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The Effect of Shareholder Proposals on Executive Compensation

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THE EFFECT OF SHAREHOLDER PROPOSALS ON EXECUTIVE COMPENSATION

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I. INTRODUCTION

During the last decade, the stratospheric increases in Chief Executive Officer (CEO) pay levels have made executive compensation a popular target for shareholder activism, particularly when high pay is accompanied by poor corporate performance. Outraged investors have made their views known to corporate boards of directors using shareholder proposals, binding bylaw amendments, "Just Vote No" campaigns, and other activist efforts. As institutional and other shareholders have attempted to monitor board decisions, the question remains: Have their efforts been successful in influencing executive compensation?

To date, little empirical research has been conducted on this question. In this paper, we examine each of the various methods by which shareholders have tried to influence executive compensation. We then attempt to determine whether one of the most popular methods for individual investors—shareholder proposals using Rule 14a-8—has had any impact on the level and composition of CEO's compensation at target companies. We use data for the 1993-1997 proxy seasons on 168 executive compensation proposals submitted to 145 different companies to determine how shareholders have chosen their target companies and whether these companies' boards have responded to investors' proposals by reducing CEO pay levels or by shifting the composition of their pay packages.

Our analysis yields several interesting results. We find that shareholders generally target their proposals at relatively poorly performing companies exhibiting higher levels of executive compensation than other similarly-sized firms in their industry. This is consistent with the claim that shareholder proposals are being used in an attempt to monitor excessive levels of executive compensation.

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Shareholder support for executive compensation proposals is not as high as with most other types of shareholder proposals. However, shareholders statistically are more likely to support executive compensation proposals that attempt to restrict executive compensation than they are proposals that simply ask for more disclosure about executive compensation. Similarly, shareholders are statistically more likely to support executive compensation proposals that raise corporate governance issues rather than those that raise social responsibility issues.

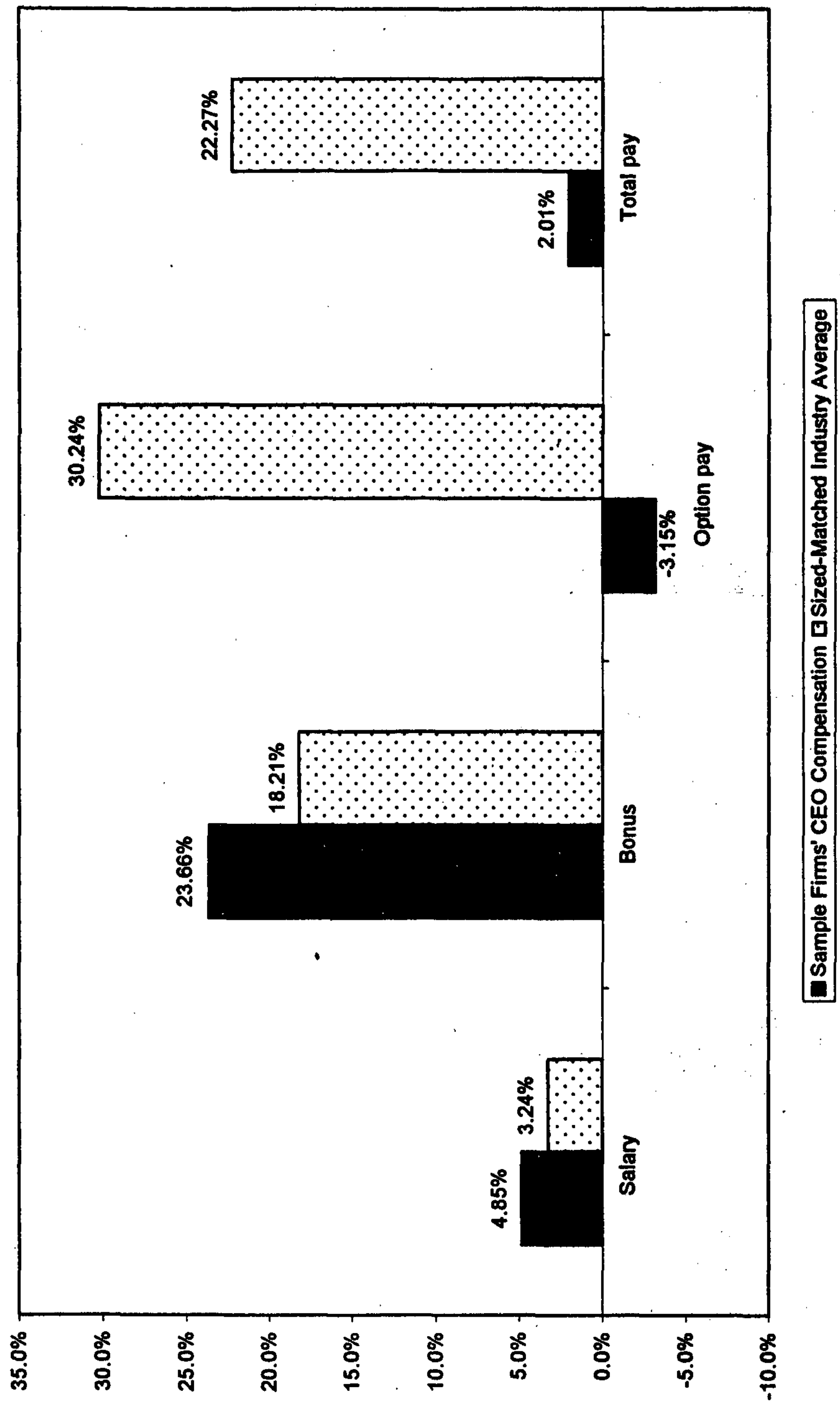
Shareholder proposals concerning executive compensation may affect the level and composition of CEO compensation. When we compare CEO compensation levels at firms receiving shareholder proposals with pay levels at similarly-sized firms in the same industry that did not receive shareholder proposals, we find that target companies do not increase average total CEO compensation levels as rapidly in the year after receiving a shareholder proposal (on average two percent increases) as firms not receiving such proposals (on average 22.3% increases). Figure 1 shows this comparison for each of the most important pay components and for total compensation.[1]

This change reduces the gap between the CEO pay levels at target companies and CEO pay levels at similarly-sized firms in their industry in the year after receipt of a shareholder proposal. However, although the dollar amount of these decreases is very substantial—over $800,000 when the total compensation packages are compared—these changes are not statistically significant. Furthermore, we find that the composition of CEO compensation at target companies shifts toward more cash, and less long term incentive compensation, in the year after the receipt of the proposal, although this change is not statistically significant.

Finally, we employ regression analysis to determine whether executive compensation levels at companies receiving shareholder proposals are affected by a variety of factors related to the proposal. The factors we examine include the level of voting support for the initiative, the type of sponsor of the proposal, and the nature of the proposal. We find some support for the hypothesis that higher levels of voting support for proposals are associated with smaller increases in CEO compensation at companies receiving proposals when compared to CEO pay levels at similarly-sized companies in the same industry. We further find that proposals to restrict executive pay have a similar effect. These results

1. Figure 1 shows the percentage changes in the various compensation components and total compensation from the year in which the shareholder proposal on executive compensation was made to the year after the proposal was made. It reports these figures for both the sample firms and a matched industry comparison group.

Figure 1
Percentage Changes in Compensation from Year of Executive Compensation Proposals to Year After



are consistent with the hypothesis that boards of directors are responsive to shareholders' expressions of dissatisfaction with their firms' executive compensation pay packages, especially when they are raised as corporate governance issues.[2]

This paper begins with a brief discussion of the current trends in executive compensation. Part II outlines the rapid rise in managerial compensation in recent years. It breaks out the different components of executive pay and examines each one separately. In Part III, we ask whether shareholders should attempt to monitor executive compensation. Initially, we focus on shareholder monitoring's role in the principal-agent model of the firm. We then we look at the limitations on shareholders' capacity to monitor executive compensation and the possibility that labor shareholders could be effective monitors of managerial pay.

Part IV examines the constraints on shareholders' ability to influence executive compensation. After a brief discussion of the collective action problems shareholders face when initiating voting campaigns, we concisely outline two recent changes in the federal securities laws, the 1992 proxy rule amendments and the 1992 executive compensation disclosure requirements, that have facilitated shareholder action on these issues. In Part V, we detail the different ways in which shareholders convey their views about executive compensation to their companies' boards of directors. The five different approaches we look at are: informal pressure; precatory shareholder proposals under Rule 14a-8; binding bylaw amendments; voting on company proposals to create stock option plans; and "Just Vote No" campaigns. We follow this discussion with a brief survey of the empirical literature related to shareholder proposals in Part VI.

In the last section of the paper, we present our empirical analysis and results. We begin with a description of our data, including a discussion of the different types of proposals submitted by shareholder groups. We then analyze the CEO compensation structures of the firms receiving shareholder proposals and contrast them to a comparably-sized group of companies within their industry. In subsection C, we then turn to the differences in corporate performance between firms receiving proposals and similarly-sized firms in their industry. Finally, we present our regression results concerning the effect of shareholder proposals on CEO compensation levels.

2. The type of sponsor is also generally significant with proposals submitted by organizations leading to lower relative pay levels. The other variable included in the regression is insignificant.

II. THE MECHANICS OF EXECUTIVE COMPENSATION

CEO pay has increased dramatically over the past ten years to reach levels unprecedented in the post-World War II era. In 1997, for example, median total compensation for CEO's was valued by a Wall Street Journal survey at $3,093,018.[3] This represented a 29.2% increase over 1996 compensation levels. Nor is this a one year blip. Using 1993-1997 data to look at the longer term trend, the same basic pattern emerges: CEO pay is up 264% over that four year period.[4]

Until recently, most institutional (and other) shareholders were relatively sanguine about this trend, deferring to boards' arguments that companies needed to be competitive in an increasingly tough managerial labor market and that incentive-based pay would produce improved corporate performance.[5] As compensation committees continued to award CEOs mega-grants of stock options, the incentive compensation component of executive pay plans soared.[6]

This explosion in incentive pay led some shareholders to question the wisdom of pay-for-performance compensation plans and to ask corporate boards to justify their decisions to award top executives so much money, particularly when some of these CEOs have not produced increases in the company's stock prices. These investors generally cannot, however, bring about changes directly. Rather, as we discuss more fully below, they must persuade their companies' boards of directors to take action.

A. *The Process of Determining Executive Compensation*[7]

The board of directors of the corporation is charged with the responsibility of determining the level and composition of executive

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3. *See The Boss's Pay*, WALL ST. J., Apr. 9, 1998, at R13.

4. *See* Adam Bryant, *Executive Cash Machine: How A Pliable System Inflates Pay Levels*, N.Y. TIMES, Nov. 8, 1998, § 3, at 1.

5. *See* James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 749 (1995).

6. Economists claim that strong managerial pay-for-performance incentives lead to significant improvements in firm performance. *See* Kevin Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS (Orley Ashenfleter & David Card eds., 1999) (surveying the empirical literature); PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT ch. 13 (1992) (surveying empirical literature). Existing empirical evidence shows that executive pay is responsive to firm performance and that increasing managerial incentives leads to improved firm performance. It is less clear that current Chief Executive Officer (CEO) pay levels provide the appropriate performance incentives and more importantly, if any performance improvements that may result are cost-justified from the firm's shareholders' perspective.

7. For a more detailed summary of the process used by compensation committees in determining executive compensation, see GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991).

compensation within the firm. At most corporations, the board of directors delegates the job of investigating and determining the appropriate levels of executive pay to the compensation committee.[8] This committee frequently would be comprised exclusively of non-employee directors,[9] many of whom would be current or retired executives from other public companies, and none of whom would spend much time on the committee's work.[10]

The company's human resources department normally will start the process by submitting a proposed executive pay package to the compensation committee. The compensation committee will consider this proposal and determine if it is appropriate or needs modification. These directors will usually rely on the information provided by the company and operate in a reactive mode, responding to the human resources department's proposals.[11]

To assist the compensation committee in performing its task, it generally retains a compensation consultant.[12] Most of these experts

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8. *See* Randall S. Thomas, *Putting a Lid on Executive Compensation: Economics' Theories, Lawyers' Critiques and the Problem of Internal Pay Differentials* (Mar. 9, 1999) (unpublished manuscript, on file with authors); Murphy, Executive Compensation, *supra* note 6, at 24; Crystal, *supra* note 7, at 214.

9. *See* JAMES D. COX ET AL., CORPORATIONS § 11.6, at 234 (1997) ("[I]ncreasingly compensation committees are composed exclusively of outside directors and are given the authority to establish compensation policies and particular packages for senior executives.").

10. *See* CRYSTAL, *supra* note 7, at 214. "A board compensation committee typically consists of about five outside directors—directors who are not employees of the company and who, at least theoretically, have no economic ties with the company. The committee meets several times a year, sometimes every time there is a board meeting." Id.

11. *See* James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1237 (1993) ("Outside directors spend most of their time reacting to management's strategic planning and reviewing other corporate policies and practices, to an extent that allows only infrequent explicit and formal review of management's performance."); Murphy, *supra* note 6, at 24 ("Compensation committees, which typically meet only six to eight times a year, lack both the time and expertise to be involved in the minutia of pay design.").

12. Crystal states that companies routinely hire compensation consultants to advise the company about top executives' pay. CRYSTAL, *supra* note 7, at 42-50. Murphy claims that compensation committees "rarely" retain their own compensation consultant, but rather rely on the company's human resource department for initial recommendations for pay levels and new incentive plans. *See* Murphy, *supra* note 6, at 24.

Crystal criticizes most compensation consultants for their lack of independence from the company's CEO. He argues that these consultants are retained by the company to perform a wide variety of other services and are therefore unlikely to risk jeopardizing their entire business relationship with an adverse recommendation concerning the CEO's pay. *See* CRYSTAL, *supra* note 7, at 219-20.

Prudent directors would be well-advised to take Crystal's suggestion to heart. The Delaware courts have stressed the importance of professional advisors' independence and competence. *See* Kahn v. Tremont Corp., 694 A.2d 422, 426-30 (Del. 1997). Although it is difficult for shareholders to succeed in a derivative action challenging a board's decisions about executive compensation, good corporate practice would dictate attempting to follow the courts' guidelines. Furthermore, this is an area in which the Securities and Exchange Commission (SEC) has indicated significant interest and may mandate additional disclosures. The SEC could well decide that shareholders should be informed about all financial relationships between the compensation consultant and the corporation.

come from a handful of well-known consulting firms specializing in executive compensation matters, many of which provide a wide variety of other consulting services to the company.[13] The compensation consultant will perform a variety of tasks for the committee.

The committee usually asks the compensation expert to compile information about the pay scales of executives at other comparable companies.[14] Much of this information is publicly available through proxy statements compiled on electronic medium.[15] Based upon this data, the consultant will prepare a report to the committee comparing the compensation of executives at comparable companies with this company's executives' pay.[16] The report will detail where within the industry-wide remuneration spectrum the company's executives' pay falls.

The compensation committee will determine what executive pay package to endorse after considering this information, and whatever other information it decides is relevant. After completing its work, the compensation committee will prepare a report and recommendation to the entire board.[17] The board normally approves such recommendations as a routine matter without much inquiry.

Shareholders have no direct input in this process. They can voice their opinions to the board of directors in a variety of ways before and after the package is approved, but this only indirectly affects the outcome of the process. Investors may also indirectly influence the shaping of executive compensation programs because boards know that shareholders must normally approve the stock option plans that are

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13. *See* CRYSTAL, *supra* note 7, at 218-20.

> Most executive compensation consultants are employed by firms that do more than executive compensation consulting.... Indeed, in many cases, the revenues derived from a given client for such work as actuarial consulting dwarf by several orders of magnitude the revenues for executive compensation consulting. So, bucking a CEO and telling him that he ought to cut his bloated pay package can potentially cost a consulting firm not only the loss of executive compensation revenues but the loss of much larger revenues being generated from other services.

Id. at 219.

14. *See id.* at 220 ("Companies are solicited to complete often voluminous questionnaires on the types of compensation plans they use, how the plans work, and how much executives earn from them. These data are then analyzed statistically, and reports are sent back to participating companies."); Murphy, *supra* note 6, at 9 (pay surveys are universally used in setting executive compensation).

15. One example is a service called Executive Compensation Plan Documents CD-ROM sold by Bowne Publishing. In 1998, this service included over 4,000 executive compensation plans from SEC filings, over 2,000 proxy statements for virtually all of the Fortune 1000 over the previous two years, and the ability to search these files by industry name, Standard Industrial Category, geographic location, and keywords relating to type of compensation.

16. *See* CRYSTAL, *supra* note 7, at 45.

17. *See* Murphy, *supra* note 6, at 24. The compensation committee must disclose its report to the company's shareholders under SEC regulations. See Part III.B *infra* for further discussion of the executive compensation disclosure requirements.

often part of executive pay packages. Boards may thus feel compelled to take shareholders' views into consideration to insure passage of any proposed stock option plan. However, shareholders do not otherwise usually vote on executive compensation packages.

B. The Components of Executive Compensation

To understand total CEO compensation, we must first examine each of its components. Executive compensation can be usefully divided into several different categories:[18] salary[19] and bonuses,[20] which are relatively fixed; and stock option grants,[21] and all other long term remuneration

18. *See* Murphy, *supra* note 6, at 5. In addition to receiving salaries, bonuses and long-term forms of compensation, executives have access to a wide range of perquisites, such as company airplanes and apartments, special dining rooms and washrooms, and country club memberships. Companies also provide executives with a variety of fringe benefits, including health, dental and medical insurance, life and disability insurance, and company cars. In some cases, the value of these benefits can reach millions of dollars. *See In re* W.R. Grace & Co., Exchange Act Release No. 39,157, 1997 SEC LEXIS 2038 (Sept. 30, 1997) (SEC criticizing independent directors and company for failing to disclose perquisites awarded to a retiring CEO valued at $3.6 million).

