of executive pay was a vast waste of government resources, enormous expenses to shareholders, and a disquieting loss of integrity on the part of prosecutors during the Bush administration. The Obama administration has continued this policy, but the acquittal of the managers of the failed Bear Stearns’ hedge funds has made it more cautious. Nevertheless, pressure continues to mount in the press for more show trial prosecutions of executives at institutions that failed during the subprime crisis.

Proxy reforms | Another corporate governance reform involves the use of SEC proxy rules. The rules require corporate managers to submit proposals from even small shareholders to a shareholder vote at the annual meeting. However, SEC rules contain a number of exemptions from the requirement, including the exclusion of proposals that would violate state law. That exemption was used historically to block shareholder votes on executive pay because state laws vest the board of directors with discretion to set executive pay, rather than shareholders.

In order to avoid this roadblock, corporate reformers demanded an “advisory” vote on executive compensation that would not violate state law because it was not binding on the board. The SEC adopted amendments to its rules to authorize such votes; Congress required such votes for firms receiving bailout funds under the 2008 Troubled Assets Relief Program, and the Dodd-Frank Act of 2010 endorsed that requirement. Several such “say-on-pay” votes have been conducted, but the results were generally supportive of management, thereby endorsing the very pay attacked by the proponents of the vote.

Board of director reforms | The next stop for the corporate reformers was to seek representation on corporate boards of directors where executives and their pay could be attacked directly. Historically, nominations for election to corporate boards were made through nominating committees selected, directly or indirectly, by the corporation’s executives. Dissidents

could wage a proxy fight to elect their own representatives, but such fights were enormously expensive and management was likely to prevail.

To avoid that obstacle, corporate reformers sought a change in SEC rules to require companies to include dissident nominations in company proxy materials at the company’s expense. The SEC had previously rejected such a proposal in 1942, after a group of congressmen criticized it as being “communist” in nature. A similar proposal was rejected in 1992.

However, there has occurred a subtle, but revolutionary, change in shareholder activism as a result of pressures from labor

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unions and their pension funds. Union pension funds are now some of the largest institutional investors and their diversified holdings include most public companies. Unlike other passive institutional investors, union pension funds seek to actively manage companies in which they invest.

Congress gave a boost to the activist role of the union pension funds in 1995 through legislation that changed the manner in which the lead plaintiffs in class action lawsuits were selected. Specifically, the legislation changed the selection process from first-suit-filed to the plaintiff with the greatest stake in the litigation. The union pension funds usually had the largest stake, and they sought the lead plaintiff role in order to harass management and improve their returns. Today, any corporate setback will immediately be the target of a class action lawsuit led by a union pension fund. That harassment has proved to be costly to other shareholders, as the size and number of settlements ballooned in the union-directed class actions, to the detriment of other shareholders.

The unions also seek to actively manage the entire spectrum of public companies through the SEC’s proxy rules. Historically, most shareholders followed the “Wall Street rule,” which posited that if you did not like management, you simply voted with your feet by selling the stock rather than cast a negative proxy vote. The unions sought to reverse the Wall Street rule and actively manage corporations through changes in the SEC’s proxy rules. This was done in three steps:

First, the unions and other “reformers” convinced the SEC to require institutional investors to disclose their proxy vote policies and to adopt policies that would assure their proxy votes are in the best interest of their clients. Those institutions have no interest in managing the companies in which they invest. Therefore, in order to satisfy the SEC rule, many of those institutions delegated their proxy votes to the discretion of a group of corporate

governance firms with questionable motivations and which are allied with the unions.

Second, the unions and other corporate governance advocates convinced the SEC to approve a change in stock exchange rules that prohibits broker-dealers from voting the shares of their non-objecting customers in board elections. Previously, because retail investors rarely voted their own proxies, their broker-dealers were allowed to act as the customers' proxy. The broker-dealers cast the vote of non-objecting shareholders in board elections for management-supported nominees. However, this rule change has now sidelined those votes.