Executives also generally will participate in company-wide and supplemental executive retirement plans (SERPs). SERPs may be a very significant source of income for managers, but they are not included in the pay figures discussed in the text. The value of SERPs is not publicly disclosed, and they have been characterized as "stealth compensation" with potentially enormous value. *See* Murphy, *supra* note 6, at 23-24.

19. Although salary has been a declining percentage of executive compensation, top managers feel it is very important because it is a key guaranteed component of their employment contract and many of the other components of executive pay are tied to the level of the executive's salary. *See* Murphy, *supra* note 6, at 9-10. For example, target bonuses are usually expressed as a percentage of base salary. *See id.*

20. Murphy describes the typical bonus plan as follows:

> Under the typical plan, no bonus is paid until a threshold performance (usually expressed as a percentage of the performance standard) is achieved, and a "minimum bonus" (usually expressed as a percentage of the target bonus) is paid at the threshold performance. Target bonuses are paid for achieving the performance standard, and there is typically a "cap" on bonuses paid (again expressed as a percentage or multiple of the target bonus).

Id. at 10-11.

21.

> A stock option gives an executive the right, but not the obligation, to purchase a fixed number of shares of company common stock at a fixed price over a fixed term of years. In almost all cases, the purchase price, generally called the strike price, is the market price per share of the stock on the date of the grant. . . . The period of time during which the option may be exercised is virtually always ten years in duration. Generally, the option may not be fully exercised during the early years of its ten-year term (typically a period of around four years from the grant date); but thereafter, the executive is free to choose the date of exercise.

CRYSTAL, *supra* note 7, at 63. *See also* Murphy, *supra* note 6, at 16 ("[M]ost options expire in ten years and are granted with exercise prices equal to the 'fair market value' on date of the grant.").

About two-thirds of the companies in major market indices offer their executives interest-free loans to finance their purchase of the company's stock. *See* Danielle Sessa & Laura Saunders Egodigwe, *Incentive Plans Can Fuel Insider Buying*, WALL ST. J., Jan. 13, 1999, at C1.

plans, whose value varies more widely from year to year.[22] Today, salaries and bonuses are the smaller component of executive pay. Median salaries and bonuses for top executives at 350 of America's largest companies were $1,596,667 in 1997, an increase of 11.7% from the previous year.[23]

Salaries and bonuses have risen sharply over the last two decades. In a recent study of executive compensation[24] using data from 1980 to 1994, average executive salary and bonuses were found to have increased by ninety-seven percent over that fifteen year period in real inflation-adjusted terms. Average executive salary and bonuses rose from $655,000 in 1980 to $1,300,000 in 1994 in real 1994 dollars.[25]

The value of stock option grants over the same time period increased much more dramatically.[26] In 1997, a Wall Street Journal survey found that the median gain for corporate leaders exercising stock options was $1,868,268.[27] Looking at historical data, the average value of stock option grants went from $155,000 in 1980 to $1,200,000 in 1994, for an increase of 683% in real inflation adjusted terms.[28] The percentage of CEO's holding stock options increased from thirty percent to almost seventy percent over the same time period.

In addition to stock options, there are a panoply of other forms of long-term compensation plans. Restricted stock is a very popular form of long-term incentive compensation.[29] Restricted stock is company stock that is given to, or sold at a deep discount to, a corporate executive subject to the limitation that it cannot be sold during a fixed period of time.[30] Usually the restriction lasts for five years, although there are instances in which the restriction will continue until the executive's

22. There are other forms of executive compensation that can be important in certain circumstances. These include signing bonuses for executives that are being recruited to the firm from outside (and rarely to employees already with the firm), and golden parachutes, which are large severance packages paid out to top executives in change of control transactions.

23. *See The Boss's Pay*, *supra* note 3, at R1.

24. *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, at 12-13 (National Bureau of Economic Research Working Paper No. 6213, 1997).

25. *See id.* at 12-13. These averages conceal large variations within industries. *See* Murphy, *supra* note 6, at 5. For example, executives in the electric utilities earn substantially less than those in financial services companies.

26. Reported values for stock options and other long term compensation are highly variable because, even though their value may result from several years' performance, the reported gain is realized all in one year. *See* MILGROM & ROBERTS, *supra* note 6, at 424-25.

27. *See The Boss's Pay*, *supra* note 3, at R12.

28. *See* Hall & Liebman, *supra* note 24, at 13.

29. *See* CRYSTAL, *supra* note 7, at 71. In 1996, roughly 28% of companies in the S&P 500 granted restricted stock to their executives. *See* Murphy, *supra* note 6, at 23. These grants accounted for 22% of the compensation of the executives that received grants. *See id.*

30. Other restrictions can also be imposed on the resale of the stock. For example, the executive may not be able to sell the shares until certain profit goals are realized, or until her retirement.

retirement.[31] Typically the executive pays nothing for these shares. Some of the other types of long-term executive compensation systems include: bonus units;[32] equity units;[33] long term management incentive plans;[34] tax protected restricted stock;[35] phantom stock;[36] and stock appreciation rights.[37] These long-term incentive pay plans have become much more popular in recent years with many companies using three or four different schemes to compensate their top executives.

III. SHOULD SHAREHOLDERS MONITOR EXECUTIVE COMPENSATION?

The principal-agent model of the corporation recognizes that in the modern public corporation, the shareholders who hold ownership rights (the principals) are separate from the managers that run the business (the agents). This separation of ownership and control creates the potential from divergences between the interests of managers and shareholders. On the one hand, shareholders want firms to maximize profits and delegate broad discretion to managers to act in their best interests to do so. Managers, on the other hand, will run the company in a self-interested manner to maximize their own utility.[38] This may lead managers to diverge from the shareholders' preferred goal of maximiz-

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31. *See* CRYSTAL, *supra* note 7, at 71. However, if the executive quits before the limitation period is up, or is fired for just cause, then she forfeits the stock. *See id.* at 72.

32. Bonus units give the recipient the right to receive a cash payment equal to the difference between the strike price of the unit (sometimes less than the market price of the company's stock at the time of issue) and the actual market price of the stock at the time of the exercise of the bonus unit. The holder is also entitled to receive dividends up until the time of exercise as if she held the actual shares. *See id.* at 67.

33. Equity units entitle the holder to purchase company stock at its book value in a particular year, then to resell the stock to the company at their future book value in a later year. *See id.* at 73. The holder also gets the dividend payments made on the stock while she holds it.

34. In these plans, the payout to the executive is based on the company's performance exceeding a specified level. For instance, a measure of performance such as a 15% rate of growth of earnings per share over a three year time period was used in one well-known executive's pay package. *See id.* at 74-75. About 27% of the CEOs at S&P 500 companies received these payouts in 1996. *See* Murphy, *supra* note 6, at 23. These amounts constituted 20% of these executives' pay. *See id.*

35. These grants of restricted stock come with the additional feature that the company agrees to pay any additional taxes that the executive would have to pay when she sells the stock. *See* CRYSTAL, *supra* note 7, at 152.

36. These are units that act like common stock but which do not constitute claims for ownership of the company. Phantom stock entitles the executive to receive the increase associated with common stock prices and any dividend payments that are declared payable to the common stock.

37. Stock appreciation rights (SARs) are the right to receive the increase in the value of a specified number of shares of common stock over a defined period of time. This enables the executive to realize the benefits of a stock option plan without having to purchase the stock.

38. Manager's utility will be increased by higher consumption of things that they individually value, such as power, happiness, and monetary rewards.

ing profits. For instance, managers may "shirk" from working as hard as they could in order to enjoy more leisure, or they may "shark" by diverting valuable resources to themselves.[39]

The principal tries to limit the extent of these divergences by giving the agent appropriate incentives[40] and by expending resources to monitor the agent's conduct to curtail deviations.[41] The agent may also expend bonding costs to guarantee that she will not undertake certain actions to harm the principal's interests or agree to compensate the principal if she does.[42] Any remaining divergences between the agent's actual performance, and the actions that the agent should have taken to maximize the principal's interests, are designated as residual losses.[43] The sum of the monitoring costs, the bonding expenditures, and any residual losses, are defined as agency costs.[44]

Several different markets constrain agency costs, including labor markets, the market for corporate control, capital markets, and product markets. These markets interact with one another. For example, if a firm's labor costs rise too high, then it becomes uncompetitive in the product market, raising its cost of capital and making it a potential target in the market for corporate control. However, these market

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39. Agents are assumed to be acting in their own self-interest in this model. Although there undoubtedly is some truth in this observation, this assumption has been criticized on a number of grounds, including that agents may like to work, and that it is an unduly pessimistic view of people's nature. *See* Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 277 (1998) (summarizing these critiques).

40. For example, the conflict between managers and shareholders interests can be mitigated through the use of incentive compensation packages which align the incentives of managers with those of shareholders. Stock options can be used to provide managers with an equity interest in the corporation. As executives' level of stock ownership increases, they will bear a greater percentage of the costs of any deviations from the standard of profit maximization. In this situation, self-interest will lead managers to act in shareholders' best interests.

However, as noted below, managers should not be given too high a level of stock ownership or they may become permanently entrenched in office, thereby interfering with the market for corporate control and shareholder voting rights.

41. "The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). Some examples of these monitoring expenditures include outside directors, "auditing, formal control systems, budget restrictions and the establishment of incentive compensation systems . . ." *Id.*

42. *See id.* at 308. Thus, the principal and agent may agree to share the risks and rewards of the business to encourage the agent to act in the principal's best interest. *See* Orts, *supra* note 39, at 276. For example, an officer may agree to base his or her salary on the firm's performance.

43. *See* Jensen & Meckling, *supra* note 41, at 308. In other words, a certain level of misconduct is inevitable and is too costly to prevent.

44. *See id.* at 308. Principal-agent relationships are valuable when the agency costs associated with them are less than the economic gains that they make possible plus any net gains achieved from monitoring and bonding. *See* Orts, *supra* note 39, at 276.

constraints are often loose ones, leaving significant scope for divergences between manager and shareholder interests.[45]

Corporate governance institutions may also act to minimize agency costs. For example, the board of directors can be thought of as a device for mitigating the agency cost problem. The board acts to monitor managers to insure that they maximize shareholder value.[46] Outside directors can be effective in controlling managerial self-dealing and overreaching.[47] Empirical studies have also shown that the likelihood that a board will terminate a poorly performing top executive increases as the proportion of outside directors on the board increases.[48]

Economists have argued that the board may better attack agency costs through the appropriate design of incentive compensation packages to motivate management to act in shareholders' best interests.[49] Incentive plans tie managerial pay to a measure of firm performance. An optimally designed compensation package would perfectly align the interests of shareholders and managers so that managers would make business decisions designed to maximize shareholder value.[50]

Shareholders can also act as monitors of executive compensation. Although they delegate substantial authority to the board of directors, they exercise ultimate control over the board and its agents through annual elections. They also have the right to vote on most stock option plans that are proposed by the board of directors. However, shareholders should not attempt to dictate how the corporation conducts its day-to-day business, or otherwise engage in micromanaging the corporate enterprise.

There are significant obstacles in shareholders' path to becoming effective monitors. We focus on two particular problems in the remainder of this section and the next: first, shareholders' capability to

45. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1083-84 (1998).

46. Proponents of the agency cost model view the board as serving its monitoring function best when it focuses solely on shareholder interests and not the broader set of interests of all participants of the firm. *See id.* at 1088.

47. *See* Cox, *supra* note 11, at 1242. By contrast, boards are less effective in improving corporate performance and controlling illegal conduct by corporate managers. *See id.* at 1239-42 (summarizing studies).

48. *See id.* at 1241.

49. *See* Hall & Liebman, *supra* note 24, at 3. Agency costs also could be reduced through board or shareholder monitoring of the CEO, but this may be difficult and costly. *See id.* at 3-4.

50. *See id.* at 4. Performance-based compensation, such as the use of stock options, or securities whose value tracks corporate performance, is designed to give managers incentives to maximize share price and may reduce managers' aversion to undertaking risky projects with high returns that shareholders might want the firm to engage in. For further discussion of the theoretical justifications for incentive pay, see generally Thomas, *supra* note 8.

act as monitors of executive compensation; and second, shareholders' ability to influence executive compensation.

A. *Shareholders Have Limited Capacity to Monitor*

Shareholders are not by and large well-equipped to act as monitors of executive compensation. Compensation plans are complex, technical documents that cannot be readily understood without a substantial amount of knowledge about the intricacies of different types of pay programs. Even directors on the compensation committee, with access to expert consultants and all of the facts surrounding these plans, may have difficulty understanding them. Shareholders cannot expect to have the same level of access to information and often will have to work without the benefit of expert help.

If shareholders have a sufficient level of expertise (or expert assistance) to understand how current compensation plans work, they will also need to be able to determine whether the current plan is the right plan for their company and its executives. To make this determination, shareholders would need to know what other alternative compensation packages could be put in place. Again this would require monitoring shareholders to have some level of expertise, or to retain a compensation expert.

Diversified shareholders that seek to monitor the wide variety of companies in their portfolio face more difficult problems. Each industrial sector has its own unique competitive challenges. As a result, different industries use executive compensation packages exhibiting a wide variety of components. Even within an industry, the individual companies will have executive compensation plans tailored to their particular situation. This makes it more difficult and expensive for investors to monitor executive compensation, as they will need to evaluate these plans on a case-by-case basis.[51] For all of these reasons, shareholders should not attempt to engage in micromanaging corporate executive compensation decisions, but rather only seek to detect particular abuses of the pay process.

When shareholder voting is required, such as with stock option plans, shareholders will need to look at each plan in order to determine how to vote on it. Each plan's complexities and differences will make it difficult for shareholders with large portfolios, such as pension funds, and other institutional investors, to adopt simple voting guidelines for

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51. *See* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1892 (1992).

their portfolio managers.[52] Instead, in order to engage in effective monitoring, their portfolio managers would need to undertake time consuming research about individual plans before deciding how to vote.[53]

Shareholders may not be good monitors of executive pay for other reasons, too. The benefits from monitoring executive compensation decisions at any particular company will be relatively small for most large investors. Even if they are successful in shaving a few million dollars from one executive's pay package, this will have only a minuscule impact on the company's bottom line and the value of their investment. The indirect benefits may be greater: other employees may feel less resentful of "unfair" executive compensation or the CEO may be motivated to work harder in the future.[54] The costs to the shareholder may be significant, though, as the CEO is likely to harbor some ill will toward them for a long time.[55]

For this cost-benefit analysis to weigh in favor of taking action, either the shareholder must be able to benefit from changes at a wide variety of companies, perhaps by reducing pay across the industry or industries, or the initiatives must have low costs, such as when the bad feelings generated toward the shareholder make little difference to her. This latter point may explain why many institutional shareholders prefer to work informally and privately to influence executive compensation,[56]

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52. CalPERS has stated that "[s]hareholder proposals on executive compensation need to be evaluated on a case-by-case basis upon due consideration of the economic and financial circumstances of the targeted company and the language of the proposal." *CalPERS Domestic Proxy Voting Guidelines* (visited Apr. 11, 1999) <http://www.calpers-governance.org/principles/domestic/voting/page11.asp> [hereinafter *CalPERS*].

By contrast, institutional investors have been able to adopt easily-applied voting guidelines about many other corporate governance issues, such as anti-takeover defenses. In part because of this difference, shareholder support for these types of corporate governance proposals has been substantially higher than it has been for executive compensation proposals. *See* Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals*, 73 WASH. L. REV. 41, 76 tbl.3 (1998).

The absence of easily applicable voting policies will also make it more difficult for any shareholder to obtain strong voting support for proposals concerning executive compensation levels or composition.

53. Alternatively, shareholders could delegate these decisions to third parties or seek expert advice on how to vote their proxies. *See* RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW AND EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL §§ 8.01-.04 (3d ed. 1998) (discussing how these services work).

54. *See* Thomas, *supra* note 8; Yablon, *supra* note 51, at 1893.

55. *See* Thomas, *supra* note 8.

56. Professor Yablon notes that institutional investors also may suffer from agency problems because their executives may be unwilling to attack high compensation levels at other companies for fear that their own compensation will come under attack. *See* Yablon, *supra* note 51, at 1893.

whereas individual shareholders are more willing to use the shareholder proposal mechanism to try to influence boards.[57]

Monitoring may be unattractive for some shareholders for other reasons. Many shareholders, such as mutual funds, care about the liquidity of their investments and their short term performance. They are unwilling to invest substantial resources in bringing about corporate governance changes that have uncertain immediate returns and may create substantial ill will from management.[58] Even public pension funds, frequently, the most active and informed of the institutional investors, may be too busy satisfying their primary responsibilities to their beneficiaries to be active monitors of executive compensation reform.[59]

Despite all of these problems, investor monitoring of executive pay practices is occurring. At one end of the spectrum, some shareholder voting advisory services, such as Institutional Shareholder Services (ISS), use extremely sophisticated techniques.[60] ISS has advanced computer models that it uses to evaluate corporate executive pay packages as part of determining how to advise its institutional investor clients about how to cast their votes on stock option plans. ISS makes these models available to companies (for a fee) so that the companies can evaluate their pay plans before submitting them for shareholder approval.[61]

Individual investors appear to use much simpler techniques in their monitoring efforts. These investors seem to focus on cruder measures of executive pay and its relation to corporate performance in detecting abnormalities in individual companies' pay practices.[62] They may also rely on the popular presses' coverage of particular pay practices as a

57. *See also id.* at 1895 (shareholder "gadfly" groups may be important force in challenging executive compensation because they do not need to maintain cordial relationships with management and have little financial stake in any one company).

58. *See id.* at 1893.

59. Joshua A. Kreinberg, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 168 (1995); Yablon, *supra* note 51, at 1890-92 (discussing the ineffectiveness of shareholder solutions and the reasons for reluctance on the part of investors to challenge compensation decisions).

60. Graef Crystal also prepares analyses of different companies executive pay packages for various organizations and the general public. *See, e.g.*, Graef Crystal, Council of Institutional Investors, *1997 Executive Pay Anti-Heroes* (Oct. 5, 1998); Graef Crystal, *The Crystal Report Online* (visited Apr. 18, 1999), <http://www.crystalreport.com>.

61. We applaud this innovative program and believe that it could develop into a new form of shareholder monitoring that could be more effective than any existing approaches. In essence, ISS is getting companies to change their stock option plan proposals in a manner that addresses shareholder concerns as a way of getting a favorable vote recommendation. If ISS's model accurately reflects shareholders' concerns about what are appropriate executive pay practices, this process has the potential to improve compensation programs and shareholder-management relationships.

62. *See infra* Part VII.C-D (discussing our data concerning which companies individual shareholders target using Rule 14a-8).

method for determining which companies to target.[63] Although these are clearly inexact measures of whether a corporation's executive compensation practices are out of whack, they do have a strong intuitive appeal and may correlate well with the more sophisticated measures.[64] However, shareholders need to develop better and more widely accepted techniques of determining what are appropriate pay levels and compensation systems if they wish to improve as corporate monitors.

B. *Labor Shareholders As Monitors*

Labor shareholders may be exceptionally good monitors of executive pay.[65] Many labor groups hold large amounts of corporate equities and have similar interests to other shareholders in monitoring executive compensation.[66] Labor shareholders, and in particular labor unions, may have a comparative advantage over other shareholders in acting as a monitor of corporate executive compensation plans.[67] At first blush, this seems implausible. Unions will only have access to the same public information regarding executive compensation that is available to shareholders. However, unions are relatively more experienced in compensation issues, are more involved in the company on a day-to-day basis, and have significant obligations at the bargaining table. All of these factors should give labor groups a greater understanding than most shareholders about the processes used to determine executive pay levels and the implications of different pay packages for corporate performance.

Unions understand the workings of compensation incentives, or disincentives, incorporated in most executive compensation packages.[68] This knowledge of compensation mechanisms makes unions better equipped to unravel the intricacies of public information about executive compensation packages and reach conclusions about its meaning. Their expertise also makes them aware that several important

63. *See* Marilyn F. Johnson & Margaret B. Shackell, *Investor Use of Expanded Proxy Statement Disclosures on Executive Compensation* (1998) (unpublished manuscript, on file with authors) (finding that individual shareholders use negative press coverage as a means of determining which companies to target with shareholder proposals).

64. However, unless other shareholders believe that such measures are the correct ones to apply, they may be uncertain about how to vote on such proposals. This may partially explain the low favorable voting percentages for such initiatives that are discussed *infra* Part VII.B.

65. By labor shareholders, we are referring to labor unions, union pension funds, individual union members, and union-oriented pension funds. *See* Thomas & Martin, *supra* note 52, at 41 n.1.

66. For a general discussion of labor's shareholder activism, see Schwab & Thomas, *supra* note 45.

67. *See id.* at 1086.

68. *See id.*

compensation systems are not disclosed in the materials that companies provide to their shareholders.[69]

Labor has used a variety of different approaches to generate public support for reforming current executive pay practices. Unions have publicized egregious examples of high executive pay to the public through the use of an Internet web site called Executive PayWatch.[70] This web site allows anyone to examine the compensation packages of corporate executives of 417 firms, and to compare them to their own salaries. Executive PayWatch provides further information to shareholders and other members of the public on how to decipher executive pay disclosures on proxy statements, and how to vote their proxies and use the shareholder-proposal mechanism to push companies to change their practices.[71]

Although labor has some advantages in monitoring executive pay, it will need to focus on evaluating different types of pay-for-performance systems, rather than worrying about how pay is determined at any particular company. By taking this approach, labor groups can best use their limited resources to have an impact on a wider range of companies.[72] Furthermore, if labor wants to obtain other shareholders' support for reducing executive compensation levels across the board, it will need to dispel the notion that it is seeking to attack management for its own selfish reasons.[73] In particular, labor will need to demonstrate to other shareholders that the executive compensation plans it challenges have, or will, negatively affect shareholder value.[74] If labor can succeed in demonstrating this to the satisfaction of other shareholders, then it can be optimistic about their willingness to support its initiatives.[75]

69. *See, e.g., supra* note 18 (discussing SERPs, the details of which are not publicly disclosed under current SEC rules and regulations).

70. *See Executive PayWatch* (visited Feb. 17, 1999) <http://www.aflcio.org/paywatch>.

71. *See id.*

72. *See* Ronald J. Gilson, Executive Compensation and Corporate Governance; An Academic Perspective, 792 PLI/CORP. 647, 677-78 (1992).

73. *See* Schwab & Thomas, *supra* note 45, at 1082-83.

74. Labor needs to avoid presenting executive compensation solely as an issue of fairness to workers, thereby reflecting the adversarial side of labor-management relations. However, labor groups could make relative pay an effective shareholder issue by tying it to firm value. Empirical research in the business and psychology fields has found that high pay differentials between corporate CEO's and lower level managers and employees negatively affects the value of the firm. *See* Thomas, *supra* note 8, for a summary of these studies. Thus, boards should consider that overpaying corporate executives in comparison to their coworkers will reduce shareholder value. For a further discussion of this point, see *id.*

75. Thomas and Martin found that other shareholders generally vote for labor shareholder proposals at roughly the same rate as they do for public institutional shareholders' proposals, and at a greater rate than for other sponsor types. *See* Thomas & Martin, *supra* note 52, at 44.

IV. SHAREHOLDERS' ABILITY TO INFLUENCE EXECUTIVE COMPENSATION

To the extent that shareholders are willing and capable of engaging in useful monitoring of executive compensation practices, they must do so through indirect methods. Shareholders do not have the right, and are not generally offered the opportunity, to approve or disapprove of compensation practices, with the exception of stock option and employee stock purchase plans.[76]

Coordinated shareholder action on matters such as executive compensation is hard to achieve successfully.[77] Widely dispersed shareholders face significant collective action barriers, including the high costs and limited rewards of individual action. Although shareholders can "vote with their feet," and sell their stock when they disapprove of the company's compensation practices, this option is unavailable for indexed investors, and unattractive for other investors whose diversification strategies would be harmed by such a sales. Of course, large investors, such as some institutional holders, may be able to influence corporate executive compensation policies through the use of proxy fights, shareholder resolutions, and coordinated action.[78]

A. *The 1992 Proxy Rule Amendments*

The Security and Exchange Commission's (SEC's) 1992 proxy rule amendments have facilitated shareholder communications by reducing

76. *See* Yablon, *supra* note 51, at 1892 n.69. Even these exceptions can be circumvented in some cases though, by employing devices such as repurchased share plans and replenishment plans. *See* Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns For Corporate Directors*, 3 STAN. J.L. BUS. & FIN. 5, 16-18 (1997) (noting that these types of plans have no dilutive effect and therefore do not require shareholder approval). *See also infra* notes 158-68 (discussing recent changes that the stock exchanges have made to their rules requiring shareholder approval of stock option plans).

77. *See* Cox, *supra* note 11, at 1236.

> Even in an era of significant concentration of ownership in the hands of a few financial institutions, the shareholders' records on such matters as cancelling poison pills, initiating antigreenmail proposals, and reining in executive compensation are reason to question their ability regularly to discharge a monitoring task except in situations in which management's ineptitude brings the firm to the brink of disaster.

Id.

78. *See* Kreinberg, *supra* note 59, at 166-67; *see also* Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 96 (1992) ("Some institutional shareholders have found their power to influence corporate governance has reached a level where companies are willing to negotiate changes to avoid a messy proxy battle.").

the regulatory barriers to, and costs of, collective shareholder action.[79] These new rules make it easier for shareholders to communicate with each other informally without having to comply with the federal proxy rules filing requirements for most matters. These changes have been very helpful to institutional and other shareholders that seek to engage in active monitoring of corporate management.[80]

One of the most significant amendments to the proxy rules created a qualified exemption for communications relating to an incipient or ongoing solicitation with or among shareholders who are not seeking proxy authority, and who do not otherwise have a substantial interest in the outcome of the regulated solicitation that differs from that of the shareholder.[81] This change has greatly facilitated shareholder opposition to management proposals, such as stock option plans.

Another key amendment allows shareholders to publish their voting positions in print or broadcast media without governmental interference.[82] This change has enabled CalPERS to create a new website in order to, among other things, broadcast its votes and voting policies.[83] Some commentators are predicting that this website will greatly enhance CalPERS' ability to influence voting on shareholder compensation issues.[84]

The 1992 changes removed some obstacles to collective shareholder action, thereby facilitating shareholders' expression of opposition to management proposals, or support for other shareholders' corporate governance initiatives. These revisions also changed the proxy rules governing non-exempt solicitations to reduce the costs and delays associated with proxy filing and SEC staff review requirements.[85]

These rule changes have enabled shareholders to engage in proxy contests against management compensation policies at a significantly reduced cost.[86] One recent empirical study found that the passage of the

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79. For a complete discussion of the scope of the 1992 proxy rule amendments, see THOMAS & DIXON, *supra* note 53, at §§ 5.01-.03.

80. *See* Heard, *supra* note 5, at 754.

81. *See id.* at 754; 17 C.F.R. § 240.14a-2(b)(1) (1995). Shareholders are required to send copies of written communications to the SEC, although press releases, public speeches and public statements disseminated to the media are exempt from the filing requirement.

82. *See* THOMAS & DIXON, *supra* note 53, at §§ 5.01-.03; 17 C.F.R. § 240.14a-1(l)(2)(iv) (1995). These communications cannot, however, request proxy voting authority.

83. The address is <http://www.calpers-governance.org>. On the site, CalPERS discloses its domestic proxy voting guidelines, among other things. These guidelines include a section on executive compensation with subsections on stock option repricing, shareholder proposals, long term incentive plans, and a variety of other compensation related issues.

84. Patrick S. McGurn, *CalPERS Unveils New Governance Web Page*, ISSUE ALERT (Feb. 1999), at 5.

85. *See* THOMAS & DIXON, *supra* note 53, § 5.

86. *See* Heard, *supra* note 5, at 760.

1992 amendments also increased the percentage of favorable votes for shareholder proposals.[87] Several institutional shareholders have taken advantage of the new rules to organize protests against corporate executive pay practices.[88]

B. The SEC Executive Pay Disclosure Requirements

In conjunction with its revisions of the proxy rules, the SEC changed Regulations S-K and S-B to require extensive disclosures about corporate executive compensation.[89] The new disclosures make it much faster and easier for shareholders to determine how much a company's top executives are being paid and in what form. The SEC also decided that companies must disclose their philosophy about executive pay and provide a written justification of the amounts awarded to their CEO in the previous year.[90]

These revisions required clearer presentation of top executives' compensation, including imposing a duty on the Compensation Committee to discuss the bases for the disclosed compensation and its relationship to corporate performance.[91] Specifically, the new rules require the following disclosures. First, there must be a table disclosing the amounts of compensation awarded to the company's CEO and the four other most highly paid executives over the previous three years. Second, a disclosure detailing the specific types of compensation given to those executives in the past year is required. Third, the Compensation Committee must prepare and disclose a report which states the company's compensation policies and the criteria upon which the CEO's pay was based.[92] Finally, the company must present a "performance graph" that illustrates the return to the shareholders of the company compared to a broad market index and an industry index of a group of peer issuers for the previous five years. The SEC's revised rules further

87. *See* Stephen Choi, *Proxy Issue Contests: Impact of the 1992 Proxy Reforms* (Mar. 24, 1999) (unpublished manuscript, on file with authors).

88. *See* Heard, *supra* note 5, at 760 (citing several instances in which institutional investors used the revised proxy system to try to stop company pay policies).

89. For an extensive discussion of the executive pay disclosure requirements, see THOMAS & DIXON, *supra* note 53, §§ 8.01-.04; Halle Fine Terrion, Comment, *Regulation S-K, Item 402: The New Executive Compensation Disclosure Rules*, 43 CASE W. RES. L. REV. 1175 (1993); Heard, *supra* note 5, at 752-53.

90. *See id.* at 752.

91. *See* THOMAS & DIXON, *supra* note 53, § 7.01; Terrion, *supra* note 89, at 1177.

92. In 1993, the SEC evaluated companies' compliance with the new guidelines and found that although compliance was generally quite good, the Compensation Committee reports were too vague and general in many cases. *See* Heard, *supra* note 5, at 755. The SEC urged companies to be more specific in describing, among other things, the determination of compensation levels, the targets that needed to be met, and the calculation of specific compensation amounts. *See id.*

require disclosure of possible conflicts of interest which may exist for any member of the compensation committee.[93]

Since that time, the SEC has continued to tinker with the executive pay disclosure rules. For example, after Congress enacted section 162(m) of the Internal Revenue Code that limits companies' ability to deduct annual executive compensation greater than $1 million,[94] the SEC amended the rules to mandate disclosure of company policies concerning these deductions.[95] The SEC is currently debating requiring companies to make even greater executive pay disclosures.[96]

The revised executive pay disclosure rules have greatly increased the amount and quality of information that is cheaply available to shareholders about firms' executive compensation practices. This disclosure gives shareholders sufficiently similar information about companies' executive compensation practices to compare the different companies' practices. This facilitates shareholder monitoring of corporate boards and helps them determine the relationship between pay and performance.[97]

Public disclosure may have the perverse effect of increasing the level of executive compensation, too. This argument would run as follows. When there was no public disclosure of information about companies' executive pay practices, compensation committees used their consultants' private surveys of comparable companies' pay practices as a basis for setting executive pay. The advent of public disclosure did not change this system. However, it may have added pressure on CEOs to demand more money in these negotiations in order to maintain (and perhaps improve) their relative position in the pay hierarchy for top executives. In other words, if CEOs feel pressure to "keep up with the

93. *See* Tracey Scott Johnson, Note, *Pay For Performance: Corporate Executive Compensation in the 1990s*, 20 DEL. J. CORP. L. 183, 196-97 (1995). As discussed *infra* at Part V.B, in 1992 the SEC also changed its interpretation of the "ordinary business" exclusion of Rule 14a-7 to permit precatory shareholder proposals concerning company's executive compensation policies to be included in the company's proxy materials. *See* THOMAS & DIXON, *supra* note 53, § 7.01; Terrion, *supra* note 89, at 1193 (stating that the SEC was changing this interpretation to reflect the increase in shareholder and public concern over executive compensation).

94. For further discussion of section 162(m), see Thomas, *supra* note 8.

95. The $1 million ceiling does not apply if an independent compensation committee establishes a pay for performance program and the shareholders approve the plan. *See id.*; Heard, *supra* note 5, at 756.

96. Some shareholder advocates are calling for further disclosures about executive incentive plans that aid managers in purchasing their companies' stock. *See* Sessa & Egodigwe, *supra* note 21, at C1 (reporting that companies that offer interest-free loans to executives to purchase their stock, or that implement guidelines about executive stock ownership, are not required to disclose this information in many circumstances).

97. *See* Heard, *supra* note 5, at 755.

Joneses," then the public disclosure of any failure to do so could lead them to feel a loss of social standing and fuel their future pay demands.[98]

Increased mandatory disclosures are not costless for other reasons, too.[99] Each company incurs costs in complying with these requirements, such as retaining attorneys to prepare them in compliance with the SEC's regulations.[100] Furthermore, this information is not costlessly digested: shareholders must read it and determine whether they need to take action. Many academics have questioned the net benefits of mandated disclosures.[101] While the issue is ultimately an empirical one, and the existing research is limited,[102] the value of increasing disclosure levels will rest to a certain extent on whether shareholder monitoring of executive compensation efforts based on these disclosures is effective.

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98. The authors gratefully acknowledge Deborah DeMott's intuitive insight on this point. This intuition could be formalized by reference to social comparison theory. This theory rests on the observation that people compare themselves to other people in a variety of ways. These social comparisons have significant consequences on people's perceptions and actions.

The seminal article in this area was written by Leon Festinger entitled, *A Theory of Social Comparison Processes*, 7 HUM. REL. 117 (1954). Festinger claimed that people engage in self-evaluation of their abilities and opinions by comparing themselves to other people who are similar in certain ways. He believed that these comparisons can help people's self-esteem and egos about things they consider important. Subsequent research has found this to be true, and that these comparisons can also be used to further self-evaluations and improvements. *See* Charles A. O'Reilly, III et al., *Overpaid CEOs and Underpaid Managers: Equity and Executive Compensation*, at 9 (Stanford University Business School Working Paper 1996) (summarizing research on these questions)). O'Reilly concludes that "there is compelling evidence that individuals use social comparisons to evaluate their own performance and abilities as well as to increase self-esteem." *Id.* at 10.

If CEOs compare themselves to their fellow CEOs, as seems highly likely, they will make comparisons of their own compensation with that of other CEOs. These comparisons will lead to increased pay demands whenever the CEO believes that she is underpaid compared to her equals. For further discussion of how this theory relates to issues surrounding corporate executive compensation practices, see Thomas, *supra* note 8.