Third, the SEC changed its proxy rules to allow the unions to nominate their own candidates for board elections in company proxies. The authority to impose that requirement was confirmed by the Dodd-Frank Act of 2010 and by a change in Delaware law. The SEC rule change seems to be specially designed for the union pension funds because it is limited to shareholders holding at least 3 percent of the company's stock for at least three years. Only time will tell how successful this union strategy will be or how much damage will be done to U.S. businesses as union board representatives seek to push corporate policy away from profits, toward other goals.

Risk management | Another focus for compensation politics in recent years has been risk management. During the subprime crisis, an outcry arose over claims that executives were receiving bonuses that induced them to take excessive risks. That claim found its way into the TARP legislation, which established a "pay czar" to monitor executive compensation at bailed-out firms. The Dodd-Frank Act of 2010 also requires regulators to prohibit any bonus arrangement at financial services firms that "encourages inappropriate risks." Financial service regulators are now considering proposals to regulate bank bonuses so that they do not encourage such risk.

This latest assault on executive compensation raises a number of issues. For example, it was never shown that bonuses encouraged excessive risks. To the contrary, the banks were not seeking excessive risks through their subprime activities. They sold off the riskier tranches of the collateralized debt obligations that securitized the subprime mortgages that were of concern during the crisis. The massive asset write-downs of the large financial service firms during the crisis were mostly associated with the investment-grade tranches of the CDOs they retained on their books, including many that were rated AAA, just like federal government bonds. Federal regulators even allowed special treatment of those securities under bank capital requirements. It is, therefore, hard to claim that the banks were excessive risk takers.

More troubling is the thought that the government should regulate the proper level of risk incurred by a private company. Business is all about incurring risk. The amount of risk incurred will measure the success or failure of an enterprise — "no risk, no reward." The unintended consequences of risk avoidance pressures could be serious. For example, if excessive business risk is to

be avoided, pharmaceutical companies must stop their quest for new drugs to cure cancer or other deadly or debilitating diseases. Most such research will prove futile, and billions of dollars will be lost in the process. However, is that risk not worth the rewards of finding a successful drug that saves lives or eases suffering?

Compensation Politics

Interestingly, concerns about income inequality tend to focus on the compensation of executives, and not on the multi-millions earned by top entertainers and athletes. For instance, a December 26, 2010 *New York Times* article dismissed the outsize payments received by performers as being merely the product of technological innovations that enable performers to appear before larger audiences. Without pausing for breath, the article then launched an extended assault on increases in executive compensation, which it blamed on deregulation by the Reagan administration.

Congress and the SEC have made no effort to curb the pay of entertainers and athletes. Indeed, the SEC exempts the salaries of entertainers and athletes from its mandatory disclosure requirements in what has come to be known as the "Katie Couric" exemption. Yet, some of those payouts are astronomical. The average salary of an actor/performer is less than \$50,000, but Oprah Winfrey has made at least \$1 billion from her television talk show, shock jock Howard Sterns was paid nearly \$600 million to move his talk show to satellite radio, and George Lucas recently made nearly \$300 million in a single year without having to put out a new episode of *Star Wars*. The average salary in Major League Baseball is around \$3.2 million; the average salary for a player in the NBA is over \$5.3 million. Where is the outrage over those large payouts?

There are other unremarked-upon wealth disparities. Some authors become millionaires, or even billionaires in the case of J.K. Rowling, but most authors receive a pittance in royalties. Yet, no one is demanding that high-earning authors redistribute their earnings to those less successful. It is also notable that wide pay disparities exist in intellectual fields. University presidents and directors of elite museums and performing arts centers receive annual salaries in excess of \$1 million, while the average income of a person holding a doctorate degree is less than \$85,000 and most K-12 teachers earn under \$60,000. Despite his paper's advocacy of social justice, *New York Times* publisher Arthur Sulzberger Jr. was paid over \$10 million between 2006 and 2008, while the average pay of a reporter on that newspaper was around \$85,000.

Conclusion

The dream of wealth redistribution from the business class was a disaster under the harsh lash of communist ideology. It has also failed to date under the modern doctrine of "social justice." Despite all the efforts of the wealth redistribution crowd, the concentration of wealth in the United States is now at the highest level since 1929. Nevertheless, the fight continues. **R**