99. *See, e.g.*, Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995) (discussing thoroughly the costs of mandatory disclosure).

100. Even if these documents are prepared by in-house counsel, there are still significant opportunity costs associated with their production.

101. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (viewing skeptically the value of mandatory disclosure). Compare John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984), for a more sympathetic view.

102. *See* SUSAN PHILLIPS & RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 51 (1981) (estimating costs of disclosures made by registered companies and companies offering new securities); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989) (examining the risk and return of securities issued before and after the 1933 Securities Act was enacted and concluding that, although average returns for listed companies were unaffected, risk levels appeared to be substantially lower after the act was enacted).

V. SHAREHOLDERS' EFFORTS TO IMPACT EXECUTIVE COMPENSATION

Shareholder groups have used a wide variety of approaches in their attempts to monitor executive compensation. Some shareholders, particularly institutional investors, have focused on the relationship between corporate performance and executive pay.[103] These groups have tried to work informally with corporate boards to influence the outcome of their decision making processes. Other shareholders have been more militant, trying to use the shareholder voting mechanism as a means of prodding boards to keep pay levels in check. This section reviews the different techniques used by shareholders in recent years.

A. Informal Pressure on Boards of Directors

Some institutional investors believe that they have experienced very limited success influencing corporate executive pay policies using the voting process.[104] Despite their easier access to information about corporate pay policies under the new SEC rules, and the reduced costs of collective action after the 1992 proxy rule amendments, these shareholders believe that executive compensation policies cannot be monitored effectively through the proxy process because they are too complex, poorly understood, and infrequently subjected to a shareholder vote.[105] Also, institutions fear that public confrontations with management will jeopardize their access to corporate information through informal channels.[106]

These shareholders have relied instead more upon informal approaches to corporate boards to try to influence their executive compensation practices. As major shareholders in most companies, they have access to corporate managers and directors. Taking advantage of this avenue of communication, they convey their views on compensation

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103. *See* Heard, *supra* note 5, at 758; Gilson, *supra* note 72, at 677 (institutional investors should focus on "the wisdom of pay for performance plans rather than the absolute compensation paid particular executives").

104. *See* Heard, *supra* note 5, at 758.

105. *See id.* at 758 ("[P]ay plans themselves are very complex, not easily understood by many shareholders, and subject to infrequent ratification. In most cases, objectionable pay practices come to light after the fact, when voting can have only a very limited and largely symbolic impact.").

106. Another possible explanation of institutional shareholders' reluctance to challenge publicly executive compensation levels may be that the institutions themselves are run by executives who do not wish to have their own compensation attacked as unreasonable. *See* Yablon, *supra* note 51, at 1893. For example, TIAA-CREF's beneficiaries have placed proposals to limit the pension funds' executives' compensation on the fund's proxy card in recent years.

to selected boards of directors privately.[107] Institutions have also used informal negotiations, backed by the threat to force a shareholder vote, as a method of prying concessions out of companies.[108]

For example, the Teachers Insurance Annuity Association - College Retirement Equities Fund (TIAA-CREF) has concluded that boards are better positioned than shareholders to monitor corporate pay policies.[109] Instead of relying on shareholder voting as a monitoring mechanism, TIAA-CREF has disseminated to corporate boards its policy statement emphasizing the use of pay-for-performance and containing a list of ten principles that it believes boards should apply to executive compensation.[110] TIAA-CREF advocates that boards have Compensation Committees comprised solely of independent directors. Other institutional investors have developed similar executive compensation guidelines.[111]

These policies vary but have important common features.[112] First, they urge the board to assume responsibility for designing and administering the executive pay plan. This generally includes a requirement that the compensation committee have a majority of outside directors. Second, these plans should limit the potential dilution that investors can suffer from increases in stock-based compensation for executives. They include specific ceilings on the amount of stock that can be issued under long term compensation plans. Finally, most of these plans try to restrict the use of certain practices that institutions find particularly objectionable, such as repricing of stock options.[113] These shareholder groups expect that boards will consider these guidelines in designing the company's executive's pay plans.

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107. *See* Heard, *supra* note 5, at 761.

108. *See* Kreinberg, *supra* note 59, at 167. Institutions have tried to get directors to take full responsibility for designing and implementing appropriate executive pay plans. Heard, *supra* note 5, at 758.

109. *See id.* at 761-62.

110. *See id.* One of these principles emphasizes the importance of board's communicating to shareholders about executive compensation. *See id.* at 764.

111. *See id.* at 754.

112. *See id.* at 759. Other institutions delegate these questions to third parties. Some of these organizations have taken a different approach. For example, Institutional Shareholder Services (ISS) tries to limit the potential amount of wealth that can be transferred to executives, although leaving the details of the design of the compensation package to the Compensation Committee. *See id.*

113. *See id.* Stock option repricing is a flashpoint for shareholder concern. Companies claim that stock options lose their incentive value for executives if the stock price falls so far below the exercise price that there is little chance the executive will exercise the option. Thus, they claim, the incentive effects of this form of compensation no longer exist. To restore these incentives, companies drop the exercise price of these existing options to the current level of their stock price, thereby "repricing" them.

Shareholder critics claim that option repricing is an egregious abuse of their rights. These shareholders argue that the alignment of shareholder and management incentives only exists if executives are unrewarded when stock prices fail to rise, or fall. Shareholders complain that they do not enjoy similar treatment for their stock when the price of the company's shares falls.

B. *Precatory Shareholder Proposals Using Rule 14a-8*

Individual investors seeking to influence board's executive compensation decisions frequently turn to Rule 14a-8, the shareholder proposal rule. Under this rule, shareholders of public companies have the ability, subject to certain limitations and restrictions, to put proposals on the company's proxy for its annual meeting.[114] This rule states that if a security holder of a corporation notifies the company of its intention to present a proposal for action at a forthcoming shareholders' meeting, the company is required to include the proposal in its own proxy material and to provide a means by which the security holders can vote with respect to the proposal. However, the issuer can exclude a proposal if the proponent fails to meet certain procedural eligibility requirements or substantive content restrictions.[115]

If the company chooses to exclude a proposal, claiming that it fails to meet Rule 14a-8's requirements, then it has the burden of demonstrating that its position is justified.[116] Typically, it will advise the SEC of its desire to exclude the proposal, and provide any legal authority that it believes support exclusion, in an attempt to persuade the SEC to issue a no-action letter.[117] If the company is successful in obtaining the no-action letter, and subsequently chooses to omit the proposal, then the shareholder proponent may file suit in federal district court seeking to force the issuer to include its proposal in the company's proxy materials.[118]

Prior to 1992, many companies had successfully opposed including shareholder proposals concerning executive compensation on their proxy statements, claiming that they raised matters of ordinary business subject to exclusion under Rule 14a-8(c)(7).[119] Companies are permitted to exclude matters of "ordinary business" because such issues fall within the board and management's exclusive power with respect to profit-

114. For a more general discussion of Rule 14a-8, see THOMAS & DIXON, *supra* note 53, §§ 16.01-.05. For a discussion for the 1998 amendments to Rule 14a-8, see Maya Mueller, *The Shareholder Proposal Rule: Cracker Barrel, Institutional Investors, and the 1998 Amendments*, 28 Stetson L. Rev. 451 (1998).

115. *See* Mueller, *supra* note 114. (discussing more completely these requirements).

116. *See id.*

117. A no-action letter is a letter from the SEC to the issuer stating that the SEC will not take any legal action against the company if it omits the proposal. These letters are usually quite short and provide only minimal guidance about the SEC's reasons for permitting exclusion.

118. The shareholder proponent has a private right of action under the federal securities laws. *See, e.g.*, Roosevelt v. E. I. duPont de Nemours & Co., 958 F.2d 416 (D.C. Cir. 1992) (concluding that a private cause of action exists to enforce Rule 14a-8).

119. This section is now 14a-8(i)(7).

making activities of the business under state statutory law.[120] Management's exercise of its specialized talents are protected from investors attempting to dictate the minutiae of daily business decisions.[121] Compensation questions, the SEC staff determined, fell within this exclusive province of the board, and therefore could not be challenged by shareholders using Rule 14a-8.

In 1992, the SEC reversed its prior interpretation that the ordinary business exception barred shareholder proposals concerning executive compensation.[122] In doing so, it noted that executive compensation issues had become the focus of widespread public attention and debate so that they were no longer in the realm of ordinary business matters. As a result, the SEC concluded that shareholders were entitled to raise these issues in precatory proposals using Rule 14a-8.[123]

Institutional shareholders have been reluctant to resort to shareholder proposals in their efforts to alter executive compensation policies.[124] Individual investors, however, have filed a large number of shareholder proposals concerning executive compensation with companies since 1992. These proposals covered a wide variety of different topics, ranging from linking executive pay to a company's stock price to restricting company pay to a low multiple of employee salaries.[125]

Few shareholder proposals of any kind garner majority support at the ballot box. Using data from the 1994 proxy season, one study found that, on average, 21.5% of shareholder votes are cast in favor of these proposals.[126] This figure conceals some wide variations though. External corporate governance proposals, such as proposals to redeem the company's Rights Plan, received the highest average percentage of favorable votes (53.7%), whereas compensation proposals received relatively low average percentages of favorable votes (12.8%).[127] The low vote totals on executive compensation proposals may reflect a variety of factors, including the difficulty of understanding and evaluating complex plans, the need for institutional investors to evaluate these

120. *See* Thomas & Martin, *supra* note 52, at 59.

121. *See* THOMAS & DIXON, *supra* note 53, § 16.04[G].

122. Heard, *supra* note 5, at 754-55.

123. *See* THOMAS & DIXON, *supra* note 53, § 16.04[G].

124. *See* Heard, *supra* note 5, at 761. According to this author, institutions have preferred to use shareholder proposals for "structural questions, such as recommending the establishment of board-level compensation committees consisting entirely of independent outside directors." *Id.* This certainly is consistent with the data concerning the sponsors of shareholder resolutions. *See* Thomas & Martin, *supra* note 52, at 75 tbl.2.

125. See Part VII *infra* for a discussion of the different types of issues raised by shareholder proposals concerning executive compensation.

126. *See* Thomas & Martin, *supra* note 52, at 76.

127. *See id.*

proposals on a case-by-case basis, and a lack of consensus among investors over what the proper criteria are for evaluating executive compensation plans.[128]

C. Binding Bylaw Amendments on Executive Compensation Issues

Shareholders have recently begun presenting proposals to amend company bylaws through a binding shareholder vote.[129] The validity of these proposals has been a hotly contested issue between management and shareholder groups, especially with regard to the redemption of poison pill anti-takeover defenses.[130] State corporate law generally grants shareholders the unilateral right to amend corporate bylaws.[131] The grant of similar powers to the board of directors in a company's articles of incorporation or bylaws usually does not divest this right,[132] although a charter provision may explicitly deny shareholders the power to initiate a bylaw amendment.[133]

State law usually has not imposed express limits on the substance of corporate bylaws or shareholder—initiated amendments to the bylaws. Thus, shareholders arguably may address through bylaw amendments any aspect of the business or affairs of the corporation or the respective rights and powers of the board and shareholders that is not barred

128. For example, CalPERS domestic proxy voting guidelines concerning shareholder proposals on executive compensation state that it will support "proposals that ask for increased pay disclosure or that ask for shareholder approval of pay packages." *CalPERS*, *supra* note 52.

129. Rule 14a-8 generally permits shareholders to submit binding resolutions on matters that state law commits to the shareholder body. See THOMAS & DIXON, *supra* note 53, § 16.04[A], for a further discussion of the issues discussed in this section. In other situations, the Commission staff has required that a mandatory proposal for action that would run afoul of (c)(1) be recast as precatory in order to be included on the proxy statement. *See id.*

130. Academic commentators are also divided over the question. *Compare* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back The Street*, 73 TUL. L. REV. 409 (1998) (arguing that such by-law changes are invalid except in very limited situations), *with* Jeffrey N. Gordon, *"Just Say Never" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997) (shareholder bylaws should generally be upheld); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998) (same).

131. *See* Schwab & Thomas, *supra* note 45, at 1055-58. *See* Bevis Longstreth & Nancy Kane, *Shareholders' Growing Role in Executive Compensation* N.Y.L.J., Feb. 27, 1992, at 5; *see also* DEL. CODE ANN. tit. 8, § 109 (1991); N.Y. BUS. CORP. LAW § 601 (McKinney 1986); MODEL BUS. CORP. ACT § 10.20 (1996). *See generally* THOMAS & DIXON, *supra* note 53, § 16.04[A].

132. *See* R. Franklin Balotti & Daniel A. Dreisbach, *The Permissible Scope of Shareholder Bylaw Amendments in Delaware*, 1 CORP. GOVERNANCE ADVISOR 19, 19 (Oct.-Nov. 1992); Kenneth J. Bialkin & Richard J. Grossman, *The Permissible Scope of Shareholder Bylaw Amendments in New York*, 1 CORP. GOVERNANCE ADVISOR 25, 25, (Oct.-Nov. 1992); *see also* DEL. CODE ANN. tit. 8, § 109(a) (1991); N.Y. BUS. CORP. LAW § 601(a) (McKinney 1986).

133. *See* DEL. CODE ANN. tit. 8, § 109(a) (1991); N.Y. BUS. CORP. LAW § 601(a) (McKinney 1986).

explicitly by state law or the corporation's certificate of incorporation.[134] At some point, however, this broad shareholder power to adopt or amend corporate bylaws must yield to the board's authority to manage the business and affairs of the corporation.[135] The problem becomes one of drawing the exact line between the respective authorities of directors and shareholders under the relevant state law.

The Oklahoma Supreme Court recently determined that shareholders of that state's corporations were entitled to pursue very broad binding by-law amendments. In a case involving the Fleming Companies' efforts to stop a shareholder initiative to amend its bylaws to require a mandatory shareholder vote before the company enacted any poison pill anti-takeover defenses, the court found that the shareholders' power to amend the corporate bylaws trumped the board's authority to manage and direct the business and affairs of the corporation. The court stated, "[w]e hold shareholders may propose bylaws which restrict board implementation of shareholder rights plans, assuming the certificate of incorporation does not provide otherwise."[136] Although the potential impact of this case is difficult to assess, it marks the first time that a state supreme court has upheld shareholders' right to enact binding bylaw amendments on important anti-takeover defenses.[137]

Binding bylaw amendments have become increasingly popular in recent years: in the 1996 proxy season only two such proposals were submitted to companies, while in the 1998 proxy season that number had increased to twenty-two.[138] In the 1999 proxy season, thirty binding

134. See Longstreth & Kane, *supra* note 131, at 5; *see also* DEL. CODE ANN. tit. 8, § 109(b) (1991); N.Y. BUS. CORP. LAW § 601(c) (McKinney 1986). According to Longstreth and Kane,

> It is highly doubtful, as a matter of statutory construction, that shareholders, who are expressly given the right to adopt or amend by-laws, which . . . may contain provisions relating to the business and affairs of the corporation and the relative rights and powers of directors and shareholders, are nonetheless preempted from exercising this right in connection with any subject matter that directors have authority to address under their power to manage.

Longstreth & Kane, *supra* note 131, at 5.

135. See Bialkin & Grossman, *supra* note 132, at 26-27 (observing that precisely when that point of irreconcilable conflict is reached under New York law is unclear, but concluding that shareholders likely would be barred from adopting bylaw amendments that unduly restricted the board's ability to determine corporate-governance and executive-compensation matters); *see also* Balotti & Dreisbach, *supra* note 132, at 21.

136. International Brotherhood of Teamsters Gen. Fund v. Fleming Cos., 975 A.2d 907, 908 (Okla. 1999). *See also* Joann S. Lublin, *Oklahoma Court Affirms Holders' Right to Pursue a Binding Bylaw Proposal*, WALL ST. J., Jan. 28, 1999, at B2.

137. *See id.* at B2.

138. Leslie Scism & Joann S. Lublin, *Not Going to Take It Anymore: Shareholders Push Binding Bylaw Measures To Force Change*, WALL ST. J., Nov. 30, 1998, at C2.

bylaw proposals have already been filed.[139] Most of these proposals concern external corporate governance topics, such as the redemption of a company's poison pill anti-takeover defense.

Recently, some institutional shareholders have begun submitting binding bylaw amendment proposals concerning executive compensation issues. At first, the SEC took an adverse position in a no-action letter involving the Shiva Corporation, raising a difficult barrier to getting these proposals on the corporate ballot.[140] In that no-action letter, the SEC permitted Shiva to omit a shareholder proposal for a mandatory bylaw amendment prohibiting the company from repricing stock options without shareholder approval because the SEC decided that this proposal raised matters of ordinary business and was therefore excludable under subsection (c)(7).

This obstacle appears to have been removed by a subsequent SEC ruling. In 1998, the State of Wisconsin Investment Board (SWIB) proposed a binding bylaw amendment to require shareholder approval of any future repricings of corporate stock options at General Datacomm Industries.[141] On December 9, 1998, the SEC informed the company that it could not exclude the proposal as pertaining to the company's ordinary business operations, in light of "the widespread public debate concerning option repricing and the increased recognition that this issue raises significant policy issues."[142] At General Datacomm's annual meeting, a majority of the shareholders voting cast their votes in favor of adopting the proposed bylaw amendment.[143]

The SEC's decision to permit this proposal opens the door for further binding bylaw amendment proposals on executive compensation.[144] With the Oklahoma Supreme Court's ruling in the Fleming Companies case, many commentators are predicting significant increases in the number of these proposals.[145]

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139. *See* Lublin, *supra* note 136, at B2.

140. *See* Shiva Corporation, SEC No-Action Letter, 1998 SEC No-Act LEXIS 1005 (May 1, 1998) (reviewed and affirmed by the SEC).

141. *See* Scism & Lublin, *supra* note 138, at C1.

142. General Datacomm Industries, Inc., SEC No-Action Letter, 1998 Sec No-Act LEXIS 1037, at *1 (Dec. 9, 1998). The SEC also noted that there was no "compelling state law precedent" which would lead it that such a bylaw restriction was improper under Delaware law. *Id. See also General Datacomm Industries Inc.: Vote Must Be Permitted on Options, SEC Decides*, WALL ST. J., Dec. 10, 1998, at B23.

143. *See* Paul M. Sherer & Barbara Tierney, *Shareholders Block General Datacomm From Reducing Employee Options Price*, WALL ST. J., Feb. 8, 1999, at A6. "The bylaw amendment gained 52% of the votes at the company's annual meeting . . . ." *Id.*

144. SWIB has already announced a proposal to require shareholder approval of future option repricings at Cambridge Technology Partners Inc. *The Jungle: Repricing Rumble*, WALL ST. J., Dec. 15, 1998, at B6.

145. *See* Lublin, *supra* note 136, at B2.

D. *Shareholder Voting on Stock Option Plans*

Until a few years ago, most, if not all, companies' stock option plans had to be approved by their shareholders.[146] As boards of directors awarded ever-larger numbers of stock options, shareholder resistance to approving these plans increased substantially. One study found that

> Where once there was an assumption that any plan presented by management and directors for approval would receive no more than a token 3% to 5% disapproval, the 1995 and 1996 proxy seasons saw significantly stronger shareholder resistance to these plans, as votes against stock option plans in the range of 20-40% become more commonplace.[147]

Although only three companies' proposals were defeated in the time period covered by that survey, another twenty-eight proposals received negative votes of forty percent or more.[148]

More recent data for stock option plans put up for votes between July 1997 to June 1998 show that fifteen were defeated out of the more than two-thousand plans proposed.[149] These defeated plans potentially would have increased the dilution of existing shareholders by between eight percent and thirty-three percent.[150] High negative votes were recorded against a large number of the other plans.[151]

This potential trend of increasing shareholder opposition to company stock option plans has coincided with several little-noticed changes in SEC and stock exchange regulations that have chipped away at the requirement that stock option plans be approved by shareholders. Prior to 1996, Rule 16b-3 required shareholder approval of employee benefit plans that were to be exempt from section 16(b) of the 1934 Exchange Act, the short swing prohibition for corporate insiders.[152] In 1996, the

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146. *See* Wagner & Wagner, *supra* note 71, at 5.

147. *Id.* at 10.

148. *See id.*; *see also id.* at 29 tbl.5.

149. *See* Joann S. Lublin & Leslie Scism, *Stock Options at Firms Irk Some Investors*, WALL ST. J., Jan. 12, 1999, at C4 (citing Richard Wagner of Strategic Compensation Research Associates). Furthermore, those plans that were approved frequently had high percentages of votes cast against them.

150. *See id.*

151. However, a 1997 study by the Investor Responsibility Research Corporation (IRRC) shows that S&P 500 companies requesting more than 10% of the company's shares for new plans received fewer average negative votes in 1997 than 1996. *See* Robert W. Newbury, IIRC, *Potential Dilution from Stock Plans at S&P Super 1,500 Companies*, (April 1998) (on file with author). For the full S&P 1,500, the average level of negative votes exceeded 20% for plans that would result in total potential dilution of more than 15%.

152. Before 1996, Rule 16b-3 stated that an employee benefit plan was exempt from section 16(b) if it had been approved "[b]y the affirmative votes of the holders of a majority of the securities" or by their written consent. 17 C.F.R. § 240.16b-3(b)(1)-(2) (1995). *See also* Wagner & Wagner, *supra* note 71, at 6, 11.

SEC reformulated the rule so that exempt plans need only be approved by the board of directors, a disinterested committee of the board of directors, or the shareholders.[153] This change eliminated one reason why corporations sought shareholder approval of stock option plans.

But companies may still need to submit their stock option plans for shareholder approval for several other reasons. First, a few important state corporate codes require shareholder approval of stock option plans.[154] Furthermore, all states require shareholder approval if the corporate charter must be amended to increase the number of authorized shares of stock for a stock option plan.

Second, under the tax code, companies obtain tax benefits if shareholders approve certain types of stock option plans.[155] Section 162(m) of the Internal Revenue Code (IRC) allows companies to deduct executive compensation in excess of $1 million if it is paid out under the terms of a performance-based stock option plan.[156] The IRC's definition of performance-based plans requires that the plan be approved by shareholders in order to qualify for this advantageous treatment.[157]

Finally, the national stock exchanges all have rules requiring shareholder approval of many stock option plans.[158] Recently, these requirements have been under attack. For example, until 1998, the New York Stock Exchange (NYSE) required listed companies to seek shareholder approval for virtually all stock option plans that were not "broadly based."[159] In January of 1998, however, the NYSE sought

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153. *See* 17 C.F.R. § 240.16b-3(d)(1)(1998). In addition, the plan can provide that the securities be held for more than six months. *See* 17 C.F.R. § 240.16b-3(d)(3) (1998). *See also* Wagner & Wagner, *supra* note 71, at 12.

154. For example, the New York Business Corporation Law states that "[t]he issue of . . . rights or options to one or more directors, officers or employees of the corporation . . . shall be authorized by a majority of the votes cast at a meeting of shareholders." N.Y. BUS. CORP. LAW § 505(d) (McKinney 1986); *see also* Wagner & Wagner, *supra* note 71, at 13 (discussing the treatment of option plans under various state laws).

155. *See id.* at 14-15 (discussing option plans under the tax code).

156. *See* 26 U.S.C. § 162(m)(4)(C) (1998). Incentive stock options (ISOs) are a second type of stock option plan that is tax advantaged but requires shareholder approval. *See* Wagner & Wagner, *supra* note 71, at 15. ISO options create no taxable income for employees when they exercise the option and purchase the stock. Furthermore, if the employee holds the stock for a minimum of one year, there is no taxable gain to the employee until she sells the underlying stock. *See id.* However, ISO plans are used primarily for lower-or middle-level corporate employees because their awards are limited to a maximum value of $100,000.

157. 26 U.S.C. § 162(m)(4)(C)(ii) (1998). *See also* Wagner & Wagner, *supra* note 71, at 14. It is possible that stock option plans directed solely to officers and directors who are not "covered individuals" under the IRC's definition could be considered performance-based, but this would require excluding the company's CEO and the four other highest paid individuals. *See id.*

158. *See id.* at 12-13.

159. *See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change By the New York Stock Exchange, Inc. Relating to Shareholder Approval Policy*, Exchange Act Release No. 34-39659, 1998 WL 63612, at *1 (Feb.

SEC approval to expand the types of option plans that were exempt from shareholder approval.[160] One of the proposals expanded the definition of a broadly based plan and created a non-exclusive "safe harbor" for those plans in which twenty percent of the company's employees, half of whom must be neither officers nor directors, are eligible to participate.[161] Plans falling within the safe harbor would not require shareholder approval. The SEC received no comments on the proposed rule changes and approved them on April 8, 1998.[162]

The adoption of the rule changes triggered an uproar by many institutional investors. They objected that under the new rules companies could easily could design option plans that would not need shareholder approval.[163] In response to these objections, the NYSE established a task force which recommended further changes to the rules.[164] Pursuant to this recommendation, the NYSE again proposed changes to the shareholder approval rules in October of 1998.[165] Under the new proposals, an option plan is classified as "broadly-based" if a majority of the company's full-time, exempt employees in the United States are eligible to participate in it and if, within the shorter of three years or the term of the plan, a majority of the shares awarded under the plan go to employees who are not officers or directors.[166]

A number of large institutional investors objected to the revised proposals.[167] On December 28, 1998, the SEC extended the period in

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12, 1998). The one exception was for plans designed to induce someone not previously employed with the company to join the firm.

160. *See id.* at *2.

161. *See id.* In addition, the proposal stated that when deciding if a plan is broad-based, a variety of factors would be examined, such as the number of people covered by the plan and the nature of the employees. Another significant proposed change was that non-broad-based plans that dilute shareholder equity less than 5% would no longer require shareholder approval. *See id.*

162. *See Self-Regulatory Organizations; New York Stock Exchange, Inc.: Order Granting Approval to Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Shareholder Approval Policy*, Exchange Act Release No. 34-39839, 1998 WL 164369 (Apr. 8, 1998). In granting approval to the changes, the Commission stated that "the changes proposed by the NYSE will provide listed companies with more flexibility in issuing stock option or purchase plans while still adequately protecting shareholder rights to approve those plans that will have a material effect on their equity." *Id.* at *3. The New York Stock Exchange Listed Company Manual contains the new rules in section 312.03.

163. *See Big Board Approves Tighter Definition of Stock-Option Plan*, WALL ST. J., Oct. 2, 1998, at B10.

164. *See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc., Relating to Shareholder Approval of Stock Option Plans*, Exchange Act Release No. 34-40679, 1998 WL 788860, at *3 (Nov. 13, 1998). The Task Force was comprised of representatives of the Individual Investors Advisory Committee and Pension Managers Advisory Committee as well as representatives of committees associated with companies or the NYSE itself. *See id.*

165. *See id.* at *1.

166. *See id.*

167. For example, in November of 1998, the Council of Institutional Investors sent a letter to the SEC stating that no option plan should be exempted from shareholder approval. *See Big Board Proposal on Stock Options at Listed Firms Comes Under Attack*, WALL ST. J., Jan. 25, 1999, at C6 [hereinafter *Big Board*]. In

which it would receive comments on the new proposal to January 25, 1999.[168] Thus, at the present, the "20%" rule remains intact.[169]

In summary, companies have greater regulatory flexibility to avoid seeking shareholder approval for their stock option plans.[170] The changes to the stock exchange requirements, combined with the revisions of the SEC's short-swing profit regulations, weaken the requirement of shareholder approval of stock option plans.

Undoubtedly, some of the pressure to lessen the need for shareholder approval stems from the increased levels of shareholder opposition. This opposition seems likely to continue to grow, given the already high level of officer and director stock ownership—over 3.5% average beneficial ownership at large American companies.[171] How investors will respond to companies' decisions not to seek authorization of their stock option plans remains to be seen.

E. "Just Vote No" Campaigns

In "Just Vote No" campaigns, shareholders withhold approval from the company's unopposed board slate at the annual election of directors to pressure management to improve its performance.[172] Although these campaigns have largely symbolic value, the negative publicity generated may provide a strong impetus for governance-related changes.[173]

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the letter, the Council accused the NYSE of being "blatantly conflicted" by its desire to attract to its listings companies which have option plans favorable to executives and urged the SEC to "reclaim this issue as its own." *Id.* Another group with strong institutional investor ties, Institutional Shareholder Services, argued that the NYSE was trying to compete with the Nasdaq for listings of high-tech companies when "executive compensation and [option] plans are a hot-button issue." *Id.*

168. *See Self-Regulatory Organizations; Notice of Extension of the Comment Period for the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Shareholder Approval of Stock Option Plans*, Exchange Act Release No. 34-40847, 1998 WL 898486, at *1 (Dec. 28, 1998). As a result of this extension, the proposed rule will likely not be adopted in time for the 1999 proxy season. *See Big Board*, *supra* note 167, at C6.

169. *See Big Board May Alter Stock-Option Policy to Calm Shareholders*, WALL ST. J., Mar. 24, 1999, at C11 (the NYSE states that the 20% rule will be in effect only through the end of September 2000).

170. *See* Wagner & Wagner, *supra* note 71, at 10.

171. This number grows to 11.9% if we take into account the tremendous potential dilution of shareholders' equity that could result if already authorized but unissued, and already granted but unvested, stock options actually are granted and exercised. *See id.*

172. *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

173. *See* Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,002, at 82,838 (June 24, 1992) (recognizing increasing shareholder use of this tactic to communicate with corporate management, and proposing enhanced disclosure of proxy voting results, including the number of votes withheld from each board candidate, in the next quarterly report on Form 10-Q or Form 10-K). This new disclosure requirement was adopted in October 1992. *See* THOMAS & DIXON, *supra* note 53, § 6.04(B)(19) n.334; John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1052 & n.194 (1993).

Institutional shareholders have actively participated in these campaigns, spotlighting selected issues, such as executive compensation.

The earliest use of the "Just Vote No" campaign being used in the executive compensation area was SWIB's 1993 campaign at Paramount Communications, Inc.[174] SWIB protested the Compensation Committee's decision to award large incentive bonuses to the company's top executives after the company's relatively poor performance. SWIB withheld its votes for the Compensation Committee's members and urged other institutional investors to do the same. These efforts led other institutional investors to mount similar campaigns at other companies.[175]

More recently, the shareholders of the Walt Disney Company used a "Just Vote No" campaign in 1997 to protest that company's "multimillion-dollar payout to former President Michael Ovitz and a rich new contract for Chairman and Chief Executive Michael Eisner."[176] Institutional and individual shareholders withheld thirteen percent of the votes cast for the five company directors that were up for reelection at the meeting while eight percent of the shareholders voted against Eisner's new contract.[177]

Institutional shareholders can participate in these campaigns without triggering the federal proxy rules solicitation provisions if they are careful to stay within the terms of certain safe harbors. As was discussed in Part III.A, shareholders can publish or broadcast announcements of how they plan to vote without complying with the federal proxy rules, so long as they are not soliciting proxies.[178] This regulatory safe harbor extends to shareholders' announced reasons for their decision to vote, abstain, or withhold proxies. They can also encourage one another to attend meetings and vote against management, so long as they do not solicit proxies to do so themselves.

Pension funds can also communicate their voting intentions to their beneficiaries without fear of violating the federal proxy rules.[179] There is no limit on the number of exempt statements relating to a specific

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174. *See* Heard, *supra* note 5, at 760.

175. *See id.*

176. *See* Bruce Orwall, *Disney Holders Decry Payouts at Meeting*, WALL ST. J., Feb. 26, 1997, at A3.

177. *See id.* An additional 3.2% abstained from voting. *See id.* TIAA-CREF launched an important "Just Say No" campaign in March of 1999 against Lubrizol Corporation, seeking to get its board of directors to redeem that company's dead-hand poison pill anti-takeover defense. *See* Joann S. Lublin, *Lubrizol and TIAA-CREF Fund Duel Over "Dead-Hand" Takeover Defense*, WALL ST. J., Mar. 23, 1999, at A4. TIAA-CREFF hired proxy solicitors to encourage the company's shareholder to withhold their votes from the five directors that were up for election at the Company's 1999 annual meeting. *See id.*

178. *See* 17 C.F.R. § 240.14a-1(*l*)(2)(iv) (1997).

179. *See* 17 C.F.R. § 240.14a-1(*l*)(2)(iv) (1997).

solicitation that the shareholders may make, so long as they do not seek proxy voting authority from others. Within these limitations, institutional investors can actively participate in "Just Vote No" campaigns.

VI. SURVEY OF EMPIRICAL WORK

Researchers seeking to study the effectiveness of shareholder monitoring efforts have focused on the effects of shareholder proposals. This empirical research has concentrated on determining the factors that lead shareholders to target certain firms, the determinants of voting support for shareholder proposals and the success of different types of sponsors.[180] Most researchers hypothesize that investors can be expected to be active monitors[181] of managers when the benefits of such monitoring exceed the costs.[182] The benefits of active monitoring include any increase in the value of the investor's holdings, weighted by the probability of being successful in bringing about the requested changes.

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180. There are a number of other important topics that researchers have examined but which are outside the scope of this paper. These questions include the effect of shareholder proposals on firm value. The studies reach conflicting conclusions. *Compare* Stephen L. Nesbitt, *Long-term Rewards from Shareholder Activism: A Study of the "CalPERS" Effect*, 6 J. APP. CORP. FIN. 75 (1994) (finding positive wealth effects related to shareholder proposals); Deon Strickland et al., *A Requiem for the USA: Is Small Shareholder Monitoring Effective?* 40 J. FIN. ECON. 319, 334 (1996) (same); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 243-45 (1996) (same); Tim Opler & Jonathan Sokobin, *Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors* 6 (April 1997) (unpublished manuscript, on file with authors) (same); John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and no Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills* 23 (Jan. 1997) (unpublished manuscript, on file with authors) (same) *with* Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence* 31 (May 8, 1995) (unpublished manuscript, on file with authors) (finding no positive wealth effect from shareholder proposals); Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. & QUANT. ANAL. 1, 20 (1996) (same); Stuart Gillian and Laura Starks, *Relationship Investing and Shareholder Activism by Institutional Investors* (1995) (unpublished manuscript, on file with authors) (same).

We chose not to investigate the impact of executive compensation proposals on firm value. Our reason for not doing so is that the companies in our sample are very large companies with billions of dollars of sales and market capitalization. *See* Table 5, *infra*. Even if a firm responded to a shareholder proposal by completely eliminating the company's CEO's pay, this will only lead to on average about a six million dollar increase in the company's net revenues. This is a small fraction of a percent of these company's value. Of course, in reality, no company would eliminate CEO pay. So the direct impact of these proposals on firm value is very unlikely to be significant.

181. By active monitors, we mean those investors who engage in activities that represent overt attempts to affect management decision making. In this paper, we focus on one form of activism, the use of shareholder proposals. Other forms of activism include litigation and informal negotiations with the board regarding the performance of the firm. *See* Wahal, *supra* note 180, at 4-5.

182. *See* Smith, *supra* note 180, at 229. For a formal model of monitoring decisions on the part of institutional investors, see Anat R. Admati et al., *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097 (1994) (describing the circumstances under which large institutional shareholders with diversified portfolios have incentives to engage in monitoring despite free-riding by other shareholders).

Active monitoring is more likely to occur when investors perceive a greater probability of success in achieving change that has a positive effect on the value of their holdings. Investors will also be more likely to engage in monitoring when their costs are low. The costs of shareholder proposals are relatively low compared to other alternative monitoring techniques.

Several studies have identified factors that influence investors to target particular firms for activism. Researchers asked investors such as CalPERS,[183] United Shareholders of America (USA),[184] and the Council of Institutional Investors (CII),[185] about the factors they used to identify targets. These studies show that investors' criteria often change over time. For example, CalPERS in 1987 and 1988 focused on corporate governance structures, using the size of its own holdings, and the level of institutional holdings in the firm to refine its list of targets.[186] In subsequent years, CalPERS predominantly focused on firm performance, with the level of stock ownership by insiders, employee stock ownership plans (ESOPs), other institutions, and CalPERS, being used as secondary factors.[187]

Similar patterns are observed with CII and USA. CII's criteria in recent years have emphasized stock performance, whereas previously they focused on factors such as governance characteristics and whether executives were overcompensated.[188] During its years of operation, USA considered firm financial performance, whether top executive compensation plans were tied to corporate performance, and the existence of policies that limited shareholder input on corporate governance issues.[189] In general, these studies suggest firm performance has become increasingly important for investors in how they select firms for activism.

Statistical tests underscore the importance of firm performance and the other factors identified above as predictors of which firms are

183. *See* Smith, *supra* note 180, at 231-32.

184. *See* Strickland et al., *supra* note 180, at 320.

185. *See* Opler & Sokobin, *supra* note 180 (manuscript at *4).

186. *See* Smith, *supra* note 180, at 231-32.

187. *See id.* Smith also reports that the target selection process became more sophisticated. In particular, firms within CalPERS' portfolio are first ranked according to their five-year stock returns and the bottom quartile (called the "Bottom 250") are selected. The remaining factors (those based on ownership of shares) are used to eliminate firms until about 50 remain. From this list (called the "Failing Fifty"), about 12 are chosen to target. *See id.* at 232.

188. *See* Opler & Sokobin, *supra* note 180, (manuscript at *4). By 1994, CII relied solely on past stock performance over a five-year window. *Id.*

189. *See* Strickland et al., *supra* note 180, at 320.

targeted for shareholder activism.[190] Using a sample of 866 shareholder proposals presented at 317 firms between March 1986 and October 1990, Karpoff, Malatesta, and Walkling[191] reported that firms targeted for activism tended to have poorer financial performance as compared to a matched sample. Targeted firms were also larger and had higher levels of institutional ownership.[192] John and Klein[193] found that during the 1991 proxy year, proposals were more likely to be received by larger S&P 500 firms reporting negative net income in the prior year. Bizjak and Marquette[194] reported that the 115 companies receiving 193 proposals to rescind shareholder rights plans between 1986 and 1993 had poorer market and accounting performance prior to receiving the proposal than a sample of matched firms. Other differences with the matched sample suggested that targeted firms had higher levels of institutional ownership, were larger in size, and unlike the findings of previous studies, also had smaller levels of insider ownership.[195] Strickland and his colleagues, examining firms targeted by the USA, reported similar results.[196] In general, these findings are consistent with investors targeting those firms in which the expected benefits of activism, and the probability of success, are greater.[197]

190. Smith was one of the few to find no significant performance difference between targeted and other firms. *See* Smith, *supra* note 180, at 237-38. Smith's results, based on a comparison between CalPERS's targeted companies and other firms in the "Bottom 250," may have been due in part to the truncation in the variation in firm performance caused by limiting the sample to the bottom quartile of CalPERS's initial performance-based ranking of firms. The findings do suggest that once in the "Bottom 250," poorer performance did not increase the probability of being in the final list of 12 or so targeted firms. Examining the relationship between the number of shareholder proposals and measures of firm performance, Daily and her colleagues conclude that shareholder proposals and firm performance are unrelated. *See* Catherine M. Daily et al., *Institutional Investor Activism: Follow the Leaders?* 30 (1996) (unpublished manuscript, on file with authors).

191. *See* Karpoff et al., *supra* note 180.

192. *See id.* (manuscript at 16).

193. *See generally* Kose John & Amy Klein, *Shareholder Proposals and Corporate Governance* (1994) (unpublished manuscript, on file with authors).

194. *See* Bizjak & Marquette, *supra* note 180.

195. *See id.* (manuscript at 12-13). Other studies examining the level of insider ownership found no differences between targeted and other firms. *See* Karpoff et al., *supra* note 180; Smith, *supra* note 180.

196. *See* Strickland et al., *supra* note 180, at 327. When prior stock performance, financial performance, market-to-book value of equity ratio, firm size, and various ownership characteristics were entered simultaneously, however, only firm size and the number of shareholders were found related to the probability of being targeted. *See id.*

197. Examining firm performance relative to the firm's industry, Wahal, *supra* note 180, reported that firms targeted between 1987 and 1993 by the nine pension funds in his data set underperformed their industries on two accounting measures, *see id.* at 18, but actually outperformed their industries on abnormal holding period returns, *see id.* at 17.

Other studies have examined the determinants of the number of votes cast in favor of shareholder proposals.[198] In Gordon and Pound's analysis of 266 shareholder corporate-governance proposals voted on between September 1989 and June 1990,[199] lower "long-run" measures of performance and price-earnings ratios were correlated with higher levels of votes in favor of proposals to change certain corporate governance features of the firms.[200] Similarly, proposals sponsored by the USA between 1990 and 1993 received greater support when firm performance was mediocre.[201] Focusing on proposals to rescind a poison pill, Bizjak and Marquette reported in a similar vein that mean operating income and prior stock performance were negatively related to the amount of support shown.[202] However, in examining management-supported anti-takeover charter amendments, Brickley and his colleagues[203] found that firm performance measures (prior stock performance and return on assets) were unrelated to the percent support received, although these measures were associated with the probability that the measure passed.[204]

Only one study has examined any of these issues using shareholder proposals relating to executive compensation. Johnson and Shackell used data concerning 169 shareholder proposals on executive compensation for the period of 1992 to 1995 to examine how shareholders use the information contained in the expanded proxy statement disclosures following the 1992 revision of the federal proxy rules.[205] The overwhelming majority of these proposals were submitted by individual shareholders.

Johnson and Shackell find that larger companies and firms with negative press coverage of their executive compensation policies were more likely to receive shareholder proposals. Johnson and Shackell also reported that shareholder voting support was greater for proposals

198. Summarizing literature investigating institutional monitoring, Black concludes that shareholder proposals at companies with poor long-term performance or "strong pro-incumbent rules" receive more support. *See* Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 926 (1992).

199. *See* Lilli A. Gordon & John Pound, *Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals*, 48 J. FIN. 697 (1993).

200. *See id.* at 712-13.

201. *See* Strickland et al., *supra* note 180, at 332.

202. *See* Bizjak & Marquette, *supra* note 180 (manuscript at 16).

203. *See* James A. Brickley et al., *Corporate Voting: Evidence from Charter Amendment Proposals*, 1 J. CORP. FIN. 5, 22, 26 (1994).

204. The probability that a measure passed in their analysis was defined according to the voting rules applicable. Their data reflected four such rules: (1) majority of votes cast; (2) supermajority of votes cast; (3) majority of shares outstanding; and (4) supermajority of shares outstanding. Indicators of which rule was applicable were also included in their model. *See id.* at 24-26.

205. *See* Johnson & Shackell, *supra* note 63.

submitted at poorly performing firms, although the specific characteristics of the company's executive compensation plans did not affect voting support. Finally, they found no evidence that compensation committees cut executive compensation upon receipt of a shareholder proposal, nor that higher levels of shareholder support for such proposals led to reductions in executive compensation.[206]

VII. EMPIRICAL RESULTS

A. *Description of the Data*

This paper investigates the targeting of compensation proposals and their impact on executive compensation levels. The data are comprised of information on the proposals combined with compensation data for CEOs of sample firms in the year of and the year following the appearance of the proposals on the firms' proxy statements. For each proposal, we obtained the identity of the targeted firm, the date of the shareholders' meeting, the type of proposal, the identity of the sponsor, and the voting results from the Investor Responsibility Research Center's (IRRC) Corporate Governance Service for the 1993 through 1997 proxy seasons. We collected compensation data on each sample firm's CEO, as well as firm performance data from Standard & Poor's ExecuComp database and matched it to the year of the proxy statement.[207]

206. *See id.* at 24-25.

207. For example, if a proposal appears on a proxy statement dated April 30, 1997, we consider 1996 to be the year of the proposal and 1997 to be the year after the proposal. We adopt this convention for the following reasons. Using the above example, we assume that a 1996 executive compensation proposal would be submitted in response to the announcement of the management 1995 pay levels earlier in 1996. This assumption is based on two observations. First, compensation committees typically meet in the spring after the close of the fiscal year. However, they do not publicly announce executive pay levels for the next year until the issuance of the proxy statement for the following year. Second, shareholder proposals need to be submitted at least 180 days prior to the next annual meeting in order to be placed in the company's proxy materials. This means that they are drafted and submitted to the company in the year prior to the calendar year of the annual meeting, usually in the fall. So in our example, the 1996 proxy statement will disclose the 1995 pay for top executives, then shareholder proposals reacting to that announcement would be filed in the fall of 1996.

We assume that if this 1996 shareholder proposal has any impact on the board of directors' and compensation committee's deliberations over executive pay levels, this impact will be on the 1997 pay levels. We believe this is a reasonable assumption. The company will be in possession of the shareholder proposal well before the spring compensation committee meetings. The directors, especially those on the compensation committee, should also be aware of the proposals for two reasons. First, management should have informed the compensation committee about these proposals, and the company's position concerning them, as part of the negotiations between management and the board over executive pay. In our discussions with directors that sit on compensation committees, they informed us that it would be good

The IRRC reports a total of 195 different firms experiencing a total of 227 shareholder proposals on compensation topics during the sample period. Due to data availability constraints,[208] our final sample consists of 168 proposals received by a total of 145 different firms. In most years, a company receives only one compensation proposal. However, for nineteen companies, two proposals were received in the same year, and in two cases, the company received three proposals in the same year.

Each proposal is placed into one of seven categories, "Report," "Disclose," "Approve," "Cap," "Link," "Reduce," or "Restrict" based on our reading of the nature of the proposal. Table 1 contains a brief description of each type of proposal. To facilitate comparisons between the different types of proposals, we group the proposals into two broad categories; : "Disclosure" proposals, comprised of the "Report" and "Disclose" categories, and "Restrictive" proposals, which include "Approve," "Cap," "Link," "Reduce," and "Restrict" categories.

B. *Voting Outcomes*

Table 2 shows that the proposals in the sample are fairly evenly distributed throughout the five-year period. A total of thirty-six proposals occurred in the 1993 proxy season, forty-one in 1994, twenty-six in 1995, twenty-nine in 1996, while thirty-six proposals were submitted in the 1997 season. Table 2 also shows the average percentage of the shareholder vote that was cast in favor of the proposals by

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corporate practice for management to do so and that they would be upset to learn about the proposals only after pay negotiations have been concluded. Second, by the time that the compensation committee is meeting concerning management's pay in the spring, the proposal will have been put into the company's draft proxy materials. All of the company's directors will review these materials as part of their regular duties. Thus, the members of the compensation committee will learn of the proposals at this point, if they have not already been informed about them by management earlier.

The company's proxy solicitors will advise the directors of the approximate expected level of shareholder support for these proposals even before the shareholder vote is held. At most companies, the company's proxy solicitors will consult with the board about the upcoming 1997 shareholders' meeting and inform them about the issues that will be raised. The solicitors will have projections about the likely shareholder vote tallies. These should include estimates of how shareholders will vote on all of the shareholder proposals on the proxy card, including the executive compensation proposals. Compensation committee members may also have other information about the shareholder proposals. They may have been contacted individually, or as a collective, by large shareholders that have concerns about the company's executive pay plans, or at least have been informed by management about such contacts.

208. We were forced to delete observations from our data set because of missing data. For example, 18 proposals were deleted from the sample because we could not locate their proxy statements online using the LEXIS research database. An additional 27 proposals were deleted because we could not find executive compensation data for them in the ExecuComp database. The remaining deletions were made for similar reasons.

year and type of proposal. For the entire sample, the average percent of the vote cast in favor of the proposals is 11.3%.[209] Although none of the proposals receive enough votes for passage, some proposals clearly receive more support than others given that the percentage of votes in favor of the proposals ranges from 1.6% to 39.1%. In general, "Restrictive" proposals receive significantly more support, on average, than do "Disclosure" proposals. The average vote for "Restrictive" proposals is 12.0%, while the average for "Disclosure" proposals is 9.9%. The t-statistic for the difference in means is 2.38 (p-value = 0.019).[210]

Table 3 categorizes the proposals by sponsor and by type of proposal and also shows the percentage of votes cast in favor of the proposals. Individuals are the most common sponsor with 126 proposals (75% of the sample), followed by churches with eleven proposals (7%), labor unions with nine proposals (5%), and one institutional investor sponsor. A total of twenty-one proposals could not be classified because the sponsors were not identified in the proxy statements. Although non-individual sponsors are not numerous, it appears their proposals are usually of a specific type. For example, all of the church-sponsored proposals involve the Report type of proposal, whereas most of the labor union proposals are the Restrict type. Nevertheless, there is no significant difference between the average percentage vote for the proposals for sponsors that are individuals and those that are not individuals (11.5% versus 11.1%, respectively, t-statistic for the difference in means = 0.28).

While not shown in a table, we also categorize proposals as either Corporate Governance or Social Policy proposals based on the supporting statements made in the proxies by the proposal sponsor.[211] We make this distinction because these proposals offer completely different justifications for changing executive pay practices which may

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209. We note that the average percentage of votes in favor of executive declines significantly over the time period of our study (1993-1997). This is true irrespective of the type of proposal. We hypothesize that this decline may be the result of several factors, including that the stock market's strong performance toward the end of this period may have led investors to be more sanguine about corporate pay levels, that hot button issues like pay-for-performance and the use of independent directors on compensation committees cooled off considerably as most companies adopted these ideas, and that Rule 14a-8 was not available during this time period as a method of seeking binding bylaw amendments on stock option repricings. *See supra*, Part V.B for further discussion of these amendments.

We note that shareholders approved the first stock option repricing proposal submitted under Rule 14a-8, with more than 52% of the votes cast being in favor of this amendment. If this pattern continues, we would anticipate that the observed decline in our data in the average percentage votes cast in favor of shareholder proposals will reverse itself quite dramatically.

210. For a discussion of t-statistics and p-values, see ROBERT S PINDYCK & DANIEL L. RUBINFELD, ECONOMETRIC MODELS AND ECONOMIC FORECASTS (1981).

211. We made this classification based on our reading of the proposal, the supporting statement of the sponsor and any other information we had concerning the proposal.

affect the levels of shareholder support and their impact on directors. For example, a typical Corporate Governance executive pay proposal might seek to bring about changes in the way the company sets pay in order to improve corporate profitability. A Social Policy proposal might seek to change the company's pay practices because they were claimed to be unfair.

A total of 129 proposals (77% of the sample) are classified as Corporate Governance and thirty-nine (23%) are considered Social Policy proposals. The percentage of votes cast in favor of Corporate Governance proposals (11.7%) is significantly greater than that cast for Social Policy proposals (9.8%). The t-statistic for the difference in means is 1.74 (p-value = 0.08).

C. Compensation Results

The first step in evaluating executive compensation levels is to determine an appropriate comparison sample. Our approach is to match each sample firm with a group of companies in the same industry classification and of approximately the same size. We make the size adjustment because firm size has a significant impact on executive compensation levels.[212] As shown in Table 5, Panel A, the firms receiving shareholder proposals tend to be very large companies with median annual sales of more than $11 billion dollars.

In order to match the target firms with comparably-sized firms in the same industry, we sort, for each of the sample years, all firms on Standard & Poor's ExecuComp data base that are in the S&P 500 index by their two-digit industry code and then sort them again by sales within each industry. We next calculate the average value of each component of the CEO's compensation package for the firms in the largest half of each industry. For simplicity, hereafter, we refer to this industry and size matched benchmark as simply the "industry average." The difference between a sample firm's compensation component and the industry average is called the "industry adjusted" compensation component.[213]

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212. *See* Murphy, *supra* note 6 (summarizing empirical studies).

213. The average and median sample firm is significantly larger that its industry average both in terms of sales and market capitalization. This result is a consequence of using firms from the largest half of each industry for our comparison groups and the fact that the sample firms are among the largest publicly-traded companies. However, we believe our methodology is adequate for two reasons.

First, many companies base their executive compensation levels in part on surveys of pay practices at other firms within their industry groups because these are the firms with whom they compete for executive talent. Our industry-based group should therefore be the most appropriate "market" for comparison purposes. Second, we conducted sensitivity analysis on how our results would be affected by

Table 4 presents average values of various components of the CEO's compensation for the sample firms, the industry average, and the industry adjusted average compensation component. Even with the industry and size adjustment, the firms in our sample pay their CEOs more than their industry average for all compensation components. However, the difference is statistically significant only for Salary, with an industry adjusted average of $83,666, and All Annual Compensation, with an industry adjusted average of $218,172. Although Option pay, All Long-term Compensation, and Total Compensation are all substantially larger for sample firms' CEOs, the average industry adjusted values of $1,407,220, $1,697,500, and $1,961,730 are not significantly different from zero.[214]

Although not reported in a table, we explore the differences in the composition of the pay packages of target firms and the comparison group. For the sample, All Annual Compensation comprises 52.88% of Total Compensation, whereas the industry average is 55.14%, a difference of 2.26%. So target firms executives receive a relatively smaller percentage of their compensation in fixed payments.

Conversely, sample firms pay their CEO relatively more using options and long-term sources of pay. The average ratio of Long-term Compensation to Total Compensation is 43.57% for the sample and 41.12% for the industry average. However, none of these differences are statistically significant.

D. *Firm Performance Characteristics*

Table 5 reports descriptive and performance statistics for the sample firms, market and industry benchmarks, and market adjusted and industry adjusted values. Common stock returns and EPS growth rates are measured for the three-years and five-years prior to the year the compensation proposal appeared in the proxy statement. Common stock returns are adjusted for average market returns by calculating the difference between the sample firm's return and the average return of the firms comprising the S&P 500 index. Earnings per share growth

using a comparison group comprised of the top quarter of firms within the industry. As noted below, we found that these differences were not significant.

214. All Annual Compensation is defined as the sum of Salary, Bonus, and Other Annual Compensation. Option compensation is valued by Standard & Poor's analysts using the Black-Scholes option valuation formula. All Long-term Compensation is the sum of Option pay, Long-term Incentive Payouts, and Restricted Stock Grants. Total Compensation is the sum of All Annual Compensation, All Long-term Compensation, and Miscellaneous Other Compensation.

rates are similarly adjusted for the average of each sample firm's industry based on two-digit S&P industry codes.

Sample firms significantly under-perform the average S&P 500 common stock return over the three and five years prior to the proxy year. The three-year market-adjusted common stock return for the entire sample is -3.27%, whereas the five-year market adjusted return is -4.05%. This poor performance appears to be due to lower than average EPS growth rates by sample firms, although the average industry adjusted growth rates are not significantly different from zero. While we cannot rule out other possibilities explaining why particular firms are targeted for compensation proposals, these results are consistent with the hypothesis that investors target under-performing firms for compensation proposals and are consistent with other empirical studies.[215]

To test our hypothesis that labor shareholders make good monitors, we also calculated similar relative pay and market returns values for the subsample of shareholder proposals offered by labor unions. We found that labor unions targeted firms with very poor performance characteristics and high levels of executive pay.[216] We further found that the relative pay levels are (statistically insignificantly) higher at firms targeted by labor groups than for the remainder of the sample.[217] Although these results are based on a small number of observations (which may explain their insignificance), and therefore should not be interpreted too strongly, they are consistent with our claim that labor shareholders may be good monitors of executive compensation.[218]

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215. *See* Bizjak & Christopher, *supra* note 180. In their study of shareholder proposals concerning executive compensation, Johnson and Shackell find that shareholders target firms that receive negative press coverage of their executive compensation practices. If the press focuses on companies with high executive pay and relatively poor corporate performance, then their results would be consistent with our findings. *See* Johnson & Shackell, *supra* note 63 (manuscript at 1).

216. Labor proposals are targeted at firms that show market-adjusted common stock returns (3 year) = - 6.23%; market-adjusted common stock returns (5 year) = - 4.90%; industry adjusted growth in EPS (3 year) = - 4.39%; and industry adjusted growth in EPS (5 year) = 3.46%. Although these numbers are more negative than those reported for the full sample in Table 5, the differences are not statistically significant.

217. For the six companies targeted by labor groups for which we have full data, we calculated that, in the year of the proposal, average total pay for the subsample was equal to $11,372,790, compared to the size adjusted industry average of $7,103,870. The difference between these figures is $4,268,920.

When we computed the same statistics for all of the remaining proposals in the sample, we found that, in the year of the proposal, average total pay was equal to $6,416,420, versus the size adjusted industry average of $4,066,750. The gap between these numbers is $2,349,660.

Although the gap between firms receiving proposals and comparably sized firms is greater for the labor sponsored proposals, the differences between the two groups are not statistically different.

218. We note that we cannot determine what techniques labor unions are using to target firms with executive compensation proposals. In particular, we do not know if they are using their firm-specific knowledge of compensation practices, or other private information, to engage in more subtle forms of

E. Impact of Proposals on Executive Compensation

Our next area of investigation focuses on the impact that executive compensation proposals have on CEO compensation. Our hypothesis is that although shareholders cannot dictate the terms of executives' pay, they can influence the board of directors' decisions on these matters. Precatory shareholder proposals are one method by which shareholders inform the board of their views about executive pay levels and composition. As noted in Table 2, even though none of the proposals in our sample received enough votes for passage, some proposals did achieve substantial support. Therefore, we seek to determine if these proposals may have had an indirect effect on executive pay packages by influencing the board's decisions.

Table 6 presents averages for the sample and industry comparison group as well as average industry adjusted values of compensation components for the year after executive compensation proposals. As in Table 4, Salary and All Annual Compensation significantly exceeded the industry average. In contrast, however, in the year after the proposal, Bonus pay and Total Compensation were also significantly greater than the industry average. This result is in spite of a relative tightening in the difference between the sample's Options pay and the industry average.

Figure 1 illustrates how comparative compensation levels change in the year after the receipt of a shareholder proposal. It compares the percentage changes in each of the major compensation components for the sample group and the industry comparison group from the year of the shareholder proposal to the year after the proposal. The percentage changes in Salary and Option pay are much lower for the sample group, while Bonus pay increases are larger. On the whole, Total pay increases are much smaller though for the sample group. Table 7 reports the underlying data and calculations illustrated in Figure 1.

Despite the fact that industry adjusted compensation components are significantly greater than zero, the dollar amount of the changes in industry adjusted compensation are not significant. For example, industry adjusted All Annual Compensation rose from $218,172 in the year of the proposal (Table 4) to $282,249 in the year after the proposal (Table 6). But the average increase of $64,077 is not significantly different from zero. In contrast to All Annual Compensation, industry

targeting than simply relying on the publicly available information about past performance and prior compensation levels.

adjusted Option pay fell from $1,407,220 (Table 4) to $820,695 (Table 6). However, the $586,525 drop is not significantly different from zero. The decline in industry adjusted Option pay, as well as declines from other long term sources of pay, more than offset the increase in industry adjusted All Annual Compensation and resulted in a decline in industry adjusted Total Compensation from $1,961,730 (Table 4) to $1,137,600 (Table 6). Again, however, this decline is not statistically significant. The explanation for the lack of significance for these results appears to be that although the magnitudes of the average dollar amount of changes are large, there is tremendous variability in dollar compensation levels.[219]

In results not shown in a table, we attempt to determine if the proposals have affected the composition of executive pay in the year after receipt of the proposal. Industry adjusted All Annual Compensation as a percent of Total Compensation increased for the sample firms from -2.26% in the year of the proposal to -0.16% in the year after the proposal. Thus, CEOs of sample firms were paid greater amounts of cash compensation adjusted for their industry average in the year after the compensation proposal and lower amounts of long-term compensation. In effect, target companies appear to have shifted the composition of executive pay to more closely track that of the rest of their industry. However, none of these results are statistically significant.

We also performed sensitivity tests on our results by making two changes. First, we examined changes in compensation components over the two years following the year in which the compensation proposal appeared in the proxy statement. Second, we compared each sample firm's compensation components with average compensation of firms in the same size quartile and two-digit industry code.[220] To avoid double counting, we excluded from this sensitivity analysis those observations that overlap a compensation proposal at the same firm but at an earlier date. For example, we excluded observations for which Year +2 (the second year following the proxy year) for a sample firm is also Year 0 (the proxy year) of a subsequent proposal at the same firm. The result of these restrictions is to limit our sample to forty-nine observations.

In spite of these sample restrictions, the pattern of results revealed in Table 7 is generally reinforced in the second year following the proxy year. In addition, many of the results become statistically significant.

219. Because of the way the significance statistics are calculated, this means that the denominators are very big and therefore the value of the statistic is reduced. *See* PINDYCK & RUBINFELD, *supra* note 210.

220. Contrary to the results shown in Table 5, neither the mean nor median sales for the sample firms are significantly different from the average industry sales when based on sales quartiles. This result holds for the year of compensation proposals as well as the two years following the proposal.

In particular, the average change in industry adjusted salary from Year 0 to Year +2, is a statistically significant $53,079 (t = 2.29). Thus, in the two years following a compensation proposal at the sample firms, the CEO's salary increased, on average, by $53,079 more than it increased at the matched sample firms. While salary increased more than the industry average, bonus pay did not. The average change in industry adjusted CEO bonus was -$33,670, which is not significant. However, the average change in industry adjusted stock option compensation from Year 0 to Year +2 was a statistically significant -$2,007,640 (t = -2.89). Given the large change in option pay, the average change in industry adjusted total compensation from Year 0 to Year +2, -$2,710,140, is also statistically significant (t = -3.74). Taken, together, these results tend to confirm the hypothesis that CEO compensation is revised significantly in the years following compensation proposals.

Finally, we try to unpack the differential effects of the shareholder proposals on executive compensation. In Table 8, we report the results of the estimation of six regressions that examine the cross sectional characteristics of changes in various industry adjusted compensation components. In these regressions, we are investigating the impact of voting support, type of proposal, and type of sponsor on compensation changes. The dependent variables in each of the regressions measure the difference in target company executives' compensation minus industry average compensation in the year after the proposal and target company executives' compensation minus industry average compensation in the year of the proposal. For example, CHGSAL is defined as the change in industry adjusted salary from the year of the proposal to the year after the proposal. In a similar manner, CHGBON, CHGANN, CHGOPT, CHGLTC, CHGTOT denote changes in Bonus, All Annual Compensation, Options, Long-term Compensation, and Total Compensation, respectively.[221]

The explanatory variables and their potential impact on changes in compensation are defined as follows. FOR represents the percentage of votes cast in favor of the proposal. If directors are responsive to the level of shareholder support for proposals, then a greater percentage of votes cast in favor of the proposal should lead them to reduce the spread between the CEO's compensation and the industry average, all else

221. The actual formulas are contained in the notes to Table 8.

equal.[222] Therefore, we hypothesize that the coefficient on FOR should be negative.

RESTRICT is a dummy variable taking on the value of one for Restrictive type proposals and zero for Disclosure type proposals. If Restrictive proposals have more influence on directors, they should be associated with lower changes in industry adjusted compensation. Therefore, the coefficient on RESTRICT should be negative.

GOV is a dummy variable taking on a value of one if a proposal is classified as dealing with corporate governance issues and zero if it deals with social policy issues. Like Restrictive proposals, governance proposals may have more influence on directors than social policy proposals. Therefore, governance proposals should be associated with lower industry adjusted changes in compensation and GOV should have a negative coefficient.

INDIVIDUAL is a dummy variable taking on a value of one if the sponsor of the proposal is an individual investor and zero if it is an institutional investor, a labor union, or a church organization. To the extent that individuals represent "nuisance" proposals that are ignored by the board of directors, INDIVIDUAL should have no effect on industry adjusted changes in compensation.[223]

In order to avoid double counting, the sample used in Table 8 is based on a sub-sample that includes firms that have only one proposal in any one year. In addition, observations are excluded if the sponsor could not be identified or classified from the proxy materials. A total of 109 observations remain.[224]

The results in Table 8 generally support the first two hypotheses discussed above. FOR has a negative coefficient in each of the regressions. However, the relationship is statistically significant only with respect to CHGANN, the change in industry adjusted All Annual Compensation. Thus, we find some support for the claim that proposals with greater support from shareholders tend to result in significantly lower industry adjusted All Annual Compensation.

222. We should note that the shareholder vote will not be finally tabulated until the shareholder meeting is held, which may be after the compensation committee determines what compensation to award to executives for the following year. However, the directors will have estimates from the company's proxy solicitors beforehand of how shareholders are going to vote on these proposals. The solicitors have substantial experience with the different types of proposals and institutional shareholders' voting preferences on them. They know the company's shareholder composition and therefore can provide the directors with fairly accurate information about the shareholders' support levels before the vote is taken.

223. We lacked a sufficient number of observations on labor sponsored proposals to determine whether labor shareholders are more effective monitors of executive compensation.

224. We do not include a control variable for firm size in the regressions because we have controlled for size in the calculation of each dependent variable. Each compensation component is adjusted for a benchmark based on industry and size.

RESTRICT is significantly negatively related to CHGBON and CHGANN. This implies that Restrictive proposals are more effective in reducing the spread between CEO annual compensation and the industry average than Disclose proposals.

The sponsor of the proposal also appears to affect industry adjusted compensation. INDIVIDUAL is significantly positively related to both CHGLTC and CHGTOT. These results indicate industry adjusted Long-Term Compensation and, as a result, industry adjusted Total Compensation increase after proposals sponsored by individuals. We offer no explanation for this result.

The GOV variable is insignificant in all of the regressions. It appears that although shareholders are more likely to vote in favor of executive pay proposals that raise corporate governance issues, rather than social responsibility questions, this difference has no effect on the board of directors' decisions about executive pay.

VIII. CONCLUSIONS

Shareholder proposals have been viewed by many investors as an ineffective method of influencing board decisions on the level and composition of executive pay. Our results lead us to a cautiously more optimistic assessment of the effectiveness of this form of shareholder activism. We turn up some evidence that shareholders are critically reviewing executive compensation at companies that should be monitored. For example, our findings that shareholders are targeting companies that exhibit relatively high pay and low performance levels are consistent with the claim that shareholders are seeking to remedy abuses of the pay system. Thus, shareholders may be capable of monitoring of executive compensation.

However, the effectiveness of shareholders in challenging executive pay practices depends crucially on how companies' board of directors respond to their precatory proposals, and in particular, whether the board lowers pay levels or changes the composition of pay packages in response to them. Our results provide some support for the proposition that shareholder proposals affect board decisions about executive compensation levels and composition. We find that target companies do not increase average executive compensation levels as rapidly in the year after receiving a shareholder proposal, so that the gap between the pay levels at target companies and pay levels at similarly-sized firms in their industry decreases, although the magnitude of these changes is not statistically significant. We also find some support for our hypothesis that higher levels of shareholder voting support for these proposals are associated with lower levels of executive compensation at companies receiving proposals when compared to pay levels at similarly-sized companies in the industry.

However, we cannot conclude that Rule 14a-8 provides shareholders with a strong means for influencing executive compensation.[225] Our results, and our conversations with corporate directors, lead us to conclude that shareholder proposals are only one of a variety of factors that compensation committees consider in setting executive pay. These proposals are given more weight by directors when they draw a relatively high level of support, over, say, ten percent of the vote, because they are then viewed as a significant expression of shareholder discontent.[226] But the shareholders' expressions of discontent via these proposals do not necessarily outweigh other concerns that directors may have in deciding about the appropriate levels of executive pay, such as the companies' ability to retain key employees and executives.

Taking a broader perspective, shareholders' ability to influence corporate boards on executive compensation issues has been affected by a variety of recent legal developments. Some of these changes have reduced shareholders' ability to vote on the issuance of stock options. For example, the New York Stock Exchange eliminated the requirement for shareholder approval of all stock option plans in some circumstances. Also, more companies are apparently seeking to avoid shareholder votes on their stock option plans through a variety of other devices.[227]

Other changes may strengthen shareholders' influence in the boardroom, such as the SEC's recent decision to permit shareholders to put binding bylaw amendments on the corporate ballot using Rule 14a-8. On this point, we hasten to add that, despite the Oklahoma Supreme Court's decision in the Fleming Companies case, discussed above, there is considerable uncertainty over how the Delaware Supreme Court will rule on the permissibility of these proposals under Delaware law.[228] To

225. We would also caution that we cannot look inside the boardroom to determine whether shareholder proposals actually do have any impact on directors' decisions concerning executive compensation. A number of other factors may be much more significant. For example, the widespread use of compensation surveys as a means of setting executive pay levels and composition may lead companies that get too far ahead of the curve on executive pay to lower their rates of pay increase temporarily in order to get their numbers closer to the industry averages. This may be especially true for firms that have experienced relatively poor performance in earlier years.

226. Although this level of support may seem low, we were informed by the directors we interviewed that they are much more sensitive to expressions of shareholder discontent when the company is performing poorly, as are most of the companies in our sample. Their explanation for this reaction is twofold. First, they wanted to receive strong shareholder support for all of their actions. Second, a strong signal of shareholder discontent might be viewed by the market as a sign of potential weakness of the company, making it more likely to become a target of an acquisition proposal.

227. *See generally* Wagner & Wagner, *supra* note 71.

228. The Delaware courts have not yet ruled on the validity of these binding bylaw amendments. However, the Delaware Supreme Court's recent decision in *Quickturn Design Systems, Inc. v. Mentor Graphics*

the extent that shareholder voting on stock option plans becomes less important as a monitoring technique, and binding bylaw amendments' future remains uncertain, Rule 14a-8's significance as a shareholders' monitoring tool will increase.[229] Should labor shareholder groups, who lack the direct management and board access of institutional investors, increase their efforts to bring about changes in executive compensation practices through the voting process, this too will augment the significance of Rule 14a-8 as a shareholder monitoring device.

However, Rule 14a-8, and shareholder monitoring in general, is best used to address occasional problems with executive pay practices. Corporate boards should have the primary responsibility for designing appropriate and reasonable compensation systems as part of their managerial functions. How much corporate employees are paid is a business judgment best left to those with the responsibility for, and expertise in, making business decisions. Injecting shareholders too directly into this process runs the risk of having them engage in micromanaging the business.[230] Our corporate law has chosen to place this power in the board's hands in most circumstances.

Shareholder monitoring is much less appealing as a remedy to the systematic problems with the compensation system that have been alleged by some well-known critics of executive pay.[231] Even assuming shareholders could reach consensus on what reforms might be appropriate, investors would have difficulty launching a broad enough campaign to implement them everywhere. Shareholders would need to identify problems in executive pay packages, to mobilize shareholders to act on the problems identified, and to find ways to ensure that boards listened to them.

For shareholder monitoring to be effective even in a limited monitoring role, the costs of engaging in monitoring and the barriers to

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Corp., 721 A.2d 1281, 1291-92 (Del. 1998), with its strong language concerning any limitations placed on a board of directors' authority to negotiate a possible sale of the company, has cast doubt on the legitimacy of these bylaw amendments under Delaware law.

229. Shareholder support for these proposals will only increase significantly if the monitoring problems discussed in section III *supra* can be addressed. This makes it even more important for shareholder advocates to develop widely accepted techniques for evaluating executive pay plans that can be applied in the widest variety of situations possible.

230. For an interesting case study of one company in which shareholders apparently did engage in such actions with unfortunate consequences, see D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons From Kmart*, 74 N.C. L. REV. 1037, 1119-22 (1996).

231. For example, Graef Crystal in his book, *In Search of Excess*, claims that the system is out of control. *See generally* CRYSTAL, *supra* note 7. Many popular press accounts concerning executive pay raise similar critiques. If the board is "captured" by corporate management and unable to act as hard-nosed negotiators with corporate CEOs over their pay packages, then one answer to this problem is to reform the director nomination and retention process. *See generally* Thomas, *supra* note 8.

collective action must be low. The 1992 SEC rule changes have certainly had this effect for Rule 14a-8 proposals. Investors also need a way of getting boards to respond to their concerns. If the courts continue to uphold the validity of binding bylaw amendments, shareholders may be on the verge of gaining an extremely potent technique for forcing changes in compensation practices.

There remains much more research to do in this area. The empirical component of this article has only focused on one of the methods used by shareholders to register their disapproval of high levels of executive pay. Several other important methods exist for shareholders seeking to bring about changes in the area of executive compensation. Shareholder opposition to highly dilutive stock option plans has become increasingly strong in recent years.[232] Binding bylaw amendments permit shareholders to vote directly to limit certain methods of compensating executives, such as option repricing. We believe that these are promising avenues for shareholder monitoring that deserve further attention from academics.

232. In other work that we have just begun, we intend to extend this research to examine how shareholder voting on company stock option plans may affect the use of stock options as a component of executive compensation.

Table 1
Description of Types of Executive Compensation Proposals

Proposal type	**Description**
Report	Seeks to require firm to appoint a committee of outside directors to review executive compensation practices and report the results to shareholders at the next annual meeting[233]
Disclose	Seeks to require firm to specifically identify all individuals within the firm whose base salary exceeds a specified level, such as $100,000, together with any other cash compensation paid to them.[234]
Approve	Seeks shareholder approval for bonuses to executives that exceed a specified level, such as $30,000.[235]
Cap	Requests the Board of Directors to establish a policy whereby no executive receives more than a specified level of compensation, such as $1 million, unless the compensation is in accordance with a shareholder-approved performance-based plan.[236]
Link	Requests the compensation of executive officers be tied explicitly to changes in the firm's stock price.[237]
Reduce	Seeks the discontinuance of the use of options or stock appreciation rights in the compensation packages of executive officers.[238]
Restrict	Seeks to limit the total annual compensation of the top executives in a firm to a pre-specified multiple of a national median wage paid full-time employees.[239]

233. See, for example, Exxon Corporation's DEF14A Proxy Statement, 4/30/97, p. 22.
234. See, for example, United Technologies Corporation's DEF14A Proxy Statement, 4/29/97, p. 13.
235. See, for example, Consolidated Natural Gas Company's DEF14A Proxy Statement, 3/24/97, p. 28.
236. See, for example, PepsiCo Inc.'s DEF14A Proxy Statement, 5/7/97, p. 16.
237. See, for example, BellSouth Corporation's DEF14A Proxy Statement, 4/28/97, p. 14.
238. See, for example, Merck & Co., Inc.'s DEF14A Proxy Statement, 4/23/97, p. 21.
239. See, for example, Lockheed Martin Corporation's DEF14A Proxy Statement, 4/24/97, p. 26.

Table 2
Average Percentage of Vote in Favor of Executive Compensation Shareholder Proposals by Proxy Year (Number of Proposals in Parentheses)

		Disclosure Proposals		Restrictive Proposals				
Proxy Year	Total	Report	Disclose	Approve	Cap	Link	Reduce	Restrict
1993	12.1 (36)	6.5 (3)	10.3 (13)	19.0 (1)	10.0 (1)	25.2 (1)		13.4 (17)
1994	12.5 (41)	8.7 (5)	12.7 (9)			15.1 (2)	26.6 (1)	12.5 (23)
1995	10.8 (26)	6.7 (6)	11.7 (4)	11.9 (4)	13.5 (1)	13.4 (1)	12.4 (2)	11.2 (8)
1996	11.4 (29)		13.0 (5)	15.3 (3)	11.4 (2)	17.2 (4)	5.7 (9)	12.6 (6)
1997	9.5 (36)	7.8 (6)	8.7 (6)	15.0 (2)	9.6 (3)	14.2 (3)	7.3 (6)	9.9 (10)
Total	11.3 (168)	7.5 (21)	11.2 (37)	14.2 (10)	10.7 (7)	16.4 (11)	8.1 (18)	12.2 (64)

b "Report" proposals typically seek to require the firm to report the link between financial results and social criteria. "Disclose" proposals typically seek to require the firm to report on the compensation of every executive with earnings greater than a specified level. "Approve" proposals typically seek to require the firm to obtain shareholder approval for executive bonuses greater than a specified level. "Link" proposals typically seek to require the firm to tie compensation to the firm's stock price. "Cap" proposals typically seek to require the firm to cap executive pay at a specified level. "Reduce" proposals typically seek to eliminate options, stock appreciation rights, or other forms of pay. "Restrict" proposals typically seek to limit executive pay to a level determined as a multiple of the national median pay.

Table 3
Average Percentage of Vote in Favor of Executive Compensation Shareholder Proposals by Sponsor Type (Number of Proposals in Parentheses)

		Disclosure Proposals		Restrictive Proposals				
Proxy Sponsor	Total	Report	Disclose	Approve	Cap	Link	Reduce	Restrict
Individuals	**11.5 (126)**	**4.4 (1)**	**10.9 (35)**	**15.2 (6)**	**12.9 (4)**	**16.4 (11)**	**7.2 (16)**	**11.7 (50)**
Non-individuals:	**11.1 (21)**	**8.0 (12)**			**7.8 (2)**			**17.4 (7)**
Churches	7.4 (11)	7.4 (11)						
Labor Unions	15.3 (9)				7.8 (2)			17.4 (7)
Institutional Investor	14.2 (1)	14.2 (1)						
Unknown Sponsors	**9.9 (21)**	**7.3 (8)**	**16.1 (2)**	**5.6 (1)**	**8.3 (1)**		**16.0 (2)**	**10.2 (7)**

b "Report" proposals typically seek to require the firm to report the link between financial results and social criteria. "Disclose" proposals typically seek to require the firm to report on the compensation of every executive with earnings greater than a specified level. "Approve" proposals typically seek to require the firm to obtain shareholder approval for executive bonuses greater than a specified level. "Link" proposals typically seek to require the firm to tie compensation to the firm's stock price. "Cap" proposals typically seek to require the firm to cap executive pay at a specified level. "Reduce" proposals typically seek to eliminate options, stock appreciation rights, or other forms of pay. "Restrict" proposals typically seek to limit executive pay to a level determined as a multiple of the national median pay.

Table 4
Average Values of CEO Compensation Components in Year of Executive Compensation Proposal
All Firms (N=145)

	Sample Average	Size-Matched Industry Average	Sample minus Industry Average[a]
Salary	$906,281	$822,615	$83,666***
Bonus	$993,054	$891,338	$101,716
All Annual Compensation[b]	$2,003,180	$1,785,010	$218,172**
Options[c]	$3,031,200	$1,623,980	$1,407,220
All Long-Term Compensation[d]	$4,036,420	$2,338,930	$1,697,500
Miscellaneous Other Compensation	$184,828	$138,764	$46,064
Total Compensation[e]	$6,224,430	$4,262,700	$1,961,730

***, **, * Paired t-test indicates significant difference from zero at the .01, .05, and .10 level, respectively.

a For each sample firm, each compensation component is compared to the average component for the largest half (based on sales) of the companies in the sample firm's industry (based on the 2-digit S&P industry code).

b All Annual Compensation is defined as the sum of Salary, Bonus, and Other Annual Compensation.

c Options are the Black-Scholes value of stock options granted.

d All Long-Term Compensation is defined as the sum of options valued using the Black-Scholes model according to S&P *ExecuComp*, long-term incentive payouts, and the value of restricted shares granted.

e Total compensation is the sum of All Annual Compensation, All Long-Term Compensation, and Miscellaneous Other Compensation.

Table 5
Descriptive Statistics of Firm Performance Variables in Year of Executive Compensation Proposal
All Firms (N=145)[a]

Panel A: Firm Descriptive Statistics

	N	Sample Median	Size-Matched Industry Median[b]
Sales ($ billions)	145	$11.62	$7.92
Market value of equity ($ billions)	144	$10.72	$8.29

Panel B: Firm Performance Characteristics

	N	Sample Average	Market or Size-Matched Industry Average[c]	Average of Industry –Adjusted or Market-Adjusted Variable[c]
Common stock return—3 years	141	13.40%	17.28%	-3.27%***
Common stock return—5 years	140	12.38%	16.48%	-4.05%***
EPS growth rate—3 years	108	10.27%	14.81%	-3.37%
EPS growth rate—5 years	95	7.05%	9.76%	-2.28%

***, **, * Paired t-test indicates significant difference from zero at the .01, .05, and .10 level, respectively.

a A total of 145 firms received executive compensation proposals during the sample period. The sample is reduced in this table due to missing data items on Standard & Poor's *ExecuComp* database.

b Medians are used in Panel A due to the presence of extremely large firms that skew the average sales and market value of equity.

c The benchmark for common stock returns is a market average calculated as the average of all firms comprising the S&P 500 index on Standard & Poor's *ExecuComp* data base as of 6/30/98. Market adjusted common stock returns are computed as the difference between the sample firm's common stock returns and the market average. The benchmark for EPS growth rates is the average of all firms comprising the sample firm's industry based on the 2-digit S&P industry code per Standard & Poor's *ExecuComp* database as of 6/30/98. Industry adjusted EPS growth rates are computed as the difference between the sample firm's EPS growth rate and the industry average.

Table 6

Average Values of CEO Compensation Components in Year After Executive Compensation Proposal

All Firms (N=145)

	Sample Average	Size-Matched Industry Average	Sample minus Industry Average[a]
Salary	$950,250	$849,279	$100,971***
Bonus	$1,227,980	$1,053,690	$174,290*
All Annual Compensation[b]	$2,266,220	$1,983,970	$282,249**
Options[c]	$2,935,800	$2,115,110	$820,695
All Long-Term Compensation[d]	$3,864,430	$2,942,580	$921,846
Miscellaneous Other Compensation	$219,100	$285,593	-$66,493
Total Compensation[e]	$6,349,740	$5,212,140	$1,137,600*

***, **, * Paired t-test indicates significant difference from zero at the .01, .05, and .10 level, respectively.

a For each sample firm, each compensation component is compared to the average component for the largest half (based on sales) of the companies in the sample firm's industry (based on the 2-digit S&P industry code).

b All Annual Compensation is defined as the sum of Salary, Bonus, and Other Annual Compensation.

c Options are the Black-Scholes value of stock options granted.

d All Long-Term Compensation is defined as the sum of options valued using the Black-Scholes model according to S&P *ExecuComp*, long-term incentive payouts, and the value of restricted shares granted.

e Total compensation is the sum of All Annual Compensation, All Long-Term Compensation, and Miscellaneous Other Compensation.

Table 7
Average Dollar Change in CEO Compensation Components
from Year of to Year after Executive Compensation Proposal
(Percentage Change in Averages in Parentheses below Dollar Change)
All Firms (N=145)

	Change in Sample Average	Change in Size-Matched Industry Average	Change in Difference between Sample Average and Industry Average[a]
Salary	$43,970 (4.85%)	$26,665 (3.24%)	$17,305
Bonus	$234,929 (23.66%)	$162,355 (18.21%)	$72,574
All Annual Compensation[b]	$263,034 (13.13%)	$198,957 (11.15%)	$64,077
Options[c]	$-95,394 (-3.15%)	$491,133 (30.24%)	$-586,527
All Long-Term Compensation[d]	$-171,997 (-4.26%)	$603,653 (25.81%)	$-775,650
Miscellaneous Other Compensation	$34,272 (18.54%)	$146,829 (105.81%)	$-112,557
Total Compensation[e]	$125,309 (2.01%)	$949,439 (22.27%)	$-824,130

***, **, * Paired t-test indicates significant difference from zero at the .01, .05, and .10 level, respectively.

a For each sample firm, each compensation component is compared to the average component for the largest half (based on sales) of the companies in the sample firm's industry (based on the 2-digit S&P industry code).

b All Annual Compensation is defined as the sum of Salary, Bonus, and Other Annual Compensation.

c Options are the Black-Scholes value of stock options granted.

d All Long-Term Compensation is defined as the sum of options valued using the Black-Scholes model according to S&P *ExecuComp*, long-term incentive payouts, and the value of restricted shares granted.

e Total compensation is the sum of All Annual Compensation, All Long-Term Compensation, and Miscellaneous Other Compensation.

Table 8
Regression Coefficients for Changes in Industry and Size Adjusted Compensation Components
(All firms with only 1 proposal in a year, N = 109, t-values in parentheses)

Dependent Variable	Intercept	FOR	RESTRICT	GOV	INDIVIDUAL	Adjusted R^2 (F-Value)
CHGSAL	31.67	-15.73	4.91	-24.62	-10.40	-0.0264
	(0.82)	(-0.08)	(0.20)	(-0.79)	(-0.28)	(0.31)
CHGBON	315.93	-1112.26	-293.29	86.38	-133.60	0.0264
	(1.36)	(-0.95)	(-1.98*)	(0.46)	(-0.60)	(1.73)
CHGANN	513.11	-2575.94	-305.71	26.67	-91.13	0.0416
	(1.87*)	(-1.86*)	(-1.74*)	(0.12)	(-0.34)	(2.17*)
CHGOPT	-1507.23	-14351.00	1955.26	3463.95	9205.86	0.0241
	(-0.26)	(-0.49)	(0.52)	(0.73)	(1.63)	(1.67)
CHGLTC	211.56	-10557.00	1552.18	1218.52	11424.00	0.0255
	(0.04)	(-0.35)	(0.41)	(0.25)	(2.00**)	(1.71)
CHGTOT	551.88	-13384.00	1384.11	1396.40	11674.00	0.0296
	(0.09)	(-0.45)	(0.37)	(0.29)	(2.06**)	(1.82)

**, * denotes significance at the .05, .10 levels, respectively.

Variable definitions:

FOR = Percentage of shareholder vote cast in favor of the compensation proposal.

RESTRICT = 1 if the proposal is classified as "restrictive", 0 if "disclosure". A "restrictive" proposal is one that seeks shareholder approval, to cap pay, to link pay to performance, to reduce pay levels, or to restrict executive pay. A "disclosure" proposal seeks a reporting of pay or a disclosure of pay levels.

GOV = 1 if the proposal is classified as a "corporate governance" proposal, 0 if a "social justice" proposal.

INDIVIDUAL = 1 if the proposal is sponsored by an individual, 0 if sponsored by a union, church, or institutional investor.

CEO prefix refers to the compensation component for the sample firm's CEO.

IND prefix refers to the average compensation component for the largest half (based on sales) of a sample firm's industry (based on the 2-digit S&P industry code).

Year t (t+1) refers to the year of (after) the executive compensation proposal.

AnnComp = Salary + Bonus + Other Annual Compensation

Options = Black-Scholes value of stock options granted

LTComp = Options + Long-term incentive payouts + Restricted stock grants

TotComp = AnnComp + LTComp + All Other Miscellaneous Compensation

CHGSAL = [(CEO $Salary_{t+1}$ – IND $Salary_{t+1}$) - (CEO $Salary_t$ – IND $Salary_t$)]
CHGBON = [(CEO $Bonus_{t+1}$ – IND $Bonus_{t+1}$) - (CEO $Bonus_t$ – IND $Bonus_t$)]
CHGANN = [(CEO $AnnComp_{t+1}$ – IND $AnnComp_{t+1}$) - (CEO $AnnComp_t$ – IND $AnnComp_t$)]
CHGOPT = [(CEO $Options_{t+1}$ – IND $Options_{t+1}$) - (CEO $Options_t$ – IND $Options_t$)]
CHGLTC = [(CEO $LTComp_{t+1}$ – IND $LTComp_{t+1}$) - (CEO $LTComp_t$ – IND $LTComp_t$)]
CHGTOT = [(CEO $TotComp_{t+1}$ – IND $TotComp_{t+1}$) - (CEO $TotComp_t$ – IND $TotComp_t$)